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CONVERGENCE REPORT 2022

Accompanying the document

**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

**CONVERGENCE REPORT 2022 (prepared in accordance with Article 140(1) of the
Treaty on the Functioning of the European Union)**

{ COM(2022) 280 final }

ABBREVIATIONS

Member States

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

Currencies

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

Central Banks

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

Other abbreviations

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

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

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Convergence Report 2022

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

Report

Convergence Report 2022

Technical annex

1. INTRODUCTION

1.1. ROLE OF THE REPORT

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

Member States for which the Council has not yet decided that they fulfil the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Article 140 of the Treaty lays down provisions and procedures for examining the convergence situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports for such Member States. Denmark negotiated an opt-out arrangement before the adoption of the Maastricht Treaty ⁽¹⁾ and does not participate in the third stage of EMU. Until Denmark indicates that it wishes to participate in the third stage and adopt the euro, it is not the subject of an assessment as to whether it fulfils the necessary conditions for such a participation.

In 2020, the Commission and the ECB adopted their latest regular Convergence Reports ⁽²⁾. None of the Member States assessed in those reports was deemed to meet the necessary conditions for adopting the euro.

In 2022, two years have elapsed since the last regular reports were prepared. Denmark has not expressed a wish to enter the third stage of EMU ⁽³⁾. Therefore, this convergence assessment covers Bulgaria, Czechia, Croatia, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2022 and includes a detailed assessment of the progress with convergence, as required by Article 140(1) of the Treaty.

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

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

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

⁽¹⁾ Protocol (No 16) on certain provisions relating to Denmark.

⁽²⁾ European Commission, Convergence Report 2020, COM(2020) 237 final, 10 June 2020; European Central Bank, Convergence Report 2020, June 2020.

⁽³⁾ The United Kingdom has withdrawn from the EU since the May 2018 Convergence Report.

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

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

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

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

policy measures taken to stabilise financial markets and preserve favourable financing conditions and, later, by higher inflation expectations and the differentiated paths of monetary tightening across Member States.

The 2020 economic recession and the fiscal response to the COVID-19 pandemic led to a sharp increase in government deficits and debt. Government deficits in most Member States rose to above the 3% of GDP reference value of the Treaty. In 2021, government deficits and debt improved and fifteen Member States had deficits higher than 3% of GDP. In March 2020, the European Commission, with the agreement of the EU Ministers of Finance of the Member States, activated the general escape clause of the Stability and Growth Pact. On 23 May 2022, in its Communication on the 2022 European Semester spring package, the Commission considered that the Union was not yet out of a period of severe economic downturn and that the conditions to maintain the general escape clause in 2023 and to deactivate it as of 2024 were met. The Commission invited the Council to endorse this conclusion to provide clarity to Member States. In spring 2020, 2021 and 2022, the Commission considered that a decision on whether to place Member States under the Excessive Deficit Procedure should not be taken, taking into account the extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic that, together with the geopolitical situation in spring 2022, create exceptional uncertainty, including for designing a detailed path for fiscal policy⁽⁴⁾. These conclusions have straightforward implications for the assessment of the criterion on the government budgetary position presented in this report.

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

⁽⁴⁾ On 3 April 2020, the Council decided that an excessive deficit existed in Romania based on the planned excessive deficit in 2019.

Box 1.1: Article 140 of the Treaty

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

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability,
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6),
- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,
- the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

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

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

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

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

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

economic developments is fully captured in the economic projections for 2022 and 2023, namely the Commission services' Spring 2022 Forecast, which are used to assess the sustainability of convergence.

The forward-looking elements of this report are based on inputs from the Commission Spring 2022 Forecast, which was published on 16 May 2022. This forecast is the first comprehensive assessment from the Commission of the likely economic effects in 2022 and 2023 of the crisis triggered by

Russia's invasion of Ukraine, and as such, it is surrounded by higher than usual uncertainty ⁽⁵⁾.

The remainder of the first chapter presents the methodology used for the application of the

⁽⁵⁾ Beyond the forecast horizon, the crisis could also have a significant effect on the economic structures of the Member States with a derogation, for instance the flow of refugees could affect their demography and labour force in the medium term, although at this stage this is subject to considerable uncertainty. Assessing this impact is beyond the scope of this report.

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

1.2. APPLICATION OF THE CRITERIA

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

1.2.1. Compatibility of legislation

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

- First, the independence of the national central bank and of the members of its decision-making bodies, as laid down in Article 130, must be assessed. This assessment covers all issues linked to a national central bank's institutional, financial independence and to the personal independence of the members of its decision-making bodies.
- Second, in accordance with Articles 123 and 124 of the Treaty, the compliance of the national legislation is verified against the prohibition of monetary financing and privileged access. The prohibition of monetary financing is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the central banks of Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies

governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or central banks of debt instruments. As regards the prohibition on privileged access as set out in Article 124, the central banks, as public authorities, may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations.

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

1.2.2. Price stability

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

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

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on

Box 1.2: Assessment of price stability and the reference value

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

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

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

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

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

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

(Continued on the next page)

Box (continued)

Table 1:

Inflation reference value in previous and current Convergence Reports

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

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

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

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

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

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

Sources: Eurostat and European Commission calculations.

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

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

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

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Box (continued)

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

23 October 1995 a framework regulation ⁽⁶⁾ setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which are used for assessing the fulfilment of the price stability criterion.

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

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

The Protocol on the convergence criteria not only requires Member States to have achieved a high

degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This deserves particular attention as sustained divergences in price developments in one or more euro area Member States can lead to the emergence of competitiveness losses that must be corrected via painful adjustment processes and can trigger negative spillover effects on other Member States.

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

From a forward-looking perspective, the report includes an assessment of medium-term prospects for price developments. The analysis of factors that have an impact on the inflation outlook – cyclical conditions, labour market developments and credit growth – is complemented by a reference to the

⁽⁶⁾ Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4), amended by Regulations (EC) No 1882/2003 and No 596/2009 of the European Parliament and of the Council, and repealed by Regulation (EU) 2016/792 of the European Parliament and of the Council.

most recent Commission services' forecast of inflation. That forecast can subsequently be used to assess whether the Member State is likely to meet the reference value also in the months ahead ⁽⁷⁾. Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

1.2.3. Public finances

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

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact (see Box 1.3 for further information on the excessive deficit procedure as strengthened by the 2011 reform of the Stability and Growth Pact). The details of the excessive deficit procedure are defined in Regulation 1467/97 as amended in 2005 and 2011 which sets out the way in which government deficit and debt levels are assessed to determine whether an excessive deficit exists, under Article 126 of TFEU. The convergence assessment in the budgetary area is therefore judged by whether the Member State is subject to a Council decision under 126(6) on the existence of an excessive deficit ⁽⁸⁾.

On 23 May 2022, the Commission adopted a report under Article 126(3) of the TFEU for 18 Member States, including for Bulgaria, Czechia, Hungary and Poland ⁽⁹⁾. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled by Bulgaria, Czechia, Hungary and Poland. Taking into account all relevant factors, the analysis also suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled by Hungary. The Commission considered, within its assessment of all relevant factors, that compliance with the debt reduction benchmark could imply a too demanding frontloaded fiscal effort that risks to jeopardise growth. Therefore, in the view of the Commission, compliance with the debt reduction benchmark is not warranted under the current exceptional economic conditions. In its conclusions, the Commission noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with the invasion of Ukraine by Russia, creates exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the EDP should not be taken in spring 2022.

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

⁽⁷⁾ Based on the Commission services' Spring 2022 Forecast, the inflation reference value is forecast to stand at 6.3% in December 2022.

⁽⁸⁾ The definitions of the government deficit and debt used in this report are in accordance with the excessive deficit procedure, as was the case in previous convergence reports. These definitions are laid out in the amended Council Regulation (EC) No 479/2009. In particular, government debt is general government consolidated gross debt at nominal value. Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/economic_governance/sdp/deficit/index_en.htm.

⁽⁹⁾ Croatia was not discussed in this report. While its government debt at end 2021 was also above 60% of GDP, the general government deficit in 2021 and 2022 was (and is projected to remain) below 3% of GDP and it respected the debt reduction benchmark in 2021.

Box 1.3: Excessive deficit procedure

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

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

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

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

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

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

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

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

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

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

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

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

(Continued on the next page)

Box (continued)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Member States with high debt were recommended to use the Recovery and Resilience Facility (RRF) to finance additional investment in support of the recovery, while pursuing a prudent fiscal policy and preserving nationally financed investment. Italy and Portugal were also recommended to limit the growth of nationally-financed current expenditure (net of discretionary revenue measures).
- Member States with low/medium debt were recommended to pursue/maintain a supportive fiscal stance and preserve nationally financed investment. Lithuania, Latvia, Bulgaria and Croatia were also recommended to keep the growth of nationally financed current expenditure under control.

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

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

⁽¹⁾ Non-consolidated for intergovernmental loans.

(Continued on the next page)

Box (continued)

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

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

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

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

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

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

1.2.4. Exchange rate stability

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

Article 3 of the Protocol on the convergence criteria stipulates: “The criterion on participation in the exchange rate mechanism of the European Monetary System [...] shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of

the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period” ⁽¹⁰⁾. Based on the Council Resolution

⁽¹⁰⁾ In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM II by the Informal ECOFIN Council, Athens, 5 April 2003.

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

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

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

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

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

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

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

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

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

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

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Box (continued)

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

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

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

⁽⁵⁾ For the details on the decision of the ERM II parties on Croatia and Bulgaria see:

https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1321

⁽⁶⁾ For more details on the prior-commitments taken by Bulgarian authorities see:

<https://www.consilium.europa.eu/media/36125/st11119-en18.pdf>

⁽⁷⁾ For the details on the decision of the ERM II parties on Croatia and Bulgaria see:

https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1321

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

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

on the establishment of the ERM II ⁽¹¹⁾, the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

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

The assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. Currently two of the Member States assessed in this Convergence Report, namely Bulgaria and Croatia,

participate in ERM II (see Box 1.5 for further information on ERM II participation). The relevant period for assessing exchange rate stability in this Technical Annex is 19 May 2020 to 18 May 2022.

1.2.5. Long-term interest rates

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

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

Box 1.6: Data for the interest rate convergence

The fourth indent of Article 140(1) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of the Protocol on the convergence criteria adds that these “Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

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

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

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

Data used in this Report can be found on Eurostat (“Maastricht criterion bond yields (mcby): EMU convergence criterion bond yields”, code: tec00097). The same series is also published by the ECB’s Statistical Data Warehouse (code IRS.M.Country Code.L.L40.CI.0000.Currency Code.N.Z) and in a dedicated page in the ECB website with additional information:

http://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index_en.html.

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

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

1.2.6. Additional factors

Article 140(1) TFEU also requires that the reports take into account other factors relevant to economic integration and convergence. These additional factors include financial, product and

labour market integration and the development of the balance of payments. The analysis of the development of unit labour costs and other price indices, which is also prescribed by Article 140 of the Treaty, is covered in the price stability section.

The assessment of additional factors gives an important indication of a Member State’s ability to integrate into the euro area without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance ⁽¹²⁾. Market integration is assessed through

⁽¹²⁾ The external balance is defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account. It is the concept closest to the current account as defined when the Maastricht Treaty was drafted.

Box 1.7: The Macroeconomic Imbalance Procedure (MIP)

Key elements of the MIP

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

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

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

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

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

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

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

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Box (continued)

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

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

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

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

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

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

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The legal basis for the Bulgarska Narodna Banka (BNB – central bank of Bulgaria), the Law on the Bulgarian National Bank (the BNB Law) of 1997, has been amended since the 2020 Convergence Report. Bulgarian authorities have amended the BNB Law to remedy certain incompatibilities and imperfections highlighted in the Commission's 2020 Convergence Report⁽¹³⁾. In particular, it concerns issues flagged in previous convergence reports in the section on central bank independence and prohibition of monetary financing and privileged access. Other issues remain unresolved. Therefore, certain comments provided in the 2020 report are repeated also in this year's assessment.

2.1.2. Central Bank independence

The Conflict of Interest Prevention and Ascertainment Act of 2008, which regarding the possibility to dismiss the Governor of the BNB had to be brought in line with Article 14.2 of the ESCB/ECB Statute, was fully repealed and replaced by the Act on Corruption Counteraction and Eviction of Illegally Acquired Property of 2018⁽¹⁴⁾. Article 80(1) of the Act on Corruption Counteraction and Eviction of Illegally Acquired Property was supplemented and now explicitly provides that the ascertainment of a conflict of interest by an enforceable instrument shall be a ground for release from office, unless otherwise provided for in the Constitution or the Statute of the European System of Central Banks and of the European Central Bank. This provision is compatible with Article 14.2 of the ESCB/ECB Statute.

Pursuant to Article 12(1) of the BNB Law, the Governor shall be elected by the National Assembly. The National Assembly has taken the view that it has the power to annul or amend its decisions, including decisions under Article 12(1) of the BNB Law. The National Assembly has substantiated this assertion by stating that pursuant to a Constitutional Court decision of 26 February 1993, the Bulgarian Constitution does not explicitly prohibit the National Assembly from

amending or annulling its decisions. Such understanding would allow the dismissal of the Governor under conditions other than those mentioned in Article 14.2 of the ESCB/ECB Statute. It should be ensured that the Governor, when properly elected or appointed, may not be dismissed under conditions other than those mentioned in Article 14.2 of the ESCB/ECB Statute.

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

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

Article 3 of the BNB Law providing that “in the formulation of the general outlines of the monetary policy, the BNB and the Council of Ministers shall inform each other” has been repealed. Thus, the

⁽¹³⁾ SG No. 12/2021 12.02.2021

⁽¹⁴⁾ SG No. 7/19.01.2018.

incompatibility in the area of independence, with Article 130 of the TFEU and Article 7 of the ESCB/ECB has been solved.

2.1.3. Prohibition of monetary financing and privileged access

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

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

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

2.1.4. Integration in the ESCB

Objectives

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

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

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

- absence of a general reference to the BNB as an integral part of the ESCB (Article 1(1) of the BNB Law) and to its subordination to the ECB’s legal acts (Articles 16 (1) and (2) and 60 of the BNB Law);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(1) and (3), 16(4) and (5), 28, 29, 30, 31, 32, 33, 35, 38, 41 and 61 of the BNB Law);
- conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 20(1), 28, 29, 30, 31, 32 of the BNB Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16(9), 24 to 27 of the BNB Law);
- non-recognition of the role of the ECB in the field of international cooperation (Articles 5, 16(12) and 37(4) of the BNB Law);
- ECB’s right to impose sanctions (Article 61, 62 of the BNB Law).

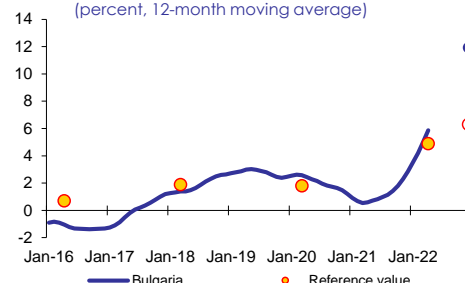
There are also numerous imperfections regarding:

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

- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 4(1) and 42 of the BNB Law);
- non-recognition of the role of the ECB and of the Council in the appointment of the external auditor (Article 49(4) of the BNB Law);
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 16(11), 46 and 49 of the BNB Law).

above the reference value. The 12-month average inflation rate is projected to remain above the reference value in the months ahead.

Graph 2.1: Bulgaria - Inflation criterion
(percent, 12-month moving average)



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

Tasks

2.1.5. Assessment of compatibility

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

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

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

1.5 percentage points. The corresponding inflation rate in Bulgaria was 5.9%, i.e. 1 percentage point

2.2.2. Recent inflation developments

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

Core inflation (measured as HICP inflation excluding energy and unprocessed food) was on a declining path since April 2020, arriving at 0.6% in August 2021. It then accelerated sharply as of

Table 2.1:

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

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

Source: Eurostat, European Commission calculations.

Table 2.2:

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

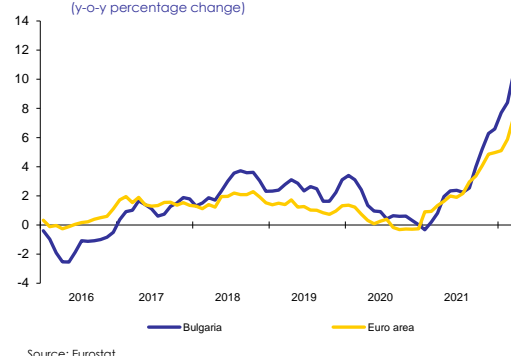
1) Commission Spring 2022 Economic Forecast.

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

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

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

Graph 2.2: Bulgaria - HICP inflation
(y-o-y percentage change)



2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Due to the adverse impact of the pandemic, real GDP contracted by 4.4% in 2020, and then recovered by 4.2% in 2021. Across demand components, economic activity in 2020 contracted mostly due to lower external demand and reduced private investment and consumption. Exports of goods rebounded quickly already in Q3-2020, while exports of services remained subdued also in 2021. Aggregate investment remained largely unchanged in 2020, despite the impulse from public investment, and then registered a sizable decline of 11% in 2021. The contraction in capital

formation in 2021 was driven by high uncertainty, combined with reduced business activity in the sectors most affected by the pandemic. In Q2-2020, private consumption contracted sharply by 3.2% quarter-on-quarter with the introduction of social distancing measures in March 2020, and then swiftly regained ground in Q3-2020. The social distancing measures subsequently introduced in late 2020 and in 2021 were less strict and more selective. Combined with the businesses adjusting to operate in the new environment (e.g. introducing home delivery), this largely avoided repeated demand slumps. In 2021, private consumption expanded strongly by 8%, underpinned by positive wage dynamics, limited job losses, due to the swift introduction of job retention schemes, supported by the SURE instrument and REACT-EU, and relatively optimistic expectations about economic activity.

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

In 2021, the fiscal stance ⁽¹⁵⁾ remained supportive at the same level as in 2020 (-0.6% of GDP), based on the Commission's Spring 2022 Economic Forecast. The fiscal stance is expected to become

even more supportive in 2022 (-3.4% of GDP) due to the expenditures financed through the Recovery and Resilience Fund and other EU grants and temporary support to mitigate the impact of high energy prices on vulnerable households and firms (around 0.3% of GDP ⁽¹⁶⁾). The budgetary costs related to people fleeing the war in Ukraine is assumed at 0.11% of GDP. The no policy-change forecast for 2023 shows a further supportive stance (-1.3% of GDP) thanks to the increasing expenditure financed by Recovery and Resilience Fund and other EU grants, despite the assumed phasing out of energy crisis measures.

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

⁽¹⁵⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

⁽¹⁶⁾ In incremental terms. The level amount is around 0.9% of GDP in 2022.

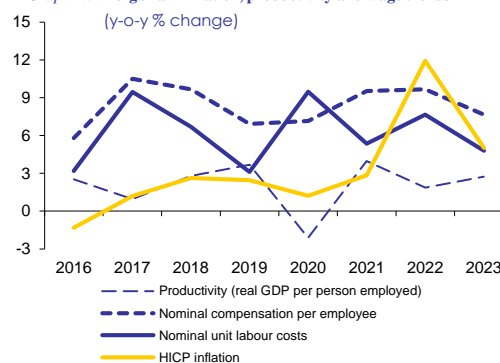
Wages and labour costs

At the onset of the COVID-19 pandemic employment quickly adjusted downwards in the sectors most affected by the domestic and external demand slump — manufacturing, trade, transport, hotels and restaurants and other services. Nevertheless, the number of persons employed fell by less compared to the economic activity in these sectors. On aggregate, gross value added declined by 6.6% quarter-on-quarter in Q2-2020, while the number of persons employed fell by 2.2% in the same period. Further job losses in the subsequent periods were prevented by the quick rebound in manufacturing production, the relaxation of containment measures and swift introduction of subsidised short-time work schemes. The recovery in employment levels continued in 2021 across all sectors. On average for 2020, the number of employed dropped by 2.3% and then grew by 0.2% in 2021. Nominal compensation per employee in the most affected sectors contracted sizably in Q2-2020, reflecting to a large extent the reduction in hours worked⁽¹⁷⁾. In the following periods aggregate wage growth resumed its upward trend, in line with the stabilisation and partial recovery of the labour market situation. On aggregate, compensation per employee grew by 7.2% in 2020 and 9.5% in 2021, broadly in line with the pre-crisis trend.

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

returned to trend growth rates, typical for the pre-crisis period. On average, ULC increased by 9.5% in 2020 and then by 5.4% in 2021. According to the Commission's Spring 2022 Economic Forecast, ULC is expected to increase by 7.7% in 2022 and 4.8% in 2023.

Graph 2.3: Bulgaria - Inflation, productivity and wage trends
(y-o-y % change)



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

External factors

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

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

Administered prices and taxes

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

⁽¹⁷⁾ While the job retention schemes were introduced fairly swiftly at the onset of the spring 2020 lockdown, they were arguably less generous than in other EU countries. With time the scope and coverage has widened. This evolution can largely explain the less distorted figures for Bulgaria at the beginning of the crisis.

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

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

Medium-term prospects

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

In parallel to the introduction of the moratorium on prices of utilities between 15 December 2021 and 31 March 2022, the government introduced support programmes for firms, public utilities suppliers and household gas consumers that have

so far mitigated the impact of sharp increases in energy prices. The discontinuation of natural gas supplies by Gazprom in late April is expected to be compensated through alternative sources, leading to a one-off increase in gas prices.

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

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

2.3. PUBLIC FINANCES

2.3.1. Recent fiscal developments

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

Table 2.3:

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

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022¹⁾	2023¹⁾
General government balance	0.3	1.6	1.7	2.1	-4.0	-4.1	-3.7	-2.4
#NAME?	35.1	37.1	38.7	38.4	38.1	39.0	40.2	40.7
- Total expenditure	34.8	35.4	37.0	36.3	42.0	43.1	43.9	43.1
of which:								
- Interest expenditure	0.9	0.8	0.7	0.6	0.5	0.5	0.5	0.5
p.m.: Tax burden	29.2	29.8	29.7	30.3	30.6	32.4	32.6	33.1
Primary balance	1.2	2.4	2.4	2.7	-3.5	-3.6	-3.1	-1.9
Fiscal stance ²⁾					-0.6	-0.6	-3.4	-1.3
Government gross debt	29.1	25.1	22.1	20.0	24.7	25.1	25.3	25.6
p.m: Real GDP growth (%)	3.0	2.8	2.7	4.0	-4.4	4.2	2.1	3.1

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

higher taxes on production and imports, income and wealth taxes, and the upswing in sales. Overall, total public revenue as a percentage of GDP increased by 0.9 of a percentage point from 2020 to 2021, slightly lowered by the recovery of GDP. Emergency measures remained largely in place, leading to a further 1.1 percentage point in the expenditure-to-GDP ratio.

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

2.3.2. Medium-term prospects

The elections held at the end of 2021, and the subsequent protracted government formation, delayed the usual adoption of the 2022 budget, which the National Assembly adopted on 25 February 2022. The budget includes, among others, the gradual increase in the excise duty on tobacco and toll taxes, increases in the minimum wage, and changes in pension policy parameters.

While initially Bulgaria's budget balance was expected to largely improve due to the gradual phasing-out of pandemic-related measures from 4.3% in 2021 to 1.8% of GDP in 2022, the worsened economic outlook due to Russia's invasion of Ukraine and rising energy costs impede the deficit recovery. Key emergency support measures that remain in place to fight the pandemic include the provision of vaccines and medical products, pension top-ups, and business support schemes. As a consequence of Russia's invasion of Ukraine, the Bulgarian government has introduced new measures like the evacuations of Bulgarian nationals residing in Ukraine and the provision of humanitarian aid (e.g. providing accommodation and daily allowances for up to three months upon arrival) to Ukrainian refugees arriving in Bulgaria. According to Commission estimations, the related total costs of the flow of refugees, due to the Russian military aggression in Ukraine, amount to 0.11% and 0.16% of GDP in 2022 and 2023.

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

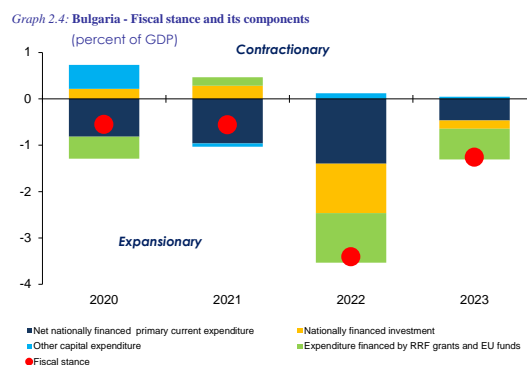
The Commission's Spring 2022 Economic Forecast, which is based on a no-policy change assumption, forecasts a general government deficit of around 3.7% of GDP in 2022. The projected government deficit is lower than the planned

deficit in the Convergence Programme due to different underlying macroeconomic assumptions, including the inflow of people fleeing the war in Ukraine and the associated costs, higher growth in revenues from taxes on production and imports as well as a smaller increase in intermediate consumption. The Commission projects the general government deficit to further decrease to around 2.4% of GDP in 2023, as the costs of both COVID-19 and energy price measures are set to phase out.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to continue to be supportive, at -3.4% of GDP⁽¹⁸⁾. The positive contribution to economic activity of expenditure financed by the Recovery and Resilience Facility grants and other EU funds is projected to increase by 1.1 percentage points of GDP in 2022, compared to 2021. Nationally financed investment is projected to provide as well an expansionary contribution to the fiscal stance in 2022 by 1.1 percentage points of GDP. At the same time, the growth in nationally financed primary current expenditure (net of discretionary revenue measures) in 2022 is projected to provide an expansionary contribution of -1.4 percentage points to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, some of this expansion is due to measures related to the energy crisis (-0.2 of a percentage point) and the assistance to those fleeing Ukraine (-0.1 of a percentage point). In 2023, the fiscal stance is projected at -1.3% of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.7 of a percentage point of GDP, compared to 2022. Nationally financed investment is projected to be expansionary too by 0.2 percentage points of GDP⁽¹⁹⁾. The growth in nationally financed primary current expenditure is projected to provide an expansionary contribution of -0.5 of a percentage point to the overall fiscal stance in 2023. This includes the impact from the phasing out of the measures addressing the increased energy prices (0.82% of GDP).

⁽¹⁸⁾ For a definition of the fiscal stance used in this report, see footnote in Section 2.2.3 on underlying factors and sustainability of inflation.

⁽¹⁹⁾ Other nationally financed capital expenditure is projected to provide a neutral contribution.



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

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

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

Several factors mitigate risks, including the lengthening of debt maturity in recent years historically low borrowing costs and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include Bulgaria's negative net international investment position, the substantial share of public debt in foreign currency and contingent liability risks stemming from the poor financial performance of some state-owned enterprises⁽²⁰⁾.

⁽²⁰⁾ For further details see the 2021 Fiscal Sustainability Report.

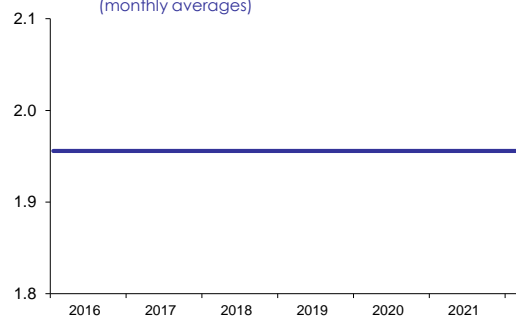
Bulgaria has developed a strong institutional setting. According to the Commission's Fiscal Governance Database, with nine national fiscal rules in place at the general and subnational level, Bulgaria has the highest number of fiscal constraints in the EU, while also showing an improving track-record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

2.4. EXCHANGE RATE STABILITY

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

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

Graph 2.5: Bulgaria - BGN/EUR exchange rate
(monthly averages)



Source: ECB.

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

The BNB does not set monetary policy interest rates. The monetary policy of the euro area affects the domestic interest rate environment directly through the operation of Bulgaria's CBA. The BNB discontinued the production of short-term reference rates (e.g. SOFIBOR) as of 1 July 2018. Instead, the central bank publishes a base interest rate (BIR) based on the index LEONIA Plus (LEv OverNight Interest Average Plus), which is a reference rate of concluded and effected overnight deposit transactions in Bulgarian leva on the interbank market in Bulgaria. In June 2020, the BIR stood at -0.7%. Since then it has been very stable until the end of 2021, when the BIR exhibited more volatility. After an increase to -0.45% in December, it fell back to -0.6% in February 2022. As a result, beside the short increase at the beginning of the year, the interest rate differential of the BIR to the 1-month Euribor

rate has remained relatively stable at around -10 basis points -7 basis points in March 2022.

Graph 2.6: Bulgaria - Annual effective interest rate spread to 1-M Euribor
(basis points, monthly values)

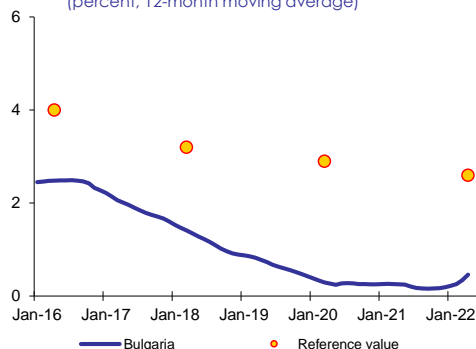


Source: Eurostat and National Bank of Bulgaria.

2.5. LONG-TERM INTEREST RATES

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

Graph 2.7: Bulgaria - Long-term interest rate criterion
(percent, 12-month moving average)

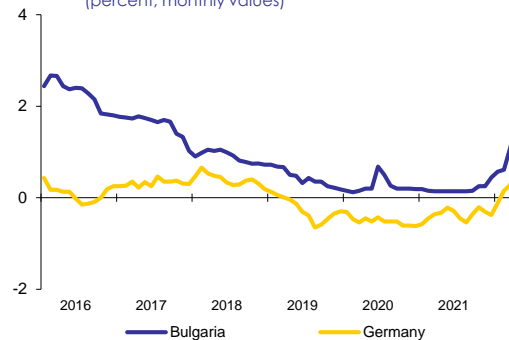


Source: European Commission.

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

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

Graph 2.8: Bulgaria - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

2.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its last Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP — see also Box 1.7), which concluded that it was not necessary to carry out further in-depth analysis in the context of the MIP. In the past, vulnerabilities in the financial sector were coupled with high indebtedness and non-performing loans in the corporate sector. Consistent policy action and a favourable macroeconomic environment have reduced risks and vulnerabilities before the onset

of the COVID-19 crisis. Taking into account the assessment in its 2020 In-Depth Review, the Commission concluded that Bulgaria was experiencing no imbalances. Notwithstanding the progress made, non-performing loans are still relatively high albeit declining in the segment of corporate loans granted by domestically owned banks.

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

Bulgaria submitted its recovery and resilience plan on 15 October 2021. The Commission's positive assessment on 7 April 2022 and the Council's approval on 4 May, paved the way for the implementation of the Recovery and Resilience Plan and the disbursement of EUR 6.3 billion in grants ⁽²¹⁾ over the period 2022-2026, which is equivalent to 10.2% in 2019 GDP.

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

The plan will address key macro-economic challenges such as social inclusion, education and skills, healthcare, decarbonisation and digital transition and business environment. Key investments are included in renewable energy production, electricity storage and interconnection capacities, energy efficiency of buildings and in the digitalisation of public administration and

digital skills. Key reforms include the introduction of a framework for coal phase-out, the liberalisation of the electricity market, a comprehensive educational reform, and a strengthening of the minimum income scheme. A significant number of reforms and investments are expected to reinforce the institutional framework. These include reforms to improve the functioning of the judiciary system and the anti-corruption bodies, to strengthen anti-money laundering and insolvency frameworks, public procurement, whistle-blower protection, regulation of lobbying, e-government and integrity of public servants.

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

The implementation of the investments in the Bulgarian plan, along with other investments under NextGenerationEU, is estimated to raise Bulgaria's GDP by 1.9% to 2.9% by 2026, of which 0.6% due to the positive spillover effects of the coordinated implementation of NextGenerationEU across Member States (Pfeiffer et al. 2021) ⁽²²⁾. This does not take into account the positive impact of structural reforms on growth.

2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital accounts) shrank, but remained positive at 1.5% and 0.3% of GDP in 2020 and 2021, respectively. The reduction was driven by the current account, which turned slightly negative in 2020 and 2021, from a surplus of 1.9% in 2019. Secondary income, which largely consists of remittances from abroad, fell roughly by 50% in 2020 and 2021 possibly due to the worsened economic situation of nationals residing abroad. In addition to the deterioration of the secondary income balance, the deterioration of the external position in 2020 was also caused by an abrupt contraction in exports of services, reflecting the imposed travel restrictions and the weaker external demand for tourist services. The trade balance became less negative than in the preceding years, as nominal imports contracted more than nominal

⁽²¹⁾ The maximum financial contribution for Bulgaria in ANNEX IV of Regulation (EU) 2021/241 is determined at EUR 6.3 billion, but 30% of the total amount available shall be recalculated with actual data by 30 June 2022..

⁽²²⁾ See Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

Table 2.4:

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

1) The combined current and capital account.

2) Including financial derivatives.

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

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

The financial account, net of official reserves, deteriorated in 2020 and then improved in 2021. In March 2020, as part of a package of measures to preserve the stability of the banking system at the onset of the COVID-19 pandemic, the Bulgarian National Bank imposed a limit on commercial banks' foreign exposures. These measures to increase the liquidity in the banking system resulted in a simultaneous net outflow of other investments and an increase in official reserves at the central bank. In 2021, the banking sector

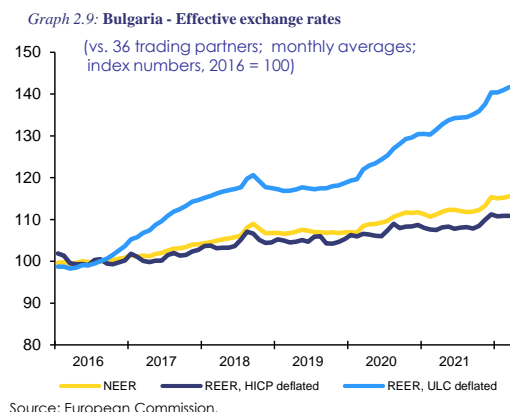
maintained high liquidity and capital adequacy ratios and improved profitability. This positive development led to renewed investment in other assets abroad by the foreign-owned banks, while official reserves kept growing, albeit less strongly. The net inflow of Foreign Direct Investment (FDI) remained positive with positive contributions from debt instruments in 2020 and from reinvested earnings in 2020 and 2021.

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

In 2020-2021, measures of competitiveness exhibited different dynamics depending on the deflator used. The rate of appreciation of the real effective exchange rate (REER) deflated by ULC, accelerated, as labour hoarding pushed up labour costs. ⁽²³⁾ The appreciation in REER deflated by HICP has been more moderate, reflecting moderate price inflation until mid-2021. The swift acceleration of inflation at the end of 2021 has not

⁽²³⁾ The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Bulgaria.

caused real appreciation vis-à-vis the rest of the world, since inflation picked up globally, including in major trade partners.



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

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

2.6.2. Market integration

The economy is well integrated with the euro area through trade and investment linkages. After a period of decline between 2017 and 2020, the ratio of trade openness rebounded to close to 64% in 2021, which is close to the peak of above 68% in 2017. Bulgaria thus remains a relatively open economy. Trade with the euro area was close to 29% of total trade in 2021. Outside the EU,

Bulgaria's main trading partners are Turkey and Russia (especially for energy imports).

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

The business environment is generally not supportive of investment, and institutional quality remains a challenge. According to the World Bank's Worldwide Governance Indicators (2020), Bulgaria ranks low in voice and accountability, government effectiveness, rule of law and control of corruption compared with the average of the five euro area Member States with the lowest scores.⁽²⁴⁾ Bulgaria also ranks relatively low in the World Bank's Ease of Doing Business indicator, where it maintained its rank of 61 between 2019 and 2020, but in a longer perspective the trend has been negative⁽²⁵⁾. In addition, institutions remain among the least performing areas in the Global Competitiveness Index. In the Council Implementing Decision, approving the Recovery and Resilience Plan, the authorities have committed to a number of measures that address challenges identified in the Cooperation and Verification Mechanism (CVM), the Rule of Law Report, and also the recitals to the country-specific recommendations. This includes problems with the functioning of the judiciary, corruption and issues with the accountability and criminal liability of the Prosecutor General. For the latter, important elements are the introduction of necessary safeguards and guarantees for an independent investigation of the Prosecutor General and his deputies; possibility for a judicial review of a prosecutor's decision not to open an investigation, and annual reporting by the Prosecutor General on investigations and convictions in corruption cases. Anti-corruption measures include the set-up of a new anti-

⁽²⁴⁾ A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

⁽²⁵⁾ The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

Table 2.5:

Bulgaria - Market integration

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

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Imports} + \text{Exports of goods with EA-19} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

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

5) International Institute for Management Development (IMD).

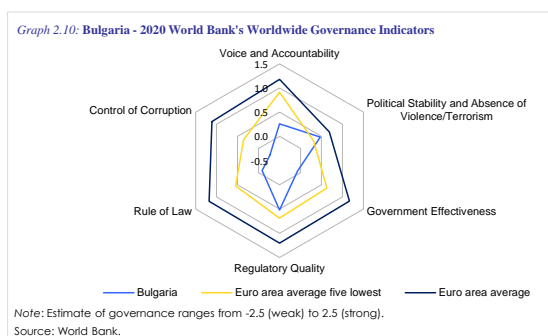
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.

(November data, as of 2016 date refers to the year of publication).

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

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

corruption body with criminal investigation powers, introduction of legislative measures to protect whistle-blowers and to regulate lobbying activities, and the establishment of an integrity verification mechanism for civil servants occupying positions that have a high corruption risk.



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

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

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

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

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

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

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

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

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

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

size is comparable to those of the five euro-area Member States with the smallest financial sectors.

Table 2.7:

Bulgaria - Financing of the economy¹⁾

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

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

Source: Eurostat.

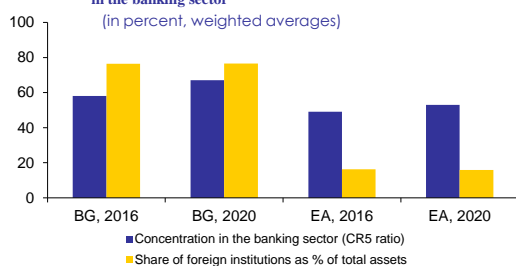
As to the financing of the economy, Bulgaria has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (debt securities and listed shares) is relatively under developed. However, Bulgaria is still fully comparable to the five euro-area Member States with the smallest national capital markets. Loans are the dominant source of funding and make up 116% of GDP in 2020, compared to 240% of GDP in the euro area. Still, corporate debt surpasses the fundamental threshold, although the gap has been narrowing and the prudential benchmark is satisfied.⁽²⁶⁾ Equity and private-sector-debt markets are very small compared to those of the euro area and represent only 14% of GDP altogether. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is significantly lower than in the euro area. In terms of share in the sum of liabilities, loans in Bulgaria are comparable to that of the euro area. For securities, the differences reflect the smaller share of market funding available in Bulgaria.

Bulgaria's banking sector is well integrated into the euro-area financial sector, in particular through a high level of foreign ownership in the banking system. The share of foreign-owned institutions in total bank assets stood at 77% in 2020. Bank concentration, as measured by the market share of the five largest credit institutions in total assets,

⁽²⁶⁾ Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne et al. (2017).

has increased significantly since 2016, and reached almost 67% in 2020. This is 14 percentage points above the euro area average in 2020. In parallel with the inclusion of the Bulgarian lev in the ERM II, the Bulgarian National Bank entered into a close cooperation with the ECB, effectively joining the Banking Union. As of 1 October 2020, Bulgaria joined the Single Resolution Mechanism, and the ECB became responsible for the direct supervision of the significant institutions in Bulgaria, as well as the oversight of less significant institutions.

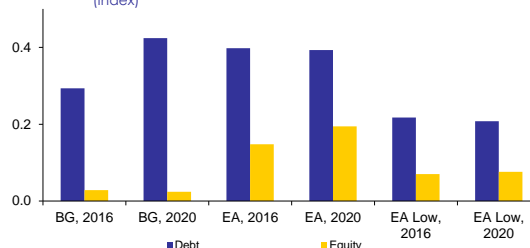
Graph 2.11: Bulgaria - Foreign ownership and concentration in the banking sector
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Although intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, Bulgaria is commensurate to levels of integration of the average euro-area Member State in debt markets.⁽²⁷⁾ Moreover, integration in this market segment has improved markedly between 2016 and 2020. Concerning portfolio investments in equity, however, the home bias is very strong in Bulgaria relative to euro-area Member States. Almost all investments in equity markets take place domestically.

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



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

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

⁽²⁷⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

3. CZECHIA

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

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

Following the Commission's 2020 Convergence Report, the ČNB Law was amended⁽²⁸⁾. However, since there have been no amendments as regards the incompatibilities highlighted in the Commission's 2020 Convergence Report, the comments made in the latter report are repeated also in this year's assessment.

3.1.2. Central Bank independence

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

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

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

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

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

⁽²⁸⁾ The amendments stem from the Act. No. 219/2021 Coll., Act No. 238/2020 Coll., Act No. 353/2021 Coll. and Act No. 417/2021 Coll.

3.1.3. Prohibition of monetary financing and privileged access

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

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

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

3.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and monetary functions, operations and instruments of the ECB/ESCB (Articles 2(2)(a), 5(1) and 23 to 26, 28, 29, 32, 33 of the ČNB Law);
- conduct of exchange rate operations and the definition of exchange rate policy (Articles 35 and 36 of the ČNB Law);
- holding and management of foreign reserves (Articles 35(c), 36 and 47a of the ČNB Law);
- non-recognition of the competences of the ECB and of the Council on the banknotes and coins (Article 2(2)(b), Articles 12 to 22 of the ČNB Law);
- ECB's right to impose sanctions (Article 46a of the ČNB Law);
- the possibility for Parliament to demand amendments to the report of the ČNB on monetary policy developments and to determine the content/scope of the extraordinary report in view of the absence of a specification regarding the non-forward-looking nature of the reports (Article 3 of the ČNB Law).
- There are also some imperfections regarding:
- the partial absence of reference to the role of the ECB and of the EU in the collection of statistics (Article 41);

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

3.1.5. Assessment of compatibility

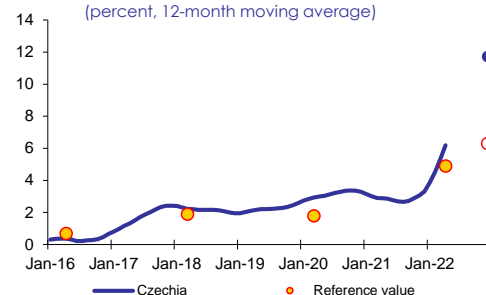
As regards the independence of the central bank, the prohibition of monetary financing and the integration of the central bank in the ESCB at the time of euro adoption, the ČNB Law is not fully compatible with the compliance duty under Article 131 of the TFEU. The Czech authorities are invited to remedy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

3.2. PRICE STABILITY

3.2.1. Respect of the reference value

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

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



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

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

3.2.2. Recent inflation developments

The annual HICP inflation rate experienced considerable volatility in the past two years. After peaking at 3.8% in January 2020, it followed a broad downward path in 2020 to reach a low of 2.1% in February 2021. The deceleration was mainly due to declining energy prices. HICP inflation then increased steadily from 2.2% to 5.4% at the end of 2021, exceeding the central bank's upper tolerance band of 3.0% continuously from August onwards⁽²⁹⁾. It surged further to 13.2% in April 2022. The acceleration of inflation since the beginning of 2021 is explained by a combination of strong domestic demand and external factors related to supply chain bottlenecks and surging energy prices. Since end 2018, annual HICP inflation has been higher in Czechia than in the euro area.

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

⁽²⁹⁾ It is important to note that the ČNB's tolerance band is based on CPI inflation, which was even higher during the same period due to a different basket composition.

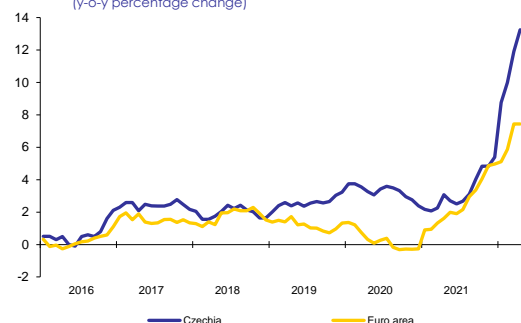
Table 3.1:
Czechia - Components of inflation

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

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

Source: Eurostat, European Commission calculations.

Graph 3.2: Czechia - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

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

remained low during much of 2021 and started rebounding only towards the end of 2021.

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

In order to help combat the negative effects of the COVID pandemic on the economy, the fiscal stance was strongly expansionary in 2020 and in 2021⁽³⁰⁾, through employment retention schemes as well as support targeted at the most affected sectors. The fiscal stance is expected to turn neutral in 2022 (+0.1% of GDP) as the expenditure financed through the RRF and other EU grants contributes positively by around 1.0% of GDP. Still, the phase-out of the pandemic-related measures is to help offset some of the inflationary pressures. Additional measures to cope with the inflow of people fleeing Ukraine as well as the support to households affected by the high inflation are also to provide an expansionary contribution. Government consumption contributed positively to GDP growth with a real growth of 3.4% in 2020 and 1.6% in 2021 but its real growth pace is expected to slow down to 0.6% in 2022, before picking up to 1.3% in 2023. On the other hand, public investments growth rate is likely

⁽³⁰⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding COVID-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy

Table 3.2:

Czechia - Other inflation and cost indicators

(annual percentage change)

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

1) Commission Spring 2022 Economic Forecast.

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

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

The ČNB conducts monetary policy within an inflation targeting framework. The use of the exchange rate as an additional monetary policy instrument was discontinued in April 2017. The decision was supported by macroeconomic data and forecasting scenarios indicating a sustainable fulfilment of the 2% inflation target over the forecast horizon. After a hike in February 2020, the ČNB eased significantly its main policy rate (the 2-week repo rate) cutting it by 200 basis points in three steps in March and May to 0.25%, to counter the impact of the pandemic on the Czech economy. The key policy rate was kept at this low level until June 2021. Due to strongly increasing domestic inflation pressures, the ČNB Board raised its policy rates as from summer 2021. Overall, the main policy rate increased by 550 basis points to reach 5.75% after the ČNB Board's decision at the meeting in early May 2022. From early March 2022, the ČNB has been repeatedly active in the exchange rate market (stabilising intervention) in the aftermath of the Russia's invasion of Ukraine ⁽³¹⁾, although shortly, on the back of self-stabilising mechanisms in the exchange rate market.

⁽³¹⁾ The details are provided in Section 3.4 on exchange rate stability.

Wages and labour costs

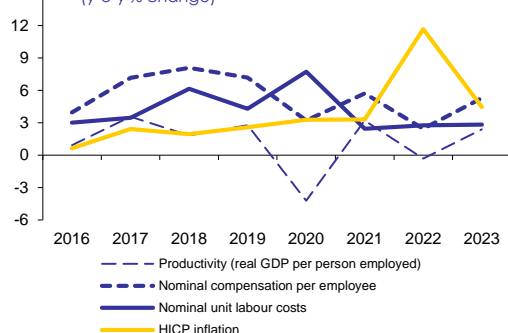
The labour market continued to perform well in 2020 and 2021. Despite its tightness, Czechia's labour market was in a good position to absorb the impact of the crisis. Cushioned by temporary job retention schemes supporting self-employed and companies, the unemployment rate increased only slightly to 2.6% in 2020 (annual average) and to 2.8% in 2021. As a result, nominal wage growth continued to be buoyant in 2020 and 2021 (supported by increases for public sector employees). Although wage growth moderated significantly in 2020 due to the impact of the pandemic and supply chain disruptions, the still high growth rate compared to the historical average is mainly attributable to persisting labour shortages, due to e.g. demographic factors, and to an increase in the minimum wage ⁽³²⁾. Wages in both the public and private sector showed similar growth dynamics in 2020 and 2021.

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

⁽³²⁾ Despite the increase in the minimum wage, the relative value in PPS of the statutory minimum wage in Czechia is the fifth lowest in the EU, after Latvia, Bulgaria, Estonia, and Slovakia.

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

Graph 3.3: Czechia - Inflation, productivity and wage trends
(y-o-y % change)



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

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

External factors

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

prices for machinery and transport equipment as well as increasing energy prices.

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

Administered prices and taxes

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

Medium-term prospects

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

Table 3.3:

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

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

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

inflation. Support measures targeted at the low-income households have also been introduced and the household allowance have been increased.

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

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

3.3. PUBLIC FINANCES

3.3.1. Recent fiscal developments

On the back of an ample fiscal expansion launched to combat the effects of the COVID crisis, Czechia reported a deficit of the general government budget of 5.8% in 2020 and 5.9% in 2021. While government revenues proved more resilient with the revenue-to-GDP ratio dropping only 1 pp from 41.4% in 2019 to 40.5% in 2021, the expenditure-

to-GDP ratio expanded from 41.0% in 2019 to 46.4% in 2021. Temporary COVID-related measures taken by the government accounted for extra expenses of about 2.7% of yearly GDP on average in 2020 and 2021. Among the largest temporary measures are the short-time work schemes, i.e. "Antivirus" programme and the Compensatory bonus for self-employed or the companies support programs "COVID-Uncovered costs" and "COVID-2021". These temporary schemes were instrumental in maintaining employment for businesses affected by the crisis. ⁽³³⁾ They were supplemented by permanent measures like the decrease in the personal income tax (about 1.8% of GDP per year) as well as cuts in VAT for certain services or the elimination of the residential transaction tax.

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

While public debt is still low compared to other EU Member States, the pace of its growth in 2020-2021 was high, with public debt-to-GDP ratio

⁽³³⁾ However, a recently published review of government accounts by the independent Supreme Audit Office found most of the 2021 increase of government expenditures as not related to the COVID-19 pandemic.

increasing from 30.1% in 2019 to 41.9% in 2021, driven by the negative headline balance only partly offset by nominal GDP growth. Liquidity support for households and companies in the form of guarantees did not have a direct budgetary impact, but the guarantees provided in response to the COVID-19 pandemic represent contingent liabilities, estimated by the Commission services at around 1.5% of 2022 GDP as of March 2022.

3.3.2. Medium-term prospects

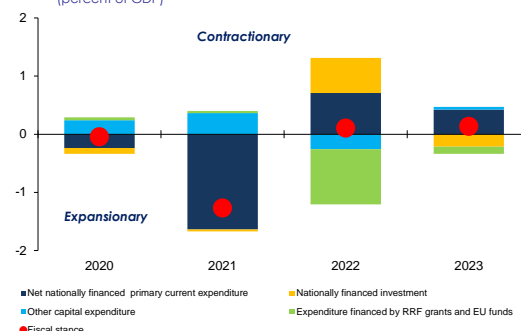
The 2022 budget approved by the Czech parliament in March 2022 envisages a central government deficit of 4.2% of GDP and aims to start a correction of the high deficit registered in the previous years. The budget maintains the tax cuts implemented in 2020 (e.g. the cut in the personal income tax) and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

The 2022 Convergence Programme has been approved by the government on 11 May 2022. The Program aims to provide a consolidation path of the public finances over the medium term. The Program expects the general headline balance at 4.5% in 2022 and at 3.2% in 2023. The consolidation path is mostly based on containment of expenses that are forecast to grow slower than the nominal GDP growth, thus creating savings of 1.4% of GDP in 2022 and another 1.8% of GDP in 2023, compared with the levels from 2021. The government deficit in 2022 is impacted by the

additional measures taken by the government to counter the social and economic impact of the increase in energy prices, as well as the provision of humanitarian assistance to people fleeing Ukraine.

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

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



Source: Commission's Spring 2022 Economic Forecast.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to be broadly neutral, at +0.1% of GDP⁽³⁴⁾. The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected at 2.0 percentage points of GDP in 2022, higher by 1.0 percentage points of GDP compared to 2021. Nationally financed investment is projected to provide a contractionary contribution to the fiscal stance of 0.6 percentage points in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide a contractionary contribution of 0.7 percentage points of GDP to the overall fiscal stance, as current expenditure is set to grow at a slower pace than medium-term potential growth.

In 2023, the fiscal stance is projected at +0.1% of GDP. The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is

⁽³⁴⁾ For a definition of the fiscal stance used in this Report, see footnote in Section 3.2.3 on underlying factors and sustainability of inflation.

projected to increase by 0.1 percentage points of GDP in 2023. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.2 percentage points of GDP⁽³⁵⁾, whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 0.4 percentage points to the overall fiscal stance in 2023.

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

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

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

Some factors mitigate risks, including and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. In addition, Czechia's negative net international investment position is contained, and this position is even positive when excluding non-defaultable instruments. Risk-increasing factors include the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis though this risk appears limited given the relatively low level and low take-up⁽³⁶⁾.

The capacity of the Czech fiscal framework to ensure sustainable public finances is under test. The act establishing the Czech fiscal rules was amended twice in 2020: the April amendment allowed for a larger structural deficit and a longer adjustment path, while the December 2020

amendment corresponded to a “tax package”, which widened further the structural deficit. As the debt outlook has deteriorated, there is a higher risk that the threshold for triggering the debt brake (at 55% of GDP) would be reached over the medium term. Moreover, the increase of the general government deficit over the forecast horizon is mostly due to permanent measures. Against this background and in line with its mandate, the Czech Fiscal Council found the 2020 budget compliant with the national fiscal rules and that the starting position for debt projections had significantly worsened the fiscal sustainability prospects over the long-term. The Committee on Budgetary Forecasts, tasked with assessing the macroeconomic and budgetary forecasts, confirmed the realism of the forecasts in all its 2021 assessments. The local governments continued to have a positive albeit decreasing contribution to the general government balance in 2020. Only six municipalities with debt above 60% of their average revenues over the previous four years had to take remedial action with respect to the debt reduction rule⁽³⁷⁾. Finally, a draft law amending Act No 166/1993 is currently under consideration to broaden the mandate of the Supreme Audit Office.

3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990s, the ČNB has been operating an explicit inflation targeting framework combined with a *de jure* floating exchange rate regime, allowing for foreign exchange market interventions by the central bank⁽³⁸⁾. The ČNB is legally allowed to conduct foreign exchange interventions to influence the koruna exchange rate and moderate excessive exchange rate volatility in exceptional situations (e.g. in 2022).

Following the expiry of the ČNB's exchange rate commitment in April 2017, the koruna followed a gradual appreciation trend against the euro, strengthening from above 27 CZK/EUR in early April 2017 to 25.5 CZK/EUR in May 2018, around which level it oscillated until end of 2019. Following the lock-down measures taken in the

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

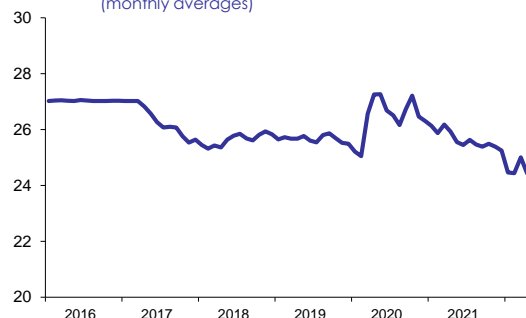
⁽³⁶⁾ For further details see the 2021 Fiscal Sustainability Report.

⁽³⁷⁾ Should the debt of a local authority exceed 60% of its average annual revenues over the last four budget years, the *debt reduction rule* implies that the local authority shall reduce its debt in the following year by at least 5% of the difference between the amount of its debt and 60% of its average revenues over the last four budget years.

⁽³⁸⁾ Since 2010, the inflation target is set at 2% with a tolerance band of +/- 1%.

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

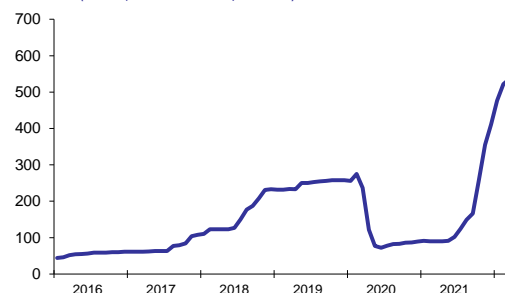
Graph 3.5: Czechia - CZK/EUR exchange rate
(monthly averages)



Source: ECB.

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

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



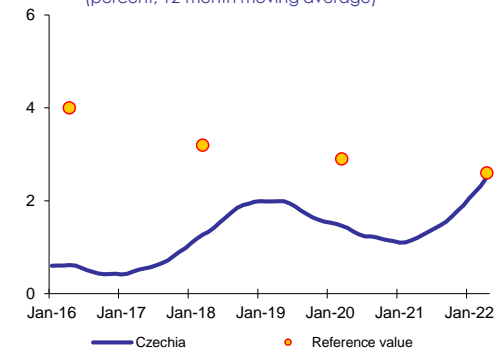
Source: Czech national Bank, Eurostat and Thomson Reuters.

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

3.5. LONG-TERM INTEREST RATES

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

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

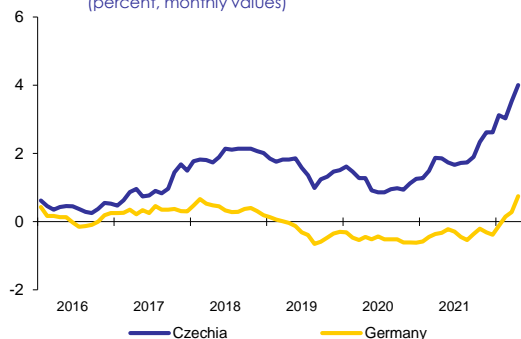


Source: European Commission.

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

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

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



Source: Eurostat.

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

3.6. ADDITIONAL FACTORS

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

In December 2021, the Commission published its tenth Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.7), which highlighted issues relating to competitiveness and pressures in the housing market in Czechia. However, since overall risks remained limited, no In-Depth Review (IDR)

was warranted for that country. While considerable improvements in current accounts have been recorded in Czechia, nominal unit labour costs have increased significantly, on the back of strong wage rises and acute labour market shortages, although some deceleration is expected. At the same time, Czechia is exposed to risks relating to the trade policy environment (such as import of commodities, strong dependence on the German economy) and related disruption of global value chains (especially in car manufacturing). Real house price growth has remained elevated both in 2020 and even accelerated in 2021. House prices appear to be overvalued in several regions in Czechia. The real house price index has continued the upward trend started in 2013, driven by supply constraints and strong demand. In 2021, it exceeded its 2015 level by about 61% ⁽³⁹⁾.

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

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

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

⁽³⁹⁾ The very fast growth of house prices in real terms (almost 11% p.a. since 2019) has been mostly driven by constraints of structural nature. The macroprudential regulation has been broadly appropriate; see ESRB, "Vulnerabilities in the real estate sectors of the EEA countries", ESRB, Frankfurt, February 2022.

Table 3.4:

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

1) The combined current and capital account.

2) Including financial derivatives.

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

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

The implementation of the investments planned in Czechia's plan, along with other investments under NextGenerationEU (NGEU), is estimated to raise Czechia's GDP by 0.8% to 1.2% by 2026, of which 0.3% due to the positive spillover effects of the coordinated implementation of NGEU across Member States (Pfeiffer et al. 2021) ⁽⁴⁰⁾. This does

⁽⁴⁰⁾ See Pfeiffer P., Varga J. and in't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery

not take into account the positive impact of structural reforms on growth.

3.6.1. Developments of the balance of payments

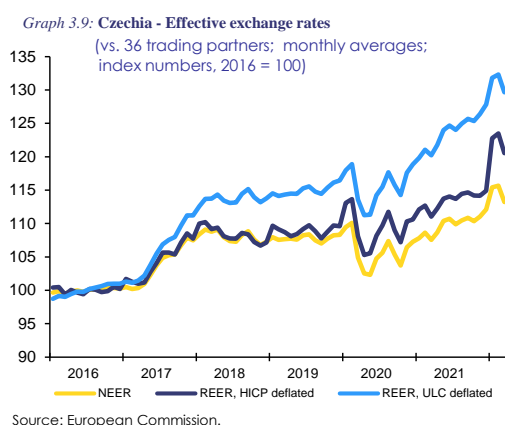
According to balance of payments data, Czechia's external balance (i.e. the combined current and capital account) rose strongly in 2020, reaching 3.2% of GDP before decreasing to 0.7% of GDP in 2021. These developments in the external balance mostly mirror those of the current account surplus with the capital account remaining broadly stable at about 1.4% of GDP ⁽⁴¹⁾, following the below-one-per-cent balance in previous few years. The trade surplus was strongly affected by the uneven impact of the COVID-19 pandemic on exports and imports: it increased strongly in 2020 before falling back in 2021. In contrast to previous years, net exports contributed negatively to economic growth in 2021. While net trade in services was

and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7–16.

⁽⁴¹⁾ In 2020, the current account recorded the highest surplus in the history of Czechia, both in absolute terms and relative to GDP. The main reason was a reduction of the deficit on primary income as a result of a massive drop in the outflow of income on direct investment of non-residents in Czechia.

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

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



Measured by the export market share, the trade performance declined in 2020. In 2020–2021, measures of competitiveness exhibited different dynamics depending on the deflator used. The rate of appreciation of the real effective exchange rate (REER) deflated by ULC, accelerated, as labour hoarding pushed up labour costs. The appreciation in REER deflated by HICP has been more moderate, reflecting moderate price inflation until

mid-2021. The swift acceleration of inflation at the end of 2021 has not caused a real appreciation vis-à-vis the rest of the world, since inflation has picked up globally, including major trade partners⁽⁴²⁾.

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

3.6.2. Market integration

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

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

Czechia's performance in international rankings of competitiveness and ease of doing business has been worsening over recent years and it is thus relatively weaker than in many euro-area Member States. In the IMD's World Competitiveness Index, Czechia's position is around the middle of the ladder and has worsened somewhat lately (from 33 in 2020 to 34 in 2021, from a total of 64

⁽⁴²⁾ The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Czechia.

Table 3.5:
Czechia - Market integration

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

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

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

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

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

5) International Institute for Management Development (IMD).

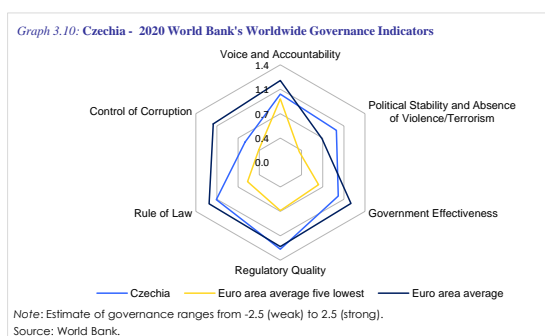
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).

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

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

surveyed economies), with attractiveness issues related to the effectiveness of the legal environment, the competency of the government and the quality of corporate governance.

According to the World Bank's Ease of Doing Business indicator, Czechia maintained the same ranking in 2020, as in 2019, i.e. 41, but a relative worsening can be noticed with respect to 2018 or 2017, when it ranked 35th and 30th respectively (⁴³).



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

measures are included in the Recovery and Resilience Plan). Concerns remain over cases of high-level corruption.

According to the World Bank's Worldwide Governance Indicators (2020), Czechia ranks higher than the average of the five euro area Member States with the lowest scores for regulatory quality, political stability and absence of violence, rule of law and government effectiveness (⁴⁴).

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

The Czech Republic has taken steps to improve its Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework. The Register on Beneficial Owners and the Central Register of Bank Accounts were established to improve transparency of beneficial owners and to provide quicker access to bank account information. The Czech authorities have achieved a substantial level of effectiveness in international cooperation; confiscation of proceeds and instrumentalities of crime; and FT investigations and prosecutions. On the other hand, the Czech Republic has achieved moderate results in the

(⁴³) The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

(⁴⁴) A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

other areas covered by the FATF standards and its transposition of the 5th AMLD is still under assessment by the European Commission.

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

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

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

1) MMF stands for money market funds.

Source: Eurostat.

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

well with the five euro-area Member States with the smallest financial sectors.

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

Table 3.7:

Czechia - Financing of the economy¹⁾

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

1) The table focuses on the financing needs of a country and how these are met by the financial system.

The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities,

equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.

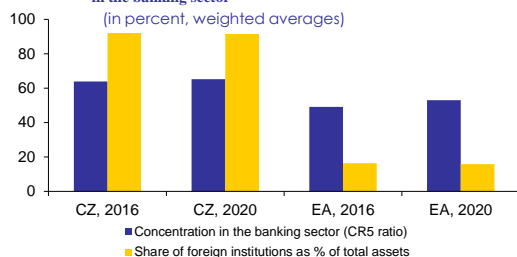
Source: Eurostat.

As to the financing of the economy, Czechia has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (especially debt securities and listed shares) is relatively under-developed. However, Czechia is still comparable to the five euro-area Member States with the smallest national capital markets. Loans are the dominant source of funding and make up 96% of GDP in 2020, compared to 240% of GDP in the euro area. Unlisted shares and other equity are another important source of funding and stand at 70% and 63% of GDP in 2020 (related to FDI), compared to 192% and 55% in the euro area respectively. The decrease of the share of trade credits and advances, the fourth source of private funding (36% of GDP), brings it at par with its euro area average counterpart. Financing through private debt markets remains

low vis-à-vis their euro area counterparts, and also equity markets are very small compared to those of the euro area and represent 10% of GDP. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is also lower than in the euro area. In terms of share of the sum of liabilities, loans in Czechia are comparable to that of the euro area, while trade credits and advances are higher than in the euro area. For security and equity financing, the large differences reflect the smaller share of market funding available in Czechia compared to the euro area.

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

Graph 3.11: Czechia - Foreign ownership and concentration in the banking sector
(in percent, weighted averages)

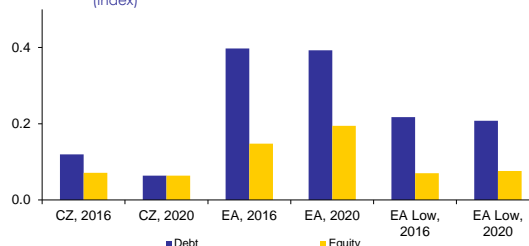


Source: ECB, Structural financial indicators.

Although intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, Czechia is roughly comparable in terms of levels of integration of the low euro-area Member State in equity markets⁽⁴⁵⁾. Integration in this market segment, has slightly worsened between 2016 and 2020. The very large home bias indicates that an overwhelming majority of investments in equity markets does still take place domestically. Similarly, in case of debt

markets, the home bias remains very strong in Czechia relative to euro-area Member States. The very large home bias indicates that most of the transactions in the debt market take place domestically.

Graph 3.12: Czechia - Intra-EU integration in equity and debt portfolio investment
(index)



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

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

⁽⁴⁵⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

4. CROATIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

The main legal rules governing the Croatian National Bank (Hrvatska narodna banka – HNB) are laid down in Article 53 of the Constitution of the Republic of Croatia⁽⁴⁶⁾ and the Act on the Croatian National Bank (the HNB Act)⁽⁴⁷⁾. The HNB Act was amended in 2013 with a view to Croatia entering the European Union on 1 July 2013. The Act provides for specific rules applying to the HNB as of EU accession of Croatia and a specific chapter for rules applying to the HNB as of the moment the euro becomes the official currency of the Republic. The Act also contains provisions regarding the close cooperation of Croatia with the ECB for banking supervision purposes⁽⁴⁸⁾. Article 53 of the Constitution of the Republic of Croatia and the HNB Act have not been amended since the Commission's 2020 Convergence Report.

4.1.2. Central Bank independence

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

No incompatibilities and imperfections exist in this area.

⁽⁴⁶⁾ Constitution as amended and published in the Official Journal of the Republic of Croatia no. 56/90, 135/97, 113/2000, 123/2000, 124/2000, 28/2001, 55/2001 and 76/2010, 5/2014.

⁽⁴⁷⁾ Official Journal of the Republic of Croatia no. 75/2008 and 54/2013.

⁽⁴⁸⁾ 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).

4.1.3. Prohibition of monetary financing and privileged access

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

4.1.4. Integration in the ESCB

Objectives

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

Tasks

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

4.1.5. Assessment of compatibility

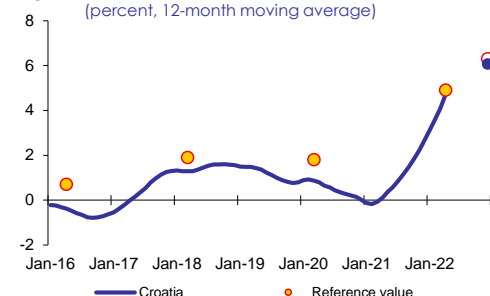
The Constitution and the Act on the Croatian National Bank are fully compatible with Articles 130 and 131 of the TFEU.

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the 2020 convergence assessment of Croatia. From then, it decreased to reach to -0.2 % in February 2021 before shifting again to an upward trend. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece, plus 1.5 percentage points. The corresponding inflation rate in Croatia was 4.7%, i.e. 0.2 percentage points below the reference value. The 12-month average inflation rate is projected to remain below the reference value in the months ahead.

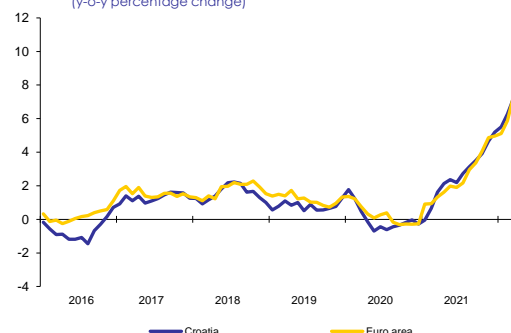
Graph 4.1: Croatia - Inflation criterion
(percent, 12-month moving average)



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

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

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



Source: Eurostat.

4.2.2. Recent inflation developments

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

respectively. The April inflation rate in Croatia was above euro area average, where prices increased by 7.4%. This puts the average inflation rate in the trailing twelve months through April 2022 at 4.7% in Croatia, just above the EA average of 4.4%.

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

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

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

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

Table 4.1:

Croatia - Components of inflation

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

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

Source: Eurostat, European Commission calculations.

In 2020-2021, the government's policy response to the COVID-19 crisis provided significant support to the healthcare sector, households and companies hit by the pandemic, including incentives to retain the workforce. This response was facilitated by new European instruments like loans from SURE (Support to mitigate Unemployment Risks in an Emergency) and grants from Next Generation EU/RRF. In 2021, the fiscal stance⁽⁴⁹⁾ remained supportive (-0.2 percentage point of GDP, after -2.3 percentage points of GDP in 2020), based on the Commission's Spring 2022 Economic Forecast. The fiscal stance is expected to remain supportive in 2022 (-1.8 percentage points of GDP) partly due to the expenditure financed through the RRF and other EU grants and temporary support to mitigate the impact of high energy prices on vulnerable households and firms. Net nationally-financed primary current expenditure in 2022 is projected to provide an expansionary contribution of 1.0 percentage point of GDP to the overall fiscal stance. The budgetary costs related to refugees from Ukraine is assumed at 0.1 percentage point of GDP. The forecast for 2023 shows a further supportive stance (-0.7 percentage point of GDP) due to the increasing expenditure financed by RRF and other EU grants and despite the assumed phasing out of energy crisis measures. Net nationally-financed primary current expenditure is projected to have a broadly

neutral contribution to the fiscal stance of -0.2 percentage point of GDP.

In 2020, the HNB took a range of measures to ensure the stability of the financial sector in the aftermath of COVID-19 pandemic. The Croatian central bank used various standard and non-standard measures, including purchases of government bonds on the secondary market, direct purchases of foreign currency from the Ministry of finance, sales of foreign currency on the FX market and a cut in reserve requirement ratio⁽⁵⁰⁾. The HNB also agreed upon establishing a precautionary currency swap line with the ECB in April 2020. The currency swap line allows for the exchange of the kuna for up to EUR 2bn that could be used to provide additional euro liquidity to Croatian financial institutions without using the HNB own international reserves, if needed. While the swap line was initially set to expire on 31 December 2020, it had been extended thereafter to 31 March 2022. The HNB continued to pursue accommodative monetary policy throughout 2021, ensuring high levels of liquidity in the banking system and simultaneously maintaining a broadly stable exchange rate of the kuna against the euro.

⁽⁴⁹⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

⁽⁵⁰⁾ Croatian National Bank (2021). Tri desetljeća izazova, brochure prepared for the celebration of the 30th anniversary of CNB.

Table 4.2:

Croatia - Other inflation and cost indicators

(annual percentage change)

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

1) Commission Spring 2022 Economic Forecast.

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

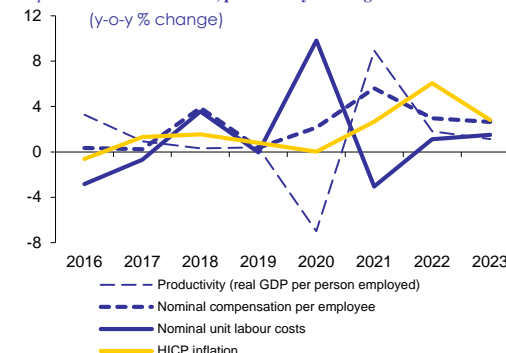
Wages and labour costs

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

Relatively strong wage growth in 2020-2021 can largely be attributed to the employment support measures and personal income tax cuts. Subdued nominal unit labour costs (ULC) dynamics in 2021 partially offset the increase registered in 2020, as productivity growth outpaced nominal compensation per employee growth (8.9% vs.

5.6%)⁽⁵¹⁾. However, a tighter labour market and continued wage growth will result in a slight rise in ULC in 2022 and 2023. As a result, risks of second-round effects of wages on inflation are expected to be limited.

Graph 4.3: Croatia - Inflation, productivity and wage trends (y-o-y % change)



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

External factors

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

⁽⁵¹⁾ However, it is important to emphasize that unlike many other countries Croatia recorded a strong fall of productivity based on hours of work in 2020, as employers in Croatia recorded full time hours despite the fact that workers were not working or they were working less hours.

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

Administered prices and taxes

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

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

Medium-term prospects

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

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

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

member states at the moment of their euro accession.

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

4.3. PUBLIC FINANCES

4.3.1. Recent fiscal developments

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

The 2021 general government deficit was 2.9% of GDP. The improvement relative to 2020 is mainly explained by the strong economic recovery and the

Table 4.3:

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

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022¹⁾	2023¹⁾
General government balance	-0.9	0.8	0.0	0.2	-7.3	-2.9	-2.3	-1.8
- Total revenue	45.9	45.5	45.5	46.3	47.2	46.4	46.4	46.7
- Total expenditure	46.9	44.7	45.5	46.1	54.5	49.2	48.6	48.5
of which:								
- Interest expenditure	3.1	2.6	2.3	2.2	2.0	1.6	1.4	1.3
p.m.: Tax burden	37.3	37.2	37.5	37.6	37.0	36.2	35.9	35.9
Primary balance	2.1	3.4	2.3	2.4	-5.3	-1.3	-0.9	-0.5
Fiscal stance ²⁾					-1.8	-0.2	-1.8	-0.7
Government gross debt	79.8	76.7	73.3	71.1	87.3	79.8	75.3	73.1
p.m: Real GDP growth (%)	3.5	3.4	2.9	3.5	-8.1	10.2	3.4	3.0

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

decreasing impact of the COVID-19 temporary emergency measures, which are estimated to have amounted to 2.1% of GDP. The 2021 deficit outturn was significantly lower than the 3.8% of GDP estimated in the 2021 Convergence programme, mainly on account of a lower than expected investment spending.

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

4.3.2. Medium-term prospects

The 2022 budget was adopted by the Parliament on 8 December 2021. Based on the expectation of a general government deficit of 4.5% of GDP in 2021, the budget foresaw a deficit of 2.6% of GDP in 2022. The 2022 budget envisaged a withdrawal of temporary emergency measures. However, considering the effects of the COVID-19 Omicron variant, some measures to retain jobs have been kept in place for the first part of the year. In light of the rising prices in energy products, the Government adopted measures to help the households and companies to cope with the

economic and social impact of rising prices. After freezing the petrol and diesel prices already at the end of 2021, authorities temporarily cut excise duties on petrol and diesel in March 2022 until end of May. On the top of these measures, the authorities adopted on 9 March 2022 a comprehensive set of measures, effective as of 1 April amounting to 1% of GDP. This package includes a temporary reduction of VAT on gas from 25% to 5% (from April 1st 2022 to March 31st 2023) and a permanent reduction of the VAT rate on electricity, gas (after March 2023 VAT rate on gas will remain at 13% vs previous 25%), heating, pellet, wood chippings and firewood, and support measures designed for population and companies. The package also includes a permanent cut of VAT rates on non-energy products, including food, hygienic products and tickets for sport and cultural events. There are also temporary support measures (until end of March 2022) for households and companies to help alleviate part of the increase in energy prices.

On 29 April 2022, Croatia submitted its 2022 Convergence Programme, in line with Article 4 of Regulation (EC) No 1466/97. The government projects real GDP to grow by 3% in 2022 and 4.4% in 2023. By comparison, the Commission's Spring 2022 Economic Forecast projects a higher real GDP growth of 3.4% in 2022 and a lower growth of 3.0% in 2023. The difference between the two forecasts comes from a lower expectation by the Croatian authorities concerning growth in real household consumption in 2022. The

Government expects in the Convergence Programme that the headline deficit will slightly decrease to 2.8 % of GDP in 2022, mainly reflecting the growth in economic activity and the unwinding of most emergency measures. Due to Russia's invasion of Ukraine, the Croatian authorities expect around twenty thousand refugees and an increase in expenditure related to costs of accommodation, food, education, social welfare and health care. Thereafter, the government deficit is expected to gradually decline to 1.6% of GDP in 2023, 1.6% of GDP in 2024 and to 1.2% by 2025. Therefore, the general government deficit is planned to remain below 3% of GDP over the programme horizon. Compared to the Commission's Spring 2022 Economic Forecast, these deficit projections are higher in 2022 and lower in 2023, mainly due to a lower level of expenditure expected by the Commission in 2022 for gross fixed capital formation and other expenditure. Furthermore the Commission's forecast entails somewhat lower level shift in both revenues and expenditures compared to the Convergence Programme attributed to a difference in the inflation outlook, where government's inflation projection is notably higher than that of the Commission.

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

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to continue to be supportive, at -1.8 percentage points of GDP ⁽⁵²⁾. The additional positive contribution to economic activity of expenditure financed by the Recovery and Resilience Facility grants and other EU funds is projected at 0.5 percentage point of GDP in 2022, after 0.3 percentage point of GDP in 2021. Nationally financed investment is projected to provide a expansionary contribution to the fiscal stance in 2022 of 0.4 percentage point. At the same time, the growth in nationally financed primary current expenditure (net of discretionary revenue measures) in 2022 is projected to provide an expansionary contribution of 1.0 percentage point

of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, most of this expansion is due to measures related to the energy crisis (0.4 percentage point of GDP) and the assistance to those fleeing Ukraine (0.1 percentage point of GDP).

In 2023, the fiscal stance is projected at -0.7 percentage point of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility (RRF) grants and other EU funds is projected at 0.5 percentage point of GDP in 2023. Nationally financed investment is projected to provide a slightly expansionary contribution to the fiscal stance of 0.1 percentage point of GDP ⁽⁵³⁾. The growth in nationally financed primary current expenditure (net of discretionary revenue measures) is projected to provide a broadly neutral contribution of -0.2 percentage point of GDP to the overall fiscal stance in 2023 as part of the support measures to face the energy crisis in 2022 are assumed to be phased out.

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

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

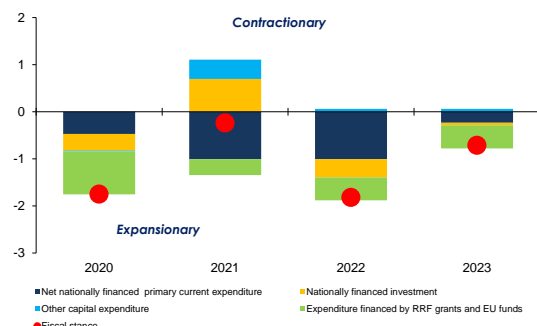
Some factors mitigate risks, including the lengthening of debt maturity in recent years and relatively stable financing sources (with a diversified and large investor base) and the expected positive impact on long-term growth of reforms under the recovery and resilience plan. Risk-increasing factors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

⁽⁵²⁾ For a definition of the fiscal stance used in this report, see footnote in Section 4.2.3 on underlying factors and sustainability of inflation.

⁽⁵³⁾ Other nationally financed capital expenditure is projected to provide a neutral contribution.

net international investment position and the recently evidenced decline in population ⁽⁵⁴⁾.

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



Source: Commission's Spring 2022 Economic Forecast.

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

4.4. EXCHANGE RATE STABILITY

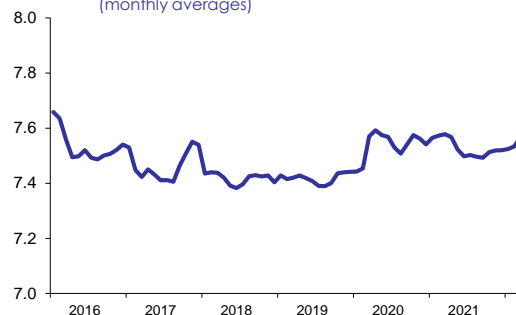
The HNB operates de jure a managed floating exchange rate regime, using the exchange rate against the euro as the main nominal anchor to achieve its primary objective of price stability. The HNB does not target a specific level or band for

the kuna exchange rate against the euro but, through its foreign exchange transactions, it aims to prevent excessive exchange rate fluctuations.

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

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

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



Source: ECB.

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

⁽⁵⁴⁾ For further details see the 2021 Fiscal Sustainability Report.

volume of repo transactions, and a new allocation of special drawing rights with the International Monetary Fund (IMF).

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



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

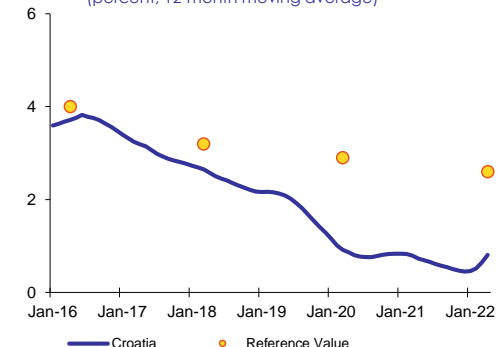
As foreign exchange interventions are the main monetary policy instrument, the HNB does not frequently change interest rates on its lending and deposit facilities and developments in the short-term rates mainly reflects changes in kuna liquidity in the banking system. Following the decision of the Croatian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

4.5. LONG-TERM INTEREST RATES

The long-term interest rates in Croatia used for the convergence assessment reflect the secondary market yield on a single benchmark government bond with a residual maturity of about 7.5 years. The Croatian 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2020 convergence assessment of Croatia. After having stabilized around those levels in the remaining months of 2020, it declined very gradually throughout 2021, standing just below

0.5% in December, before starting to rise gradually in the first months of 2022. In April 2022, the reference value, given by the average of long-term interest rates in France, Finland and Greece, plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the Croatian benchmark bond stood at 0.8%, i.e. 1.8 percentage points below the reference value.

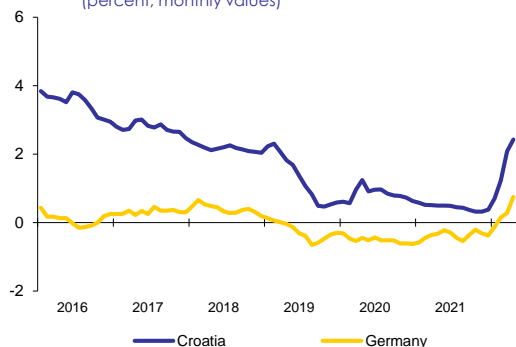
Graph 4.7: Croatia - Long-term interest rate criterion
(percent, 12-month moving average)



Source: European Commission.

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

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



Source: Eurostat.

4.6. ADDITIONAL FACTORS

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

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

However, the findings of the Commission's 2022 In-Depth Review (IDR) indicate that the unwinding of macroeconomic imbalances resumed in 2021, following a relatively contained deterioration in 2020. The public debt ratio decreased owing to strong economic recovery and partial phasing out of pandemic-related fiscal measures. The recovery also reduced the private debt ratio, which returned close to the pre-pandemic level. Both household and corporate debt are below prudential thresholds, although still above the levels suggested by fundamentals. External balances improved, with the current account balance returning to positive territory and the net international investment position (NIIP) returning to an upward trajectory. Croatia's RRP should facilitate reforms in different areas and thus

support the unwinding of macroeconomic imbalances in the medium term. A range of RRP reforms should help improve the fiscal framework, the cost effectiveness in the public sector, access to financing and the business environment. They are also expected to increase the export potential of the economy, participation on the labour market and boost long-term productivity.

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

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

Table 4.4:

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

1) The combined current and capital account.

2) Including financial derivatives.

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

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

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

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

The plan devotes 40.3% of its total allocation to measures supporting climate objectives, 20.4% to

the digital transition and 23% on social expenditure, all while respecting the do no significant harm principle.

The implementation of the investments in the Croatian plan, along with other investments under Next Generation EU (NGEU), is estimated to raise Croatia's GDP by 2.9% by 2026, of which 0.5% due to the positive spillover effects of the coordinated implementation of NGEU across Member States ⁽⁵⁵⁾. This does not take into account the positive impact of structural reforms on growth.

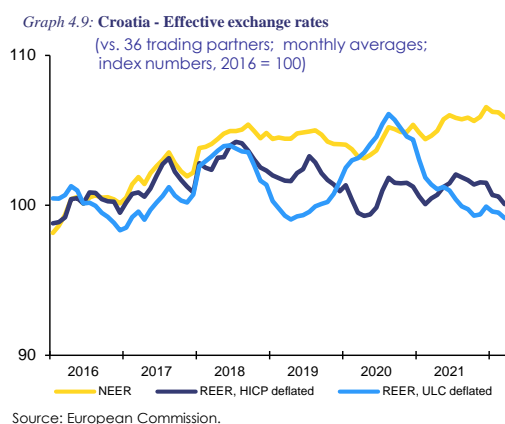
4.6.1. Developments of the balance of payments

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

⁽⁵⁵⁾ Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

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

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



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

Based on national accounts, external cost competitiveness, as measured by the ULC-deflated

real effective exchange rate, has increased since the beginning of the pandemic. However, the evolution of ULC-deflated REER in 2020 should be interpreted with caution due to challenges in calculating ULC. ⁽⁵⁶⁾ On the other hand, the HICP based REER indicates a slight deterioration in external price competitiveness since 2020.

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

4.6.2. Market integration

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

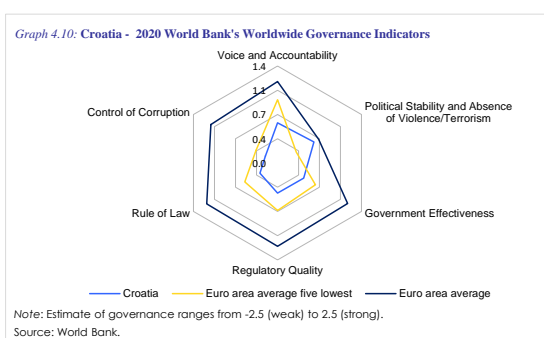
FDI has so far been mainly directed to the banking, real estate and retail sectors. Croatia has so far failed to attract significant FDI inflows into the tradable goods sector and it is thus weakly integrated into global supply chains. The unfavourable business environment appears to be the main obstacle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

With regard to the business environment, Croatia performs worse than most euro-area Member States according to several commonly used indicators (e.g. the World Bank's Ease of Doing Business Index or the IMD World Competitiveness Index). In the World Bank's Ease of Doing Business, Croatia's worst rankings concern dealing with construction permits and starting a business ⁽⁵⁷⁾. According to the World Bank's

⁽⁵⁶⁾ The ULC-deflated REER should be interpreted with prudence as unit labour costs were distorted by the uneven approach to recording working hours in the presence of labour retention schemes.

⁽⁵⁷⁾ The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency

Worldwide Governance Indicators (2020), Croatia ranks low in voice and accountability, regulatory quality and rule of law compared with the average of the five euro area Member States with the lowest scores. Croatia ranks higher than the average five lowest euro area Member States for political stability and absence of violence. ⁽⁵⁸⁾ On the other hand, Croatia stepped up its transposition of EU internal market directives. In addition, there has been renewed effort to improve the business environment, in particular to reduce the administrative burden and regulatory restrictions, especially supported by RRP funds and post-entry ERM II commitments.



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

The 4th Anti-money Laundering Directive imposed transposition by 26 June 2017 and during

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

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

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

under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

⁽⁵⁸⁾ A Member State is considered to have a 'low' ('high') ranking compared with the average of the five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

Table 4.5:
Croatia - Market integration

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

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Imports} + \text{Exports of goods with EA-19} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

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

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.

(November data, as of 2016 date refers to the year of publication).

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

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

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

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

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

1) MMF stands for money market funds.

Source: Eurostat.

As for the funding structure of the Croatian economy, this is dominated by bank loans and trade credits to a larger extent than in the euro area. The outstanding bank loans and trade credits amounted to over 164% of Croatia's GDP and the majority of bank loans was denominated in euro. Possibly reflecting the large use of limited liability companies and the importance of SOEs in Croatia, other equity⁽⁵⁹⁾ represented the second most important source of funding of the Croatian economy, amounting to 124% of GDP. At the same time, the listed and unlisted shares represented about 64% of GDP, broadly in line with the importance of government debt market in terms of GDP. However, the importance of listed shares amounted to just 36% of GDP in 2020, declining somewhat compared to 2016 when it stood at 41% and being thus just half of its

⁽⁵⁹⁾ Other equity refers to equity claims such as equity in incorporated partnerships, equity in limited liability companies whose owners are partners, capital invested in cooperative societies or investment by the government in the capital of public corporations whose capital is not divided into shares.

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

Table 4.7:

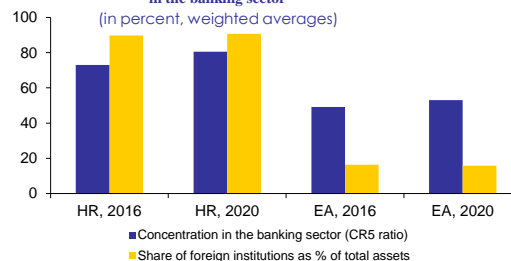
Croatia - Financing of the economy¹⁾

	HR		EA		Ratio to GDP (%)	
	2016	2020	2016	2020	EA 5 smallest	
Liabilities (total)	441	461	743	770	324	335
Loans	163	164	238	236	115	112
Non-financial co. debt securities	5	4	12	15	3	4
Financial co. debt securities	0	0	74	68	11	12
Government debt securities	57	65	83	95	51	57
Listed shares	41	36	65	73	17	18
Unlisted shares	28	28	186	193	55	56
Other equity	109	124	51	56	42	48
Trade credits and advances	38	39	33	35	29	29
					Share of total (%)	
	HR		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	37	36	32	31	35	33
Non-financial co. debt securities	1	1	2	2	1	1
Financial co. debt securities	0	0	10	9	3	3
Government debt securities	13	14	11	12	16	17
Listed shares	9	8	9	9	5	5
Unlisted shares	6	6	25	25	18	18
Other equity	25	27	7	7	13	14
Trade credits and advances	9	8	4	5	9	9

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

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

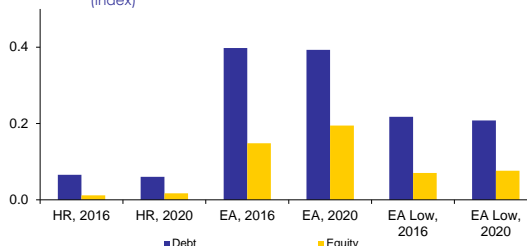
Graph 4.11: Croatia - Foreign ownership and concentration in the banking sector



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

Measures of intra-EU integration in equity and debt markets, as based on the home bias in portfolio investments, ⁽⁶⁰⁾ indicate that the level of integration of Croatia is very low in both segments and in particular in equity markets. Although intra-EU financial integration, by the same measure, is in general relatively low across EU Member States, Croatia's integration is well below that of the euro-area Member States exhibiting low integration. The very large home bias indicates that almost all investments in financial markets takes place domestically.

Graph 4.12: Croatia - Intra-EU integration in equity and debt portfolio investment (index)



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

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

4.7. SUSTAINABILITY OF CONVERGENCE

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

⁽⁶⁰⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

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

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

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

Any assessment of the sustainability of convergence has limits and must be based on a judgement of the likely future evolution of the economy. In particular, as experience has shown, the sustainability and robustness of the convergence process after euro adoption is to a significant extent endogenous, i.e., it depends on a Member State’s domestic policy orientations after it has joined the euro area. Therefore, while the assessment of sustainability is an essential element in determining a Member State’s readiness to adopt the euro based on initial conditions and

existing policy frameworks, the outcome of such an assessment should be seen as a snapshot at a specific point in time, whereas the long-term sustainability of the convergence process will also depend on the adoption of appropriate policies over time. In this respect, the on-going surveillance carried out in the context of the European Semester will play a major part in ensuring that such policies are implemented by the Member State after euro adoption.

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

Price stability

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

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

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

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

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

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

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

Fiscal sustainability

After a timely abrogation of the excessive deficit procedure in 2016, Croatia's public finances performed well in the preventive arm of the

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

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

At the same time, Croatia is classified at medium fiscal sustainability risk over the medium term, according to the Commission Debt Sustainability Analysis. ⁽⁶¹⁾ The debt ratio is projected to decline from its 2021 level of 79.8% of GDP until the mid-2020s, assuming a favourable interest-growth rate differential, but it will increase again as from 2027 unless measures are taken to correct the projected structural primary deficit, especially given the projected increase in the cost of ageing in coming years. Under less favourable macro-financial assumptions, debt could revert close to its 2021 level by 2032. Additional factors may aggravate sustainability risks, including the large share of debt held in foreign currency, the impact of the recent decline in population and the country's negative net international investment position.

⁽⁶¹⁾ The classification based on the Commission DSA takes into account in particular the projected debt level and trajectory under the baseline, stress test scenarios and stochastic simulations.

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

Structural resilience and growth sustainability

The last report by the Commission on Croatia's macroeconomic imbalances⁽⁶²⁾ noted that the country was still experiencing imbalances related to elevated private and public debt levels in the context of low potential growth. However, in recent years indebtedness of private and public sector has declined notably. Public debt declined from the peak of around 84% of GDP in 2014 to slightly above 71% in 2019, while private sector debt decreased from a peak of 120% of GDP to around 88% of GDP in 2019. This deleveraging has come against the backdrop of years of solid economic growth and prudent fiscal policy. The COVID-19 crisis in 2020 temporarily halted the downward trajectory of debt, which resumed already in 2021 in both private and public sector. Despite the current uncertainties surrounding the economic situation, debt ratios should continue to decline steadily, supported by solid economic growth but also by some MIP-relevant policies included in Croatia's recovery and resilience plan, such as changes in bankruptcy and solvency framework and new equity-based financial instruments which should reduce the dependence of firms on bank loans.

External balances have also improved notably in recent years. After six consecutive years of current account surpluses, the COVID-19 shock pushed the balance slightly into negative territory, but Croatia managed to record again a surplus of 3.2% of GDP in 2021. At the same time, the net international investment position (NIIP) improved from -87% of GDP to -34% of GDP, which brought it in conformity with the indicative -35% of GDP threshold in the scoreboard of the Macroeconomic Imbalance Procedure. Moreover, Croatia's NIIP excluding non-defaultable instruments (NENDI) was virtually balanced in 2021 and foreign exchange reserves reached 44% of GDP, thus mitigating exchange-rate risks.

Current commodity price shocks are expected to negatively affect Croatia's goods trade balance, but stable tourism inflows, remittances and accelerating inflows of EU funds should keep the current account balance in surplus. A strong inflow of EU funds on the capital account should also support continued improvement of NIIP.

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

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

In July 2019, Croatia committed to implementing policy measures prior to joining the ERM II in the following six areas: i) banking supervision (close cooperation with the ECB), ii) the macroprudential framework, iii) the anti-money laundering framework, iv) statistics, v) public sector governance and vi) business environment. In June 2020, the Croatian authorities notified the ERM II parties of the fulfilment of these commitments,

⁽⁶²⁾ European Commission (2021), Alert Mechanism Report 2022. Available at: https://ec.europa.eu/info/sites/default/files/economy-finance/2022_european_semester_alert_mechanism_report.pdf

which the ECB and the Commission assessed as effectively implemented. ⁽⁶³⁾

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

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

Notwithstanding the AML measures implemented by Croatia in the context of its prior and post-entry commitments, the Mutual Evaluation Report assessing Croatia's framework for combatting money laundering and terrorist financing ⁽⁶⁴⁾ identified a number of remaining shortcomings with regard to the effective implementation of Croatia's AML framework. The Croatian authorities are currently focusing their efforts in swiftly addressing the recommended actions listed in the report with a view to achieve a satisfactory level of progress within the next year.

The aforementioned structural deficiencies are weighing on the long-term potential growth by stifling competitiveness and business activity,

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

Financial resilience

Although the resilience of Croatia's financial sector has been tested by the outbreak of the pandemic, prompt policy support and regulatory measures ⁽⁶⁵⁾ have so far alleviated the impact of the crisis on the financial sector. Overall banking system capital adequacy ratio actually increased in 2020 and reached a record high in the second quarter of 2021.

The Croatian banking sector entered the COVID-19 pandemic in an already strong position as shown by the positive results of the comprehensive assessment of major Croatian banks conducted by the ECB ahead of its decision to establish close cooperation in the field of banking supervision with the Croatian National Bank (HNB). Following Croatia's request for close cooperation with the ECB in May 2019, the ECB adopted a

⁽⁶³⁾ https://ec.europa.eu/info/business-economy-euro/euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en

⁽⁶⁴⁾ The report was adopted in December 2021 by the Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

⁽⁶⁵⁾ The measures of support during the pandemic included an expansionary monetary policy, fiscal support to companies and favourable regulatory treatment of the moratoriums to mitigate to an extent the problem of non-performing loans, coupled with other regulatory reliefs and the temporary restriction of banks' profit distribution.

favourable decision in July 2020 after conducting a comprehensive assessment of five Croatian banks⁽⁶⁶⁾, which comprised an asset quality review (AQR) and a stress test.⁽⁶⁷⁾ The comprehensive assessment showed that the five banks did not face any capital shortfalls as they did not fall below the relevant thresholds used in the AQR and the stress test. However, the assumptions used for the stress test scenarios could not take into account the COVID-19 crisis given that this exercise started well before the outbreak of the pandemic.

A more recent stress test exercise conducted by the HNB and published in May 2021, uses as a starting point the situation of Croatian banks' balance sheets at the end of 2020⁽⁶⁸⁾. It concludes that the overall banking system is resilient and ready to bear increased credit losses even under an adverse scenario⁽⁶⁹⁾, which envisaged further unfavourable developments in the pandemic from the second quarter of 2021. Moreover, the observed economic developments in 2021 turned out to be much more favourable than envisaged in the stress test exercise scenario, with the economy expanding by over 10% as opposed to a hypothetical cumulative contraction of about 6.6% over the 2021-2023 period in the adverse scenario.

However, Croatia's strong economic recovery in 2021 and the increased loss-absorption capacity of the overall banking system compared to the pre-COVID situation mask a considerable heterogeneity across Croatian banks. While systemically important banks should be able to

continue to operate even under very unfavourable conditions, the results of HNB's stress tests for other credit institutions show that the latter are much more vulnerable to adverse economic conditions, with the aggregate capital surplus being all but fully exhausted in the first year of the adverse scenario. However, these credit institutions account for less than 5% of the total banking system assets (HNB, 2021).

In addition to the more bank-specific vulnerabilities discussed above, a number of pandemic-induced developments and policy measures are likely to have increased some pre-existing vulnerabilities of the Croatian banking system. Thus, its exposure to the government and the real estate market has risen. With over 20% of total bank assets placed on Croatian government bonds, Croatia is among the EU countries with the largest government exposures of credit institutions. While the overall banking system can be considered resilient in light of the results of recent stress tests, this strong sovereign-bank-nexus could pose risks to its resilience as Croatia stands out in terms of the level of public debt in GDP. Even before the outbreak of the pandemic, Croatia had the highest level of public debt in GDP of all Central and Eastern European countries. The growing imbalances in the real estate sector is also a risk factor for the Croatian banking system.⁽⁷⁰⁾ Thus, around 45% of loans to the private sector are covered by real estate collateral and a possible decrease in real estate prices may raise credit risk costs (HNB, 2021). Finally, the banking sector in Croatia remains also highly exposed to a currency-induced credit risk but the risks themselves are contained given the historical stability of the kuna exchange rate vis-à-vis the euro and the sizeable foreign exchange reserves of the CNB. Overall, the above-mentioned high exposures of the Croatian banking system could represent a risk for its resilience to the extent they continue to weigh on its profitability looking ahead.

Conclusion

The broad-based analysis of underlying factors relevant for the sustainability of Croatia's convergence suggests that sufficiently robust conditions are in place for the country to be able to

⁽⁶⁶⁾ The comprehensive assessment covered Zagrebačka banka, Privredna banka Zagreb, Erste & Steiermärkische Bank, OTP banka Hrvatska and Hrvatska poštanska banka, all of which consented to the disclosure of the exercise's findings.

⁽⁶⁷⁾ Such assessment is required as part of the process of establishing close cooperation between the ECB and the national competent authority of an EU Member State whose currency is not the euro. For more details please see <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200605~ca8b62e58f.it.html>

⁽⁶⁸⁾ See Croatian National Bank (2021), Financial Stability, No. 22: <https://www.hnb.hr/documents/20182/3899508/e-fs-22.pdf/c82deec6-2de6-1d35-d4fb-849d8a5c15d9>

⁽⁶⁹⁾ The adverse scenario envisages further unfavourable developments in the pandemic from the second quarter of 2021 and a hypothetical fall in economic activity of 1.2% in 2021, 4.0% in 2022 and 1.4% in 2023 as well as a high unemployment rate throughout the observed adverse scenario horizon. In addition to the assumption of difficulties and delays in global response to the pandemic, the adverse scenario also includes a materialisation of additional sources of systemic risks such as a sharp fall in residential real estate prices and depreciation of the exchange rate that would rise to HRK 8.0/EUR following the escalation of the pandemic (CNB, 2021).

⁽⁷⁰⁾ As a result of the continued accumulation of cyclical systemic risks amid economic recovery following the crisis caused by the pandemic, the growth in the prices of residential real estate and the pickup in lending activity, the CNB adopted on 28 March 2022 the decision to increase the countercyclical buffer rate to 0.5% as of 31 March 2023.

maintain a sustainable convergence path in the medium term, thus supporting a positive assessment. However, significant challenges remain, and policy discipline will need to be maintained in a determined manner to fully exploit the benefits of participation in the euro area and minimise risks to the convergence path going forward. Recent measures and policy orientations included in Croatia's RRP should contribute to ensure that it remains on a sustainable convergence path in the medium term.

5. HUNGARY

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The main rules governing the Magyar Nemzeti Bank (MNB – Hungarian national bank, hereafter MNB) are laid down in Article 41 of the Hungarian Fundamental Law and Act CXXXIX 2013 on the MNB (hereafter: MNB Act). No amendments to these legal acts were passed with regard to the incompatibilities and imperfections mentioned in the Commission's 2020 Convergence Report. Therefore, the comments provided in the Commission's 2020 Convergence Report are repeated also in this year's assessment.

5.1.2. Central Bank independence

Frequent amendments to the Central Bank Act of a Member State can create instability in the Central Bank's operations. Therefore, a stable legal framework that provides a solid basis for a Central Bank to function is essential for ensuring central bank independence. Pursuant to Article 176 of the MNB Act, the MNB has become the legal successor of the liabilities of the former Hungarian Financial Supervisory Authority (HFSA), which ceased to exist on 1 October 2013. This legal succession also implies the transfer of all employees from the HFSA to the MNB pursuant to Article 183 of the MNB Act. The principle of central bank independence pursuant to Article 130 of the TFEU implies that the MNB must have sufficient financial resources to perform its ESCB and ECB-related tasks, in addition to its national tasks. The tasks transferred from the HFSA to the MNB must not affect its ability to carry out these tasks from an operational and financial point of view.

Further to this principle, the MNB should be fully insulated from all financial obligations resulting from any HFSA activities. Contractual relationships in the period prior to 1 October 2013 including, amongst others, all employment relations between any new MNB staff member and the former HFSA can be continued only with the proviso that the continuation does not impinge on the MNB's independence and its power to fully carry out its duties under the Treaties. Against this background, Article 176 and 183 of the MNB Act have to be aligned to the principle of central bank

independence as enshrined in Article 130 of the TFEU.

According to Article 9(7) of the MNB Act, the Governor and the Deputy Governors shall take an oath before the President of the Republic and other members of the Monetary Council before the Parliament upon taking office with the words required by Law XXVII of 2008 as amended on the oath and solemn promise of certain public officials. The Law requires making an oath with words "I, (name of the person taking the oath), hereby make an oath to be faithful to Hungary and to its Fundamental Law, to comply with its laws, and make sure others citizens comply with them too; I will fulfil the duties arising from my position as a (name of the position) for the benefit of the Hungarian nation [...]". The oath does not contain a reference to the principle of central bank independence enshrined in Article 130 TFEU. What is more, the Fundamental Law contains only an indirect reference to EU law. Since the Governor and the Deputy Governors as members of the Monetary Council are involved in the performance of ESCB related tasks, any oath should make a clear reference to the central bank independence under Article 130 of the TFEU. Therefore, the oath is an imperfection as regards the institutional independence of the MNB and the wording of the oath should be adapted to be fully in line with Article 130 of the TFEU.

Article 153(6) of the MNB Act provides for the possibility for members of the Monetary Council (including the Governor) and MNB employees to take on roles in the management, boards of trustees or supervisory boards of foundations and business associations under majority ownership of the MNB established by the MNB under Article 162(2) of the MNB Act without being subject to the conflict of interest rules provided for in Article 152(1) to (5) of the MNB Act, including any formal disclosure requirement. Hence, for those activities the MNB officials involved, including the Governor, are fully shielded from any scrutiny. Moreover, Article 153(6) of the MNB Act also provides for an explicit exemption to the rule of Article 156(1) of the MNB Act, which determines that members of the Monetary Council (including the Governor) may only perform other activities, which are compatible with their central bank decision-making duties. Hence, under national law

such members may undertake activities in the MNB's foundations and business associations that are incompatible with their central bank decision-making duties. The provision conflicts with Article 162(2) of the MNB Act, which provides that the MNB may only establish foundations and business associations in line with its tasks and primary objective of ensuring price stability. Moreover, central bank decision-making duties always have to be performed in compliance with Article 130 of the TFEU. The exemption therefore seems to imply that the latter principles of primary Union law may be disregarded by members of the Monetary Council when acting in the context of the foundations and business associations under MNB ownership. Therefore, the incompatibility needs to be removed.

In addition, Article 156(7) read in conjunction with Article 152(1) of the MNB Act, extends the application of conflict of interests provisions to Monetary Council members to six months following termination of their employment relationship with the MNB. However, an exemption is granted as regards organisations covered by acts enumerated in Article 39 in which the Hungarian State or the MNB has a majority stake. Such an exemption could create situations where the privileged position of Monetary Council members could give them an unfair advantage in obtaining nominations or posts in other organisations, putting them in a position of conflict of interest while still in employment at the MNB.

Moreover, Article 157 of the MNB Act provides for an obligation for members of the Monetary Council, including the Governor and the Deputy Governors, to file declarations of wealth in the same manner as Members of Parliament, pursuant to the provisions of Article 90 of the Law XXXVI of 2012 on the Parliament. According to Article 157(1) of the MNB Act and Article 90(2) of the Law XXXVI of 2012, the obligation to submit a wealth declaration extends to close family members (spouse, domestic partner, and children). Pursuant to Article 90(3) of the Law XXXVI of 2012, members of the Monetary Council who fail to submit a wealth declaration will not be allowed to exercise their functions and will receive no remuneration until compliance with the obligation. This provision allows for the temporary removal from office of inter alia the Governor which seems to automatically fall into place once the failure to submit a wealth declaration as required by the above provisions is established by the Parliament.

Such an automatism may lead to situations where the removal from office would result from an unintentional action that could not be qualified as a serious misconduct under Article 14.2 of the ESCB/ECB Statute. In order to preserve fully the principle of central bank independence, this incompatibility should be removed by an amendment of Article 157 of the MNB Act, which would provide for an exception for such kind of unintentional omission.

5.1.3. Prohibition of monetary financing and privileged access

Pursuant to Article 36 of the MNB Act and subject to the prohibition of monetary financing set out under Article 146 of the MNB Act, the MNB can provide an emergency loan to credit institutions in the event of any circumstance arising in which the operation of a credit institution jeopardizes the stability of the financial system. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU, it should be clearly specified that the loan is granted against adequate collateral to ensure that the MNB would not suffer any loss in case of debtor's default.

Pursuant to Article 37 the MNB may grant loans to the National Deposit Insurance Fund and Investor Protection Fund in emergency cases, subject to prohibition of monetary financing under Article 146 of the Act. Though the Act adequately reflects conditions for central bank financing provided to a deposit guarantee scheme a specific requirement should be included to ensure that the loans granted to the National Deposit Insurance Fund are provided against adequate collateral (e.g. a claim on future cash contributions, government securities, etc.) to secure the repayment of the loan. Therefore, Article 37 is incompatible with the prohibition on monetary financing as laid down in Article 123 of the TFEU.

Article 177(6) of the MNB Act provides for state compensation to the MNB of all expenses resulting from obligations, which exceed the assets the MNB has taken over from the HFSA. The law does not contain any provisions on the procedure and deadlines on how the state shall reimburse the MNB of the expenses. Therefore, the reimbursement under Article 177(6) of the MNB Act is not accompanied by measures that would fully insulate the bank from all financial obligations resulting from any activities and contractual relationships of the HFSA originating from prior to the transfer of tasks. In case of a

substantial time gap between the costs arising to the MNB and the reimbursement by the state pursuant to Article 177(6) of the MNB Act, the reimbursement would result in an ex-post financing scheme. Should the expenses incurred at the MNB exceed the value of assets taken over from the HFSA, such a scenario would constitute a breach of the prohibition of monetary financing laid down in Article 123 of the TFEU. In order to comply with the prohibition of monetary financing, Articles 176 and 183 of the MNB Act should be amended in order to insulate the MNB by appropriate means from all financial obligations resulting from the HFSA's prior activities or legal relationships and obligations including those deriving from the automatic further employment of HFSA staff by the MNB.

Article 162(3) and (4) of the MNB Act lay down the conditions of disclosure of data by a company related to the MNB. Furthermore, Article 162(5) provides for supervision of the State Audit Office of the operations of foundations established by the MNB. Notwithstanding the limitations regarding access to data of MNB companies, it is noted that pursuant to the principle of sincere cooperation (Article 4 TEU) a Member State is required, in full mutual respect, to assist the Commission and the European Central Bank in carrying out tasks which flow from the Treaties, such as providing the information necessary for monitoring the application of EU law.

Pursuant to Article 162(2) of the MNB Act, the MNB may establish business associations under majority of MNB ownership, or foundations. In order to dispel any concerns from the perspective of Article 123 of the TFEU, the provision should be amended by providing for a clear framework delimiting the operations of such foundations and the volumes or resources which the MNB could endow them with, enabling them to purchase large volumes of Hungarian government securities. Moreover, the exemption provided under Article 153(6) of the MNB Act to the rule of Article 156(1) of the MNB Act which determines that members of the Monetary Council (including the Governor) may only perform other activities which are compatible with their central bank decision-making duties is incompatible with Article 123 of the TFEU. The exemption provided for in national law seems to imply that the prohibition of monetary financing enshrined in Article 123 of the TFEU may be disregarded by members of the Monetary Council (including the Governor) when

acting in the context of the foundations and business associations under MNB ownership. This incompatibility needs to be removed.

5.1.4. Integration in the ESCB

Objectives

Article 3(2) of the MNB Act determines that, without prejudice to the primary objective of price stability, the MNB shall uphold to maintain the stability of the financial intermediary system, to increase its resilience, to ensure its sustainable contribution to economic growth and support the economic policy of the government. The objective laid down in Article 3(2) of the MNB Act is reduced to supporting the economic policy in Hungary. The provision has to be aligned to the secondary objective of the ESCB enshrined in Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute in order to embrace the support of the general economic policies in the entire EU rather than in Hungary only.

Tasks

The MNB Act contains a series of incompatibilities with regard to the following ESCB/ECB tasks:

- definition of monetary policy and the monetary functions, operations and instruments of the ESCB (Articles 1 (2), 4(1), 9, 16 – 21, 159 and 171 of the MNB Act);
- conduct of foreign exchange operations (Articles 1(2), 4(3), (4) and (12), 9 and 159(2) of the MNB Act) and the definition of foreign exchange policy (Articles 1(2), 4(4) and (12), 9, 22 and 147 of the MNB Act);
- competences of the ECB and of the Council for banknotes and coins (Article K of the Fundamental Law and Articles 1(2), 4(2) and (12), 9, 23, 26 and 171(1) of the MNB Act).

There are also some imperfections in the MNB Act regarding the:

- non-accurate reflection of the principle of central bank independence in the MNB Act (Article 1(2) and (3) of the MNB Act);
- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 1(2), 4(5) and (12), 9, 27-28, and 159(2), 171 (2) of the MNB Act);

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Article 1(2), 30(1) and 171(1) of the MNB Act);
- non-recognition of the role of the ECB in the field of international cooperation (Article 135(5) of the MNB Act));
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 12(4)(b) and Law C of 2000/95 (IX.21.) in conjunction with Government Decree 221/2000 (XII.19.));
- non-recognition of the role of the ECB and the Council in the appointment of external auditors (Articles 6(1) (b), 15 and 144 of the MNB Act).

5.1.5. Assessment of compatibility

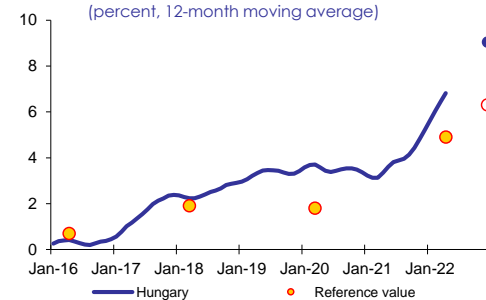
As regards central bank independence of the MNB, the prohibition on monetary financing and the integration of the MNB into the ESCB at the time of euro adoption, existing Hungarian legislation is not fully compatible with the Treaties and the Statute of the ESCB and the ECB pursuant to Article 131 of the TFEU. The Hungarian authorities are invited to remedy the abovementioned incompatibilities.

5.2. PRICE STABILITY

5.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since the convergence assessment of Hungary in 2018. It has remained above 3% since early 2019 and started moving further up in spring 2021, surpassing the 5% threshold in December. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece, plus 1.5 percentage points. The corresponding inflation rate in Hungary was 6.8%, i.e. 2.9 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Graph 5.1: Hungary - Inflation criterion
(percent, 12-month moving average)



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

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

5.2.2. Recent inflation developments

Over the last two years, HICP inflation was on an upward path in Hungary, with unprocessed food and energy prices adding volatility to the headline figure. Annual HICP inflation accelerated from 3.4% in 2020 to 5.2% on average for 2021, and was as high as 9.6% in April 2022. During the last two years, annual HICP inflation in Hungary remained above that of the euro area with the differential narrowing somewhat in 2021.

Energy price inflation, which was negative for much of 2020, reached double digits in 2021, due to rising crude oil prices. The government introduced a temporary price cap on motor fuel between November 2021 and July 2022. Since residential energy is supplied at regulated prices to households and these remained unchanged in 2020 and 2021, the recent higher prices on European wholesale gas and electricity markets have had no direct effect on consumer prices yet. Instead, the higher wholesale price have been absorbed by the (mostly state-owned) utility sector, creating a fiscal burden. However, the wholesale energy price increases have had an indirect impact on consumer prices, through the rising costs of companies.

Processed food price inflation accelerated in 2021, reflecting adverse commodity price developments. The price of processed food was also affected by successive increases of the excise duty on tobacco. As of 1 February 2022, the government introduced a temporary price cap on some basic food items in effect until July 1, 2022.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) eased slightly to 3.2% in March 2021 due to the COVID-19 crisis, but then increased to 9.2% in April 2022, signalling broad-based price increases in the wake

Table 5.1:

Hungary - Components of inflation

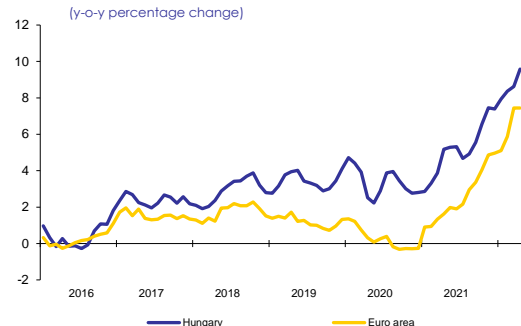
	(percentage change) ¹⁾							weights in total
	2016	2017	2018	2019	2020	2021	Apr-22	2022
HICP	0.4	2.4	2.9	3.4	3.4	5.2	6.8	1000
Non-energy industrial goods	1.0	0.4	0.4	1.1	1.2	3.2	5.0	255
Energy	-3.7	4.2	4.8	0.5	-3.2	12.4	13.2	113
Unprocessed food	0.0	1.4	6.4	7.0	12.9	2.1	5.7	55
Processed food	1.0	4.0	4.1	5.7	5.9	6.6	8.2	265
Services	1.8	1.9	2.4	4.0	3.8	3.8	5.2	312
HICP excl. energy and unproc. food	1.4	2.1	2.3	3.7	3.7	4.5	6.0	832
HICP at constant tax rates	0.6	2.9	3.4	3.2	3.3	4.7	6.5	1000
Administered prices HICP	0.3	0.3	0.3	1.0	0.3	0.9	2.0	119

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

Source: Eurostat, European Commission calculations.

of the reopening of the economy after the pandemic, and also related to the indirect effects of the energy price increases. Rising excise duties on tobacco added to inflation in 2020 and 2021.

Graph 5.2: Hungary - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

The prices of non-energy industrial goods have been on the rise following the currency depreciation that has taken place since early 2020. More recently, supply chain disruptions and rising commodity prices further exacerbated these trends leading to increases in producer and consumer prices of industrial goods.

Overall, service inflation increased in 2020-2021 due to the rapid recovery of consumer demand, fast wage growth and rising energy costs. However, this figure has to be taken with some caution. The measurement of service prices was temporarily disrupted by the pandemic-related restrictions on economic activity in spring 2020, because the prices of several services could not be

observed. Service inflation was also affected by various government measures ⁽⁷¹⁾.

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Hungary's economy rebounded swiftly after the pandemic-induced recession. After contracting by 4.7% in 2020, real GDP rose by 7.1% in 2021. The strong recovery was partly due to the limited restrictions related to the COVID-19 crisis after spring 2020, and strongly accommodating fiscal and monetary policies in 2021. Private consumption was boosted by strong wage and employment growth. Fiscal stimulus measures included the refund of 2021 personal income tax payments to families with children in February 2022, the reintroduction of the 13th month's pension in 2021-2022 and wage increases in the public sector. Business investment was spurred by strong demand, low financing costs and investment subsidies from the budget. Public investment also remained high. Exports recovered after their sharp contraction in spring 2020, but they were hampered by supply chain disruptions from the second half of 2021.

Hungary's economic prospects are strongly affected by Russia's war of aggression against Ukraine, due to Hungary's geographical proximity, its high dependence on energy imports from Russia, and its relatively strong trade links to both countries. High inflation erodes consumers' purchasing power, while investments are hindered by weaker demand, uncertainty and tighter

⁽⁷¹⁾ Examples are the temporary introduction of free parking in Budapest during the pandemic, and the extension of free school textbooks to secondary education.

financing conditions. Exports face headwinds from weaker global growth, sanctions against Russia, and recurring supply chain bottlenecks. According to the Commission's Spring 2022 Economic Forecast, GDP growth is projected slow down to 3.6% in 2022 and by 2.6% in 2023.

In 2020-2021, the government provided a large fiscal stimulus that helped to mitigate the health consequences of the COVID-19 pandemic, supported households' incomes, provided support to companies and increased public investment activity. The fiscal stance was strongly expansionary in 2021, at -3.4% of GDP⁽⁷²⁾. According to the Commission's Spring 2022 Economic Forecast, which is based on a no policy change assumption, the fiscal stance will continue to be broadly neutral in 2022 (at -0.1% of GDP). The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to decrease by 1.0 percentage point of GDP compared to 2021 due to expected slowdown in the EU funds absorption⁽⁷³⁾. At the same time, the growth in nationally-financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of 0.4 percentage points to the overall fiscal stance. This includes the additional impact of the measures to address the economic and social impact of the increase in energy prices (0.1% of GDP) as well as the costs to offer temporary protection to displaced persons from Ukraine (0.2% of GDP). The no policy-change forecast for 2023 shows a contractionary stance (1.9%).

Monetary policy, conducted within an inflation targeting framework⁽⁷⁴⁾, began tightening in summer 2021 in response to rising inflation after the use of many policy instruments had ensured abundant liquidity in response to the COVID-19

crisis, in particular via FX liquidity swaps⁽⁷⁵⁾ and long-term collateralized loans, asset purchase programs and funding schemes. The base rate⁽⁷⁶⁾, which had been cut by 30 basis points in the first half of 2020, increased from 0.6% to 5.4% between June and April 2022. Since this instrument is limited in size, monetary conditions are rather influenced by the interest rate on the one-week deposit rate, which is available without limit. The one-week deposit rate was raised from 0.75% to 6.45% between June 2021 and April 2022.

The central bank also took steps to reduce the excess liquidity in the financial sector, particularly to improve the transmission of higher interest rates to the currency market. The FX swap tenders that boosted forint liquidity were discontinued from November 2021. On the other hand, on March 28, in relation to the Russia's invasion of Ukraine, the ECB has decided to extend its temporary bilateral repo line to the central bank of Hungary, which was due to expire at the end of March 2022, even if the size of the agreement will remain unchanged. By the end of 2021, the central bank also phased out its unconventional monetary policy instruments, such as government and corporate bond purchases and subsidised lending to small and medium sized enterprises.

Wages and labour costs

Domestic employment declined by 4.7% in the second quarter of 2020, but recovered quickly in line with the rebound of output. The employment rate rose to a historically high 78.8% in 2021, while the unemployment rate remained at 4.1%.

⁽⁷²⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding COVID-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

⁽⁷³⁾ The Commission has not yet assessed the Recovery and Resilience Plan for Hungary. The figures in the text are based on the projections by the European Commission.

⁽⁷⁴⁾ As explained below, the Hungarian central bank set a target inflation of 3% with a symmetric tolerance band of 1%.

⁽⁷⁵⁾ Given the limited effectiveness of the base rate explained in the next footnote, the MNB, in order to loosen monetary conditions by boosting liquidity, offered to banks the possibility to use swaps to buy forint in exchange for foreign currency from 2016 until 2021. The forints then entered the money market providing liquidity and lowering market rates. Indeed market rates were well below the base rate until March 2020. Moreover, to support the liquidity in euros where needed, the MNB offered to banks the possibility to use swaps to buy foreign currency for forint on short maturities, to help them meet the regulatory requirements on FX position and liquidity at the end of each quarter. It should be noted that the MNB, in order to support FX liquidity for the companies and bank in need of foreign currency, has also established repo agreements with the ECB and they function in a similar manner to FX support in many countries.

⁽⁷⁶⁾ The main policy instrument used by MNB is the 3-month deposit, a liability of the central bank, and the base policy rate is the rate on 3-month central bank deposits. The size of the deposit is limited. Therefore, this instrument has limited effectiveness in controlling market liquidity and other instruments become necessary, among which the FX liquidity swaps discussed above.

After a temporary decrease in 2020, the number of vacancies returned to earlier levels by the end of 2021.

The growth of labour costs slowed down sharply in 2020 partly reflecting the lower number of hours worked. They rose again in 2021 as these temporary factors were reversed and labour shortages began to re-emerge. Wage growth is projected to remain strong in 2022 on the back of a 20% minimum wage rise, and salary increases in the public sector. Wage growth in manufacturing and services could diverge, with manufacturing wages held back by trade and supply chain disruptions, while service sector wages lifted to a larger extent by the minimum wage increase and also boosted by strong domestic demand in 2022. Employers' social contributions were cut by 2 percentage points in 2020, and by another 4 percentage points in 2022. However, the economic slowdown is forecast to lead to lower employment and wage growth in 2023.

Labour productivity, measured in terms of GDP per worker, declined temporarily in 2020 because of labour hoarding during the economic downturn, but this trend was reversed in 2021 as the recovery gathered steam. These trends led to a fast growth of unit labour cost in 2020 (despite slowing wage growth), followed by a slowdown in 2021. Large wage increases are expected to boost unit labour cost again in 2022, but the cooling of the labour market is projected to moderate ULC growth again in 2023.

External factors

Due to the high degree of openness of the Hungarian economy, developments in import prices play an important role in domestic price formation. Import prices contributed to inflation in 2020 and 2021, first due to the pass-through of currency depreciation, and later reflecting the rise of global commodity prices. The forint's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated by 6.3% in 2020, and by a further 1.3% in 2021.

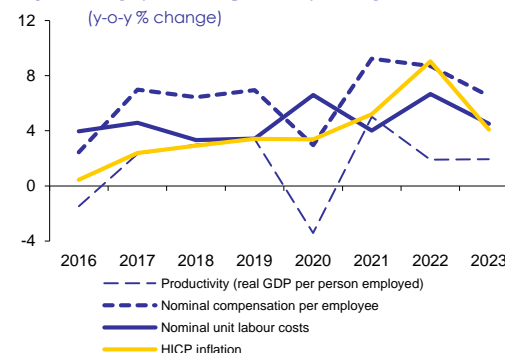
Administered prices and taxes

The share of administered prices in the Hungarian HICP basket (12.4%) is somewhat below the euro area average. The share has decreased over past years because many administered prices, notably for residential energy and other utilities, have remained unchanged for several years.

Administered prices increased by 0.3% in 2020 and 0.9% in 2021. Overall, administered prices had a minor effect on headline inflation, contributing between 0-0.1 percentage point in 2020 and 2021.

Changes in indirect taxation increased headline inflation by 0.1 percentage point in 2020 and by 0.5 percentage point in 2021. This is mainly due to rising on excise duty on tobacco.

Graph 5.3: Hungary - Inflation, productivity and wage trends
(y-o-y % change)



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

Furthermore, the excise duty on motor fuel temporarily rose in 2020 when the crude oil price fell persistently below 50 USD/barrel. This increase was reversed in 2021, in line with the legislated formula for the excise duty. The excise duty on motor fuel was reduced further in two steps in February and March 2022. This measure is set to remain in effect until the expiration of the price cap on motor fuel currently foreseen on 1 July 2022.

Medium-term prospects

According to the Commission's Spring 2022 Economic Forecast, inflation is forecast to remain high in 2022, reaching 9.0% on average. It is then projected to ease to 4.1% in 2023, once the pass through of commodity price increases to consumer prices is completed and slowing demand begins to weigh on core inflation. Inflation is projected to return to the central bank's target towards the end of 2023.

Energy-related policy measures have a significant impact on inflation in 2022. In April 2022, the price cap on petrol and gasoline was estimated to be on average 22% below the levels warranted by market conditions, reducing inflation by approximately 1.5 percentage point in April. The price cap on certain food items lowered inflation

Table 5.2:

Hungary - Other inflation and cost indicators

(annual percentage change)

	2016	2017	2018	2019	2020	2021	2022 ¹⁾	2023 ¹⁾
HICP inflation								
Hungary	0.4	2.4	2.9	3.4	3.4	5.2	9.0	4.1
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Hungary	1.0	3.3	3.3	4.6	3.3	6.3	9.0	4.1
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Hungary	2.4	7.0	6.4	6.9	3.0	9.2	8.7	6.5
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Hungary	-1.5	2.3	3.0	3.4	-3.4	5.0	1.9	1.9
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Hungary	4.0	4.6	3.3	3.4	6.6	4.0	6.7	4.5
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Hungary	-2.5	1.9	4.0	1.2	2.7	11.7	10.4	-1.7
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

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

further, although the weight of the affected products is smaller in the HICP basket.

There are upside risks to the inflation outlook. The current level of administered residential energy prices creates significant losses in the largely state-owned utility sector. If wholesale energy prices remain persistently high, the pressure to raise consumer prices could also increase significantly. The tight labour market and high inflation expectations are further sources of inflationary risk even if this was not visible yet.

The level of consumer prices in Hungary stood at about 63% of the euro area average in 2020, with the relative price gap larger for services than for goods. This suggests that there is significant potential for price level convergence in the long term, as GDP per capita in PPS (72.4% of the euro area average in 2021) increases towards the euro area average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably in the non-traded sector and on the success with anchoring inflation expectations at the central bank's 3% target.

5.3. PUBLIC FINANCES

5.3.1. Recent fiscal developments

The general government deficit remained high over the 2020-2021 period, reaching 7.8% of GDP in 2020 up from 2.1 in 2019, before declining somewhat to 6.8% of GDP in 2021.

Revenues as a share of GDP remained broadly stable in 2020 at 43.4% but dropped to 41.1% in 2021. The considerable decline in the revenue ratio in 2021 reflects largely the impact of deficit-increasing recovery measures, such as a permanent cut in employers' social contribution rate, a one-off refund of income tax to families in early 2022, a lowering of the VAT rate for newly built houses and a cut in business tax. The expenditure-to-GDP ratio surged to 51.2% in 2020, from 46% in 2019, due to increased discretionary spending and lower GDP (denominator effect). The nominal growth of expenditure moderated in 2021 but the ratio remained at 47.9%, significantly above the pre-crisis level. The increase in expenditure in 2020 reflected the introduction of temporary emergency measures in response to COVID-19 crisis (4.5% of GDP) and additional spending from the Country Protection Fund. In 2021, spending was gradually directed away from the COVID-related measures (only 0.6% of GDP in 2021) and towards recovery measures (0.4% of GDP).

Table 5.3:

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

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022¹⁾	2023¹⁾
General government balance	-1.8	-2.5	-2.1	-2.1	-7.8	-6.8	-6.0	-4.9
- Total revenue	45.0	44.3	44.0	43.9	43.4	41.1	41.3	41.4
- Total expenditure	46.8	46.7	46.1	46.0	51.2	47.9	47.3	46.4
of which:								
- Interest expenditure	3.1	2.6	2.3	2.2	2.3	2.3	2.7	3.0
p.m.: Tax burden	39.2	38.0	36.9	36.5	36.2	33.8	35.0	34.9
Primary balance	1.3	0.2	0.2	0.1	-5.5	-4.4	-3.3	-1.9
Fiscal stance ²⁾					1.4	-3.4	-0.1	1.9
Government gross debt	74.8	72.1	69.1	65.5	79.6	76.8	76.4	76.1
p.m: Real GDP growth (%)	2.2	4.3	5.4	4.6	-4.5	7.1	3.6	2.6

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

The 2021 budgetary outturn was below the 7.5% GDP deficit target set in the 2021 Convergence Programme essentially due to stronger-than expected growth, and this despite significantly higher expenditure. The real GDP growth of 7.1% was well above 4.3% expected in the Convergence Programme. The stronger-than-expected rebound in economic activity was broad-based, with investments and exports considerably exceeding expectations. However, the additional fiscal space generated by higher revenues and higher denominator were offset by higher-than-projected expenditure, especially on social benefits, intermediate consumption and compensation of employees. Additionally, following the submission of the Convergence Programme, the authorities also extended some of the temporary tax relief measures and introduced new expansionary measures such as a refund of income tax to families in early 2022 and a one-off income support for self-employed.

The government debt-to-GDP ratio rose from 65.5% in 2019 to 79.8% in 2020 and stabilised at 76.8% by the end of 2021. The increase in 2020 was driven mainly by the high primary balance and debt-increasing stock-flow adjustment due to growing fiscal reserves in the form of government deposits held by the central bank. In 2021, the debt-decreasing impact of high GDP growth and inflation was largely offset by the high budget deficit.

5.3.2. Medium-term prospects

The 2022 budget was adopted by the Hungarian Parliament on 15 June 2021. It targeted a headline deficit of 5.9% of GDP, and included emergency reserves of 0.4% of GDP to cover potential slippages based on risk scenarios. As in 2021, the 2022 budget included large budgetary reserves to finance additional investment activity and support the economic recovery, notably appropriations for the Investment Fund and Economic Restart programmes. The budget allowed for the continuation of several debt-increasing spending measures such as subsidies for housing renovation for families (0.3% of GDP), partial reinstatement of the 13th month's pension and increase in doctors' wages (0.8% of GDP). It also envisaged new tax measures, notably further cuts to employers' social contributions (0.3% of GDP) and exemption from personal income tax for those under 25 years old (0.2% of GDP).

Since the adoption of the budget, several new measures have been introduced by government decrees on the back of better-than expected growth. Those include further cuts to social security contributions and the abolition of the training levy (0.9% of GDP), a full reinstatement of the 13th month's pension already in 2022 (0.6% of GDP), and a service benefit for military and law enforcement employees brought forward to 2022 (0.4% of GDP). In late 2021, amid rising macroeconomic uncertainty, the government revised the deficit target from 5.9% to 4.9%. The achievement of the lower deficit target was

supported by the decision to postpone investment projects in the size of 1.3% GDP, notably those funded by the Investment Fund.

The government deficit in 2022 is also impacted by the fiscal costs of the measures taken by the government to counter the social and economic impact of the increase in energy prices, as well as the provision of humanitarian assistance to refugees from Ukraine. These measures mainly consist of permanent price caps on retail gas and electricity prices, a temporary cut in excise duties on fuels, a temporary cap on fuel prices and compensations for independent petrol stations.

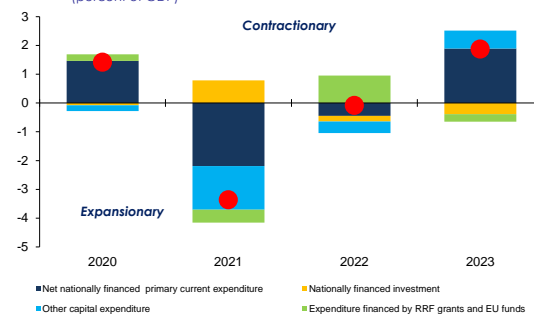
On 29 April 2022, Hungary submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to decline steadily to 4.9% of GDP in 2022 and 3.5% in 2023. The government deficit in 2022 is impacted by the introduction of several expansionary measures, notably the full re-introduction of the 13th monthly pension, a one-off service benefit for military and law enforcement employees, cuts to social security contributions and abolition of the training levy.

Based on the Commission's Spring 2022 Economic Forecast, the deficit is projected to decrease to 6.0% of GDP in 2022, above the official target set out in the 2022 Convergence Programme reflecting the introduction of several expansionary measures and additional spending related to high energy prices. According to the Commission's Spring 2022 Economic Forecast, the fiscal stance is projected to be broadly neutral in 2022 at -0.1% of GDP⁽⁷⁷⁾. The contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to be contractionary at 1.0% percentage point of GDP in 2022, compared to the contribution of -0.4% in 2021. Nationally financed investments are projected to provide a slightly expansionary contribution to the fiscal stance of -0.2 percentage point of GDP in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of -0.4 percentage point of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, most of this expansion

is due to measures related to the energy crisis (1.2% of GDP) and the humanitarian aid for people fleeing Ukraine (0.2% of GDP). The measures in response to rising energy prices mainly consist of permanent price caps on retail gas introduced in and electricity prices introduced in 2013, a temporary cut in excise duties on fuels, a temporary cap on fuel prices and compensations for independent petrol stations. The large fiscal impact of the energy measures in the Commission's Spring 2022 Economic Forecast stems from the assumption that the losses of the utility companies resulting from the regulated energy prices are compensated by the government with capital transfers at the end of the year. All measures other than the permanent price caps on retail gas and electricity prices have been announced as temporary. Some of these measures are not targeted in nature, notably the general price cap on retail prices of energy and cuts in excise duties.

The phasing out of several temporary measures and an expected overall decrease in nationally financed current expenditure in 2023 will contribute to a strongly contractionary fiscal stance of 1.9% of GDP in 2023.

Graph 5.4: Hungary - Fiscal stance and its components
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

The contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to be expansionary at -0.3 percentage point of GDP in 2023. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of -0.4 percentage point of GDP, whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 1.9 percentage point of GDP to the overall fiscal stance in 2023.

Based on the Commission's Spring 2022 Economic Forecast, the general government debt is

⁽⁷⁷⁾ For a definition of the fiscal stance used in this report, see footnote in in Section 5.2.3 on underlying factors and sustainability of inflation.

set to decrease gradually from 79.2% of GDP in 2021 to 76.4% in 2022 and 76.1% in 2023. The 2022 Convergence Programme projects a more rapid decline in the debt-to-GDP ratio to 76.1% in 2022 and 73.8% in 2023. The difference is driven by higher primary deficit in 2023 in the Commission's forecast.

Debt sustainability risks appear medium over the medium run. Government debt is projected to decrease reaching around 73% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -1.4% of GDP, which is close to its 2019 level.

The sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the projected improvement in the structural primary balance in 2022-2023 were to occur, the projected debt ratio in 2032 would be close to 13 percentage points of GDP higher than in the baseline, and would not be on a decreasing path anymore.

Some factors mitigate risks, including the lengthening of debt maturity in recent years (although it remains relatively low), relatively stable financing sources (with a diversified and large investor base) a stable and moderate share of government debt denominated in foreign currency and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis ⁽⁷⁸⁾.

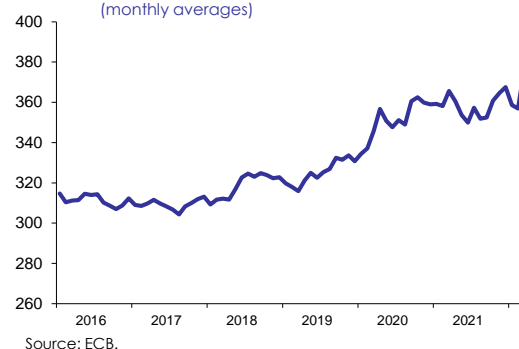
In recent years, the Hungarian fiscal framework has seen certain improvements. With reforms starting after 2011, the national fiscal rules were brought more in line with EU requirements, for example on the way the public debt ratio is calculated. The national Hungarian debt rule was later reformed in order to include a stronger role for the Fiscal Council (Hungary's independent fiscal institution) in ensuring compliance with the debt rule. In some cases however, the role of the Fiscal Council in shaping fiscal policies could be reinforced, in particular when it comes to ex-post evaluations and endorsement of the budgetary forecasts. The medium-term budgetary framework has been further developed since 2011, but could

still be improved in order to reduce the volatility of the medium-term plans. The link between the targets in annual budgets and the medium-term framework can be strengthened, as well as the involvement of the independent fiscal institution and national parliament in the preparation of this medium-term framework.

5.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. Between mid-2001 and early 2008, the MNB operated a mixed framework that combined an inflation target with a unilateral peg of the forint to the euro, with a fluctuation band of +/-15%. On 26 February 2008, the exchange rate band was abolished and a free-floating exchange rate regime was adopted that however allows for foreign exchange interventions by MNB. In March 2015, a +/-1 percentage point ex ante tolerance band was designated around the continuous medium-term inflation target of 3 percent (that is in place since 2005).

Graph 5.5: Hungary - HUF/EUR exchange rate
(monthly averages)



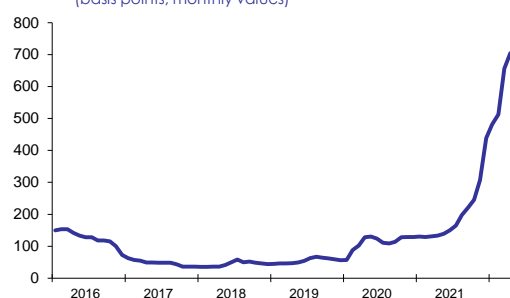
The long-term depreciation tendency of the last years continued in 2020 and 2021. In particular, a steep depreciation movement of the forint against the euro started in spring 2019, when the forint traded below 320 HUF/EUR, following the MNB signal to keep loose monetary conditions longer than other regional central banks. As a result of the COVID-19 crisis, it continued until October 2020 when the forint surpassed the 360 HUF/EUR. Afterwards, the forint oscillated around this value until Russia's invasion of Ukraine in February 2022. After the invasion, the forint initially depreciated strongly to near 400 HUF/EUR but it then returned to the range of 370-380 HUF/EUR after the central bank raised interest rates further. In April 2022 it traded against the euro on average at about 375 HUF/EUR.

⁽⁷⁸⁾ For further details see the 2021 Fiscal Sustainability Report.

International reserves held by the MNB that had already reached around EUR 28bn end-2019, moved above EUR 30bn mid-2020 and above EUR 38bn in September 2021. International reserves were lifted by successive foreign currency bond issuances, EU fund inflows and an increase in special drawing rights by some EUR 2.3 bn in August 2021. At the same time, the outstanding stocks of liquidity-providing FX swaps in euros are gradually unwinding, which reduces the international reserves at the central bank ⁽⁷⁹⁾. International reserves, decreased to EUR 34bn in April 2022, which corresponded to about 22% of GDP.

Short-term interest rate differentials vis-à-vis the euro area increased substantially after the beginning of the COVID-19 crisis, when the previous upward movement was strongly accentuated. The spread trespassed the 100 basis points in March 2020, to reach the 130 basis points two months later. After a temporary decrease in summer 2020, the spread started increasing again and it came back to 130 basis point in January 2021. There it stabilized until June 2021 when it started increasing steeply, with euro area 3-months rates remaining at around -0.55% while the 3-months Bubor was increasing very fast, reflecting the rapid tightening of monetary policy and later the interventions following Russia's invasion of Ukraine. The spread continued reached 705 basis points in April 2022.

Graph 5.6: Hungary - 3-M Bubor spread to 3-M Euribor
(basis points, monthly values)



Source: National Bank of Hungary, Eurostat and Thomson Reuters.

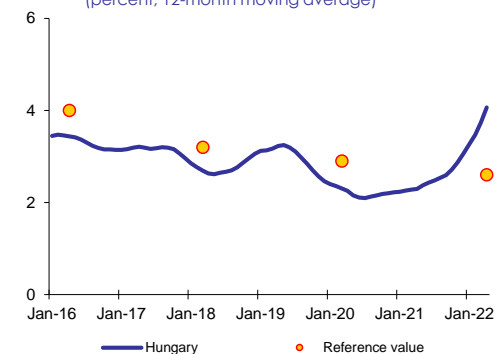
5.5. LONG-TERM INTEREST RATES

The long-term interest rate in Hungary used for the convergence assessment reflects the secondary

market yields on a single benchmark bond with a residual maturity of about 10 years.

The Hungarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2020 convergence assessment of Hungary. It decreased from the 3.3% of May 2019 to reach 2.1% in July 2020 and then started to increase again. In April 2022, the latest month for which data are available, the reference value, given by the average of long-term interest rates in France, Finland and Greece, plus 2 percentage points, stood at 2.6%. In April, the 12-month moving average of the yield on the Hungarian benchmark bond stood at 4.1%, i.e. 1.5 percentage points above the reference value.

Graph 5.7: Hungary - Long-term interest rate criterion
(percent, 12-month moving average)

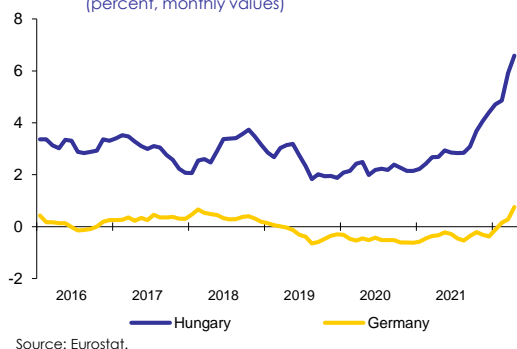


Source: European Commission.

The long-term interest rate of Hungary, which stood just around 2.0% in January 2020, peaked in April at 2.5% and has been oscillating below this level until January 2021, reflecting also the monetary easing conducted by major central banks. Hungary's long-term interest rate started increasing again in 2021, in particular since September 2021, reflecting the tightening of monetary policy, to surpass 4% in November. This mirrored the rapid tightening of monetary policy and accelerating inflation pressures in Hungary.

⁽⁷⁹⁾ The reduction concerns the swaps used by banks to buy forint in exchange for foreign currency from 2016 until 2021.

Graph 5.8: Hungary - Long-term interest rates
(percent, monthly values)



The increase in long-term rates continued, and accelerated further since March 2022, on the back of Russia's invasion of Ukraine. The long-term rate reached 6.6% in April 2022. Despite the slight increase of rates on the German benchmark bond over the same period, the long-term spread vis-à-vis the German benchmark bond increased over the last two years and reached 584 basis points in April 2022.

5.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic

integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, as well as product, labour and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In November 2021, the Commission published its latest Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which highlighted issues related to unit labour costs, government debt financing and the housing market in Hungary. Unit labour cost growth is projected to pick up after the pandemic, as productivity growth continues to lag behind substantial wage rises that are driven by the tightening labour market and administrative measures. Although the maturity of government debt increased, the gross financing need remains high, which could create risks if global financing conditions deteriorate. Real house prices continued to grow after the pandemic, supported by various government subsidies for home buying. A debt moratorium was introduced during the pandemic and a temporary cap on mortgage rates in the first half of 2022. They both expire on 1 July 2022. The phase-out of these measures could pose challenges

Table 5.4:

Hungary - Balance of payments

(percentage of GDP)

	2016	2017	2018	2019	2020	2021
Current account	4.5	2.0	0.2	-0.7	-1.0	-2.9
of which: Balance of trade in goods	3.4	1.4	-1.7	-2.5	-0.9	-2.5
Balance of trade in services	5.3	5.5	5.9	4.9	2.9	3.2
Primary income balance	-2.6	-3.9	-3.7	-2.5	-2.5	-3.0
Secondary income balance	-1.5	-0.9	-0.4	-0.5	-0.6	-0.7
Capital account	0.0	0.8	2.3	1.9	2.0	2.5
External balance ¹⁾	4.5	2.8	2.5	1.2	1.0	-0.4
Financial account	3.0	1.4	0.8	0.2	-1.7	-3.1
of which: Direct investment	-2.3	-1.6	-2.2	-0.2	-1.9	-1.3
Portfolio investment	4.2	3.0	-0.1	1.0	-1.9	0.2
Other investment ²⁾	6.4	0.0	0.5	-0.8	-2.4	-4.4
Change in reserves	-5.3	0.0	2.7	0.2	4.5	2.4
Financial account without reserves	8.3	1.4	-1.9	0.0	-6.2	-5.5
Errors and omissions	-1.5	-1.4	-1.7	-0.9	-2.7	-2.7
Gross capital formation	21.5	23.1	26.8	28.5	27.3	30.6
Gross saving	25.7	24.7	26.8	27.6	26.2	27.7
Net international investment position	-59.0	-54.4	-50.7	-49.1	-48.9	-44.8

1) The combined current and capital account.

2) Including financial derivatives.

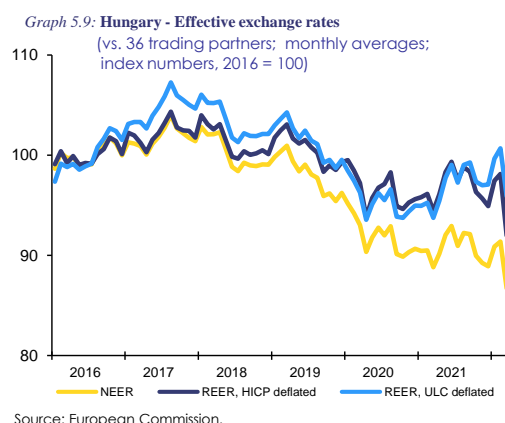
Sources: Eurostat, European Commission calculations, Magyar Nemzeti Bank.

for some borrowers and thus for the banking sector whose tier-1 capital ratio is lower than the EU average. The profitability of banks is also affected by increasing funding costs and losses on their government bond holdings due to the rise in yields. Some Hungarian banks have Russian and Ukrainian exposures either directly or through their parent companies, and this might also weigh on the banking sector's profitability and capital situation. However, since overall risks remained limited, no In-Depth Review (IDR) was warranted.

Hungary submitted its Recovery and Resilience plan on 11/05/2021. The submitted plan has a total allocation of EUR 7.175bn and contains proposed investments and reforms to strengthen primary care and hospitals, increase the capacity of suburban rail and increase renewable energy production at residential level. The plan is currently being assessed by the Commission to make sure that all assessment criteria are being fulfilled.

5.6.1. Developments of the balance of payments

According to balance of payments data, the surplus of Hungary's external balance (i.e. the combined current and capital account) turned negative in 2020. It decreased from a surplus 0.2% of GDP in 2018 to a deficit of 2.9% of GDP in 2021. Exports fell in 2020 due to the pandemic. Goods exports then staged a robust recovery until mid-2021, but they were held back by growing supply chain disruptions (e.g. semiconductor shortages) in the second half of 2021. Service exports declined more than goods exports in 2020. Their rebound in 2021 also proved slower as the pandemic hindered the recovery of international tourism. Imports decreased in 2020 but robust domestic demand led to their strong recovery in 2021. Following global energy prices, the terms of trade improved in 2020 but worsened in 2021. The primary income balance deteriorated especially in 2021, as the inward investment income flows recovered slower than outward flows. The capital account remained in surplus due to the absorption of EU funds.



Price and cost competitiveness indicators improved in early 2020 due to a nominal currency depreciation at the outbreak of the COVID-19 pandemic. Apart from some fluctuations, real effective exchange rates remained stable in the remainder of 2020 and in 2021. While the growth of ULC and consumer prices was higher in Hungary than in its trade partners, this was mostly offset by nominal depreciation over the course of 2020 and 2021⁽⁸⁰⁾. Hungary's export market share increased in 2020 and 2021.

According to the Commission's Spring 2022 Economic Forecast, which is based on national accounts data, the external balance is expected to deteriorate in 2022 and 2023. This is mainly driven by rising commodity prices, which worsen Hungary's terms of trade and swell its net energy imports that amounted to 4.4% of GDP in 2021. The current account deficit is projected to peak at 5.5% of GDP in 2022 before improving to 3.6% in 2023 due to somewhat lower energy import prices.

As the deteriorating external balance was due to higher budget deficits, it was mostly financed by the external borrowing of the government sector. The government also used freshly raised funds to bolster foreign currency reserves. Consequently, the inflows of portfolio and other investments rose in 2020 and 2021, and gross external debt rose. Meanwhile, direct investments continued to register net inflows in 2020 and 2021. The net international investment position posted slight improvements in 2020 and 2021.

⁽⁸⁰⁾ REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes.

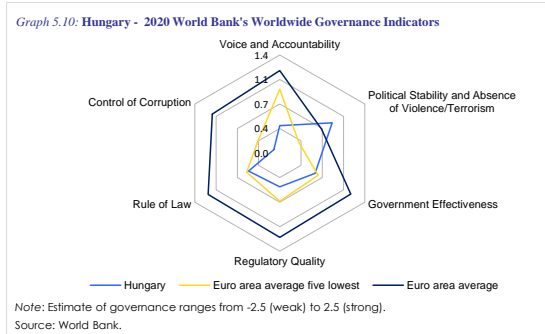
5.6.2. Market integration

Hungary's economy is highly integrated with the euro area through trade and investment linkages. The economy is strongly embedded into continental and global value chains. Trade openness increased somewhat in 2021 to 89.5%, after the strong decrease of 2020 when international trade and Hungary's exports of tourism and travel services were temporarily hit by the pandemic. Flows with the euro area dominate trade, accounting for more half of the total trade in goods and services in 2021. Hungary's main euro area goods trading partners in 2021 were Germany, Austria, Slovakia and Italy. Outside the euro area, the main trading partners were China and Poland.

The stock of FDI in Hungary amounted to about 63% of GDP in 2020 (excluding special purpose entities, 'SPEs' ⁽⁸¹⁾), with FDI mainly originating from Germany, the Netherlands and Austria. Manufacturing and services each accounted for about 45% of inward FDI, suggesting that FDI plays an important role in enhancing Hungary's export capacity and contributes significantly to economic integration with the euro area.

Concerning the business environment, Hungary performs in general worse than many euro-area Member States in international rankings, even if certain features of Hungary's business environment, such as low corporate taxes, flexible labour market regulations and the authorities' supportive attitude towards export-oriented FDI, make the country attractive for the more labour-intensive and cost-sensitive tasks within global value chains. However, Hungary scores poorly according to the World Bank's Ease of Doing Business and the Global Competitiveness Index rankings by the International Institute for Management Development ⁽⁸²⁾. According to the World Bank's Worldwide Governance Indicators (2020), Hungary ranks low in voice and accountability, and control of corruption compared with the average of the five euro area Member

States with the lowest scores. Hungary ranks higher than the average five lowest euro area Member States for political stability and absence of violence. ⁽⁸³⁾ The Commission's 2021 Rule of Law Report, elaborated on the challenges that Hungary faces in areas such as the control of corruption, judicial independence and the quality of decision-making. Shortcomings in the anti-corruption framework include the unaddressed links between businesses and political actors, such as the lack of effective checks and oversight of asset and interest declarations. Concerns remain over cases of high-level corruption. In December 2021, the government postponed the implementation of most measures in its anti-corruption strategy for 2020-22, which would have helped to more effectively detect and prosecute of corruption in public institutions and state-owned enterprises. Access to public information, which is essential for the independent oversight of decision-making and anti-corruption framework, was made more difficult by special rules introduced by Hungary during the state of danger. These issues can be particularly detrimental to innovative companies. In addition, several barriers hamper competition in services, including the large number of regulated occupations, untransparent state interventions and inefficient insolvency procedures. According to the latest data, Hungary's transposition deficit of EU Directives was at 1.0%, similar to the EU average but above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).



⁽⁸¹⁾ The Hungarian statistics introduced the notion of special purpose enterprise (SPE) for those passive financial intermediaries that have financial relations only with non-residents, and allocated them to the financial corporations sector as private financial intermediaries (S.127).” They are typically related to tax optimization by holdings. See [a-nem-penzugyi-vallalatok-penzugyi-szamlai-en.PDF \(mnb.hu\)](#), page 8.

⁽⁸²⁾ The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

⁽⁸³⁾ A Member State is considered to have a ‘low’ (‘high’) ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

Table 5.5:
Hungary - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness ¹⁾ (%)	91.9	93.3	92.5	91.1	87.9	89.6
Trade with EA in goods & services ²⁾⁺³⁾ (%)	53.1	53.2	52.3	51.7	49.8	50.5
World Bank's Ease of Doing Business Index rankings ⁴⁾	41	48	53	52	52	-
IMD World Competitiveness Ranking ⁵⁾	46	52	47	47	47	42
Internal Market Transposition Deficit ⁶⁾ (%)	0.8	0.3	0.9	0.5	1.0	-
Real house price index ⁷⁾	112.3	121.9	135.0	150.9	153.4	166.5

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Imports} + \text{Exports of goods with EA-19} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

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

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.

(November data, as of 2016 date refers to the year of publication).

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

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

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017, and Hungary notified the Commission of the adopted measures within that deadline. New measures were notified during 2019 and 2020. The Commission has analysed the communicated measures and concluded that the directive has been fully transposed. As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Hungary has notified national transposition measures and declared a partial transposition. In view of some missing transposition measures the Commission has addressed a letter of formal notice (“LFN”) to Hungary on 13/02/2020 and a Reasoned Opinion on 09/06/2021 as the reply to the LFN was not satisfactory. At the same time, new transposition measures were notified in June 2021 and the Commission is currently assessing whether they address the gaps in transposition.

The size of the financial sector, measured as the ratio of assets managed by the financial sector to GDP, is in Hungary slightly more than half of the comparable euro area average, while being less than half in 2016, indicating a faster growth than in the euro area in recent years. However, when excluding SPEs that perform no financial intermediation in the domestic economy, the size of the total financial sector grew from 162% of GDP in 2016 to 193% in 2020, indicating both a much lower level of financial development and convergence with the euro area. Taking into account this correction, Hungary can be considered similar in terms of financial sector size to the euro area members with the least developed financial sectors.

Table 5.6:
Hungary - Allocation of assets by financial sub-sector

	HU		EA		Ratio to GDP (%) EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	335	435	722	796	177	215
Central bank	27	41	45	78	37	61
Monetary financial institutions	98	109	286	311	97	98
Other financial intermediaries	185	259	202	179	20	28
Non-MMF investment funds ¹⁾	14	14	100	127	4	5
Insurance co. and Pension Funds	12	11	90	102	18	23
Share of total (%) EA 5 smallest						
	HU		EA		2016	
	2016	2020	2016	2020	2016	2020
Central bank	8	9	6	10	21	29
Monetary financial institutions	29	25	40	39	55	46
Other financial intermediaries	55	60	28	22	11	12
Non-MMF investment funds	4	3	14	16	2	2
Insurance co. and Pension Funds	4	3	12	13	10	11

1) MMF stands for money market funds.

Source: Eurostat.

Due to the presence of SPEs, the structure of the financial sector is different from the euro area average, where the banking sector is the largest sub-sector in the financial sector. In Hungary banking accounts for a quarter of the financial sector's assets (109% of GDP), decreasing from almost 30% (98% of GDP) in 2016, against a 39% (311% of GDP) in the euro area. Other financial intermediaries, which cover SPEs, make up for 60% of total financial assets and 259% of GDP⁽⁸⁴⁾. Without SPEs, the banking sector shows a large and relatively stable weight, with around 60% of total assets in 2016 (around 160% of GDP) and 58% in 2020 (around 190% of GDP). With this correction, the financial system can be assessed as even more bank-based than the EU average. The weight of the central bank is also higher than the EU average if SPEs are excluded, as it accounted for 16% (27% of GDP) of total

⁽⁸⁴⁾ As indicated above, this likely reflects the large presence of foreign holdings in Hungary for tax optimization purposes.

non-consolidated assets in 2016, which rose to 21% by 2020 (40% of GDP).

Insurance companies and pension funds are clearly underdeveloped compared to the euro area, with assets representing 3% of total assets of the financial sector, for an amount of 11% of GDP. This is very small also compared to the countries with the smallest shares in the euro area. Since end-2016, the Hungarian sector has decreased its holdings of financial assets by 1 percentage point of GDP, while in the euro area it increased by more than 12 percentage points of GDP to reach 13% of total assets.

This structure of the financial sector is reflected in the financing of the economy, which traditionally shows relatively low intermediated and market credit to households and non-financial corporations. Funding via other equity, possibly reflecting the relevant presence of foreign holdings and SPEs in Hungary, remained at 40% of total liabilities in 2020, representing 261% of GDP. This compares to an average of 7% for the euro area (56% of GDP). Considering also the role of unlisted shares, one almost reaches 50% of total liabilities, which are not allocated via the banking sector. This is still much higher than the average euro area and compares with countries like Estonia or Cyprus.

For the rest, loans are the dominant source of funding and made up 29% of total liabilities, which represented almost 190% of GDP in 2020, posting a very large increase compared to the 25% of 2016. This figure is inflated by the presence of SPEs, and is not only reflecting loans to Hungarian households and non-financial companies. Even so, this compares to 31% in the euro area, where it represents more than 235% of GDP. Debt and equity markets relative to GDP are smaller than the respective average in the euro area and market financing (debt securities and listed shares) is relatively underdeveloped, with the market for private debt smaller than in the smallest euro area members. Equity and private-sector debt markets represent 3% and 1% of total liabilities respectively. This compares to 9% of total liabilities for both listed stocks and private-sector debt in the euro area. Government debt is also significantly lower than in the euro area.

Table 5.7:
Hungary - Financing of the economy¹⁾

	HU		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	550	647	743	770	324	335
Loans	136	189	238	236	115	112
Non-financial co. debt securities	2	3	12	15	3	4
Financial co. debt securities	5	8	74	68	11	12
Government debt securities	74	75	83	95	51	57
Listed shares	18	17	65	73	17	18
Unlisted shares	52	58	186	193	55	56
Other equity	229	261	51	56	42	48
Trade credits and advances	34	35	33	35	29	29

	HU		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	25	29	32	31	35	33
Non-financial co. debt securities	0	0	2	2	1	1
Financial co. debt securities	1	1	10	9	3	3
Government debt securities	13	12	11	12	16	17
Listed shares	3	3	9	9	5	5
Unlisted shares	10	9	25	25	18	18
Other equity	42	40	7	7	13	14
Trade credits and advances	6	5	4	5	9	9

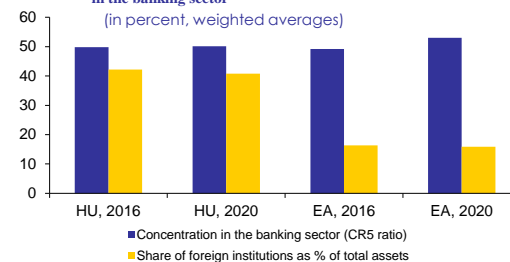
¹⁾ The table focuses on the financing needs of a country and how these are met by the financial system.

The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.

Source: Eurostat.

The Hungarian banking sector is well integrated into the euro area financial sector, posting a level of foreign ownership in its banking system that is well above the one of the euro area. The share of foreign-owned institutions in total bank assets was around 40% both in 2016 and in 2020, with the corresponding figure for the euro area being at around 16%. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, was stable at around 50% since 2016, and in 2020, a value comparable to the euro area average (53% in 2020).

Graph 5.11: Hungary - Foreign ownership and concentration in the banking sector

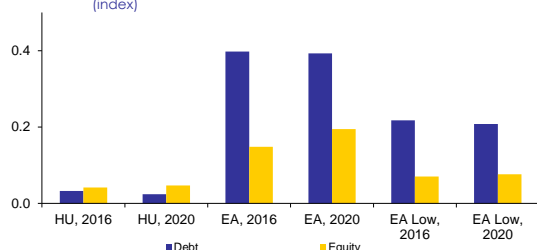


Source: ECB, Structural financial indicators.

In 2020, the banking sector in Hungary posted a Core tier 1 ratio just above 16%, one point below the average of the euro area. This ratio has been decreasing after 2018 and has been accompanied in 2020 by lower profitability. Nonetheless, it remains well above the lows of the 2010s. The ratio of non-performing loans to total loans is slightly above the euro area average but continued to decrease. For these reasons, the unfolding of the COVID-19 crisis and of the consequences of Russia's invasion of Ukraine could have a

significant impact on the financial stability and profitability indicators over the coming months.

Graph 5.12: Hungary - Intra-EU integration in equity and debt portfolio investment (index)



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

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

Measures of intra-EU integration in equity and debt markets, as based on the home bias in portfolio investments, indicate that the level of integration of Hungary is very low in both segments and in particular in debt markets.⁽⁸⁵⁾ Although intra-EU financial integration, by the same measure, is in general relatively low across EU Member States, Hungary's integration is well below also the countries where the home bias is the largest in the euro area. The very large home bias indicates that almost all investments in financial markets takes place domestically.

⁽⁸⁵⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

6. POLAND

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The main rules governing the Narodowy Bank Polski (NBP – Polish national bank, hereafter NBP) are laid down in the Act on the Narodowy Bank Polski (the NBP Act) which was adopted on 29 August 1997. The consolidated version of the NBP Act was published in Dziennik Ustaw of 2020, item 2027. The NBP Act has been slightly amended since the Commission's 2020 Convergence Report⁽⁸⁶⁾. In absence of any legislative action regarding the issues mentioned in the Commission's 2020 Convergence Report, the comments provided in the latter report are repeated also in the 2022 assessment.

6.1.2. Central Bank independence

The Polish Constitution and the NBP Act do not explicitly prohibit the NBP and members of its decision-making bodies from seeking or taking outside instructions; they also do not expressly prohibit the Government from seeking to influence members of NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB related tasks. The absence of such an explicit reference to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute or its content constitutes an incompatibility. However, the Polish Constitutional Court has recognised that the central bank's independence is based on Article 227(1) of the Constitution. In this respect, it is noted that at the occasion of a future amendment to the Polish Constitution the Polish authorities should seize the opportunity to clarify in the Constitution that the principle of central bank independence as enshrined in Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute applies. Alternatively, or in addition, the NBP Act could also be amended to ensure full compatibility with the principle of central bank independence.

The Commission recalls the recent rulings of the Polish Constitutional Tribunal which considered certain provisions of the EU Treaties incompatible with the Polish Constitution, expressly challenging the primacy of EU law⁽⁸⁷⁾. The primacy of EU law is instrumental for assessing the compatibility between the national legislation, including the statute of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB. The Commission considers that these rulings of the Constitutional Tribunal are in breach of the general principles of autonomy, primacy, effectiveness and uniform application of Union law and the binding effect of rulings of the Court of Justice of the European Union. Moreover, the Commission considers that the Constitutional Tribunal no longer meets the requirements of an independent and impartial tribunal previously established by law⁽⁸⁸⁾. It should be ensured that the primacy of Articles 130 and 131 and the Statute of the ESCB and of the ECB over national law is fully observed by Polish public authorities and courts. Article 23(1)(2) of the NBP Act provides that the NBP's Governor has, inter alia, to provide draft monetary policy guidelines to the Council of Ministers and the Minister of Finance. This procedure provides for the opportunity for the Government to exert influence on the monetary and financial policy of the NBP and thus constitutes an incompatibility in the area of independence with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Article 9(3) of the NBP Act foresees that the Governor of the NBP shall assume his/her duties after taking an oath before the Parliament. This oath refers to the observation of the provisions of the Polish Constitution and other laws, the economic development of Poland and the well-being of its citizens. The Governor of the NBP acts in dual capacity as a member of NBP's decision-making bodies and of the relevant decision-making bodies of the ECB. Article 9(3) of the NBP Act needs to be adapted to reflect the status and the obligations and duties of the Governor of the NBP as member of the relevant decision-making bodies

⁽⁸⁶⁾ The amendments stem from the Act of 31 March 2020 amending the Act on special arrangements for preventing, counteracting and combating COVID-19, other infectious diseases and crisis situations caused by them, and other laws (Dziennik Ustaw of 2020, item 568), the Act of 8 July 2021 amending the Act on the Bank Guarantee Fund, Deposit Guarantee Scheme and Resolution, and other laws (Dziennik Ustaw of 2021, item 1598) and the Act of 17 December 2021 amending the Act on Narodowy Bank Polski and the Executive Penal Code (Dziennik Ustaw of 2022, item 22).

⁽⁸⁷⁾ Polish Constitutional Tribunal, Judgment No. P 7/20 of 14 July 2021; Polish Constitutional Tribunal, Judgment No. K 3/21 of 7 October 2021.

⁽⁸⁸⁾ On 22 December 2021, the Commission launched an infringement procedure concerning the Constitutional Tribunal and its case-law; see Commission press release IP/21/7070. The procedure is ongoing.

of the ECB. Moreover, the oath does not contain a reference to central bank independence as enshrined in Article 130 of the TFEU. The oath as it stands now is an imperfection and should be adapted to be fully in line with the TFEU and the ESCB/ECB Statute.

The wording of Article 9(5) of the NBP Act containing grounds for dismissal of the NBP's Governor could lead to interpretative issues and is an imperfection. The provision would benefit from a clarification that these grounds correspond to a lack of fulfilment of conditions required for the performance of the Governor's duties or a serious misconduct of which the Governor has been guilty, as set out in Article 14.2 of the ESCB/ECB Statute.

The State Tribunal Act⁽⁸⁹⁾ provides for the suspension of the Governor from his/her duties following a procedure, which raises questions regarding its compatibility with the principle of central bank independence and Article 14.2 of the ESCB/ECB Statute. Pursuant to the second sentence of Article 11(1) of the State Tribunal Act read in conjunction with its Articles 3 and 1.1(3), the Governor of the NBP can be suspended as a result of an indictment by the Parliament for violating the Constitution or an act of law when performing his/her duties even before the State Tribunal has delivered its judgment on the removal from the office. While suspending a Governor for the purpose of a (criminal) investigation may be necessary, the Governor concerned should be able to bring an action for annulment of a temporary measure before the Court of Justice of the European Union (CJEU) pursuant to Article 14.2 of the ESCB/ECB Statute. The purpose of such action is to enable the CJEU to verify that a temporary prohibition of performing a Governor's duties is taken only if there are sufficient indications that he/she has engaged in serious misconduct capable of justifying such a measure⁽⁹⁰⁾. Such a guarantee is a reflection of the principle of central bank independence and of great importance, especially in case of a suspension from office on grounds of serious

misconduct further to an indictment by a parliamentary body depriving the Governor of the possibility to continue exercising the duties. In the absence of any clear reference in the NBP Act or Constitution to the principle of central bank independence the NBP Act would benefit from an explicit clarification that the Governor of the NBP has the possibility to seek legal redress against his/her dismissal, including suspension before the CJEU, as enshrined in Article 14.2 of the ESCB/ECB Statute.

According to Article 203(1) of Poland's Constitution, the Supreme Audit Office (Najwyższa Izba Kontroli (NIK)) is entitled to examine the NBP's activities as regards its legality, economic prudence, efficiency and diligence. The NIK controls are not performed in the capacity of an independent external auditor, as laid down in Article 27.1 of the ESCB/ECB Statute and thus, should for legal certainty reasons be clearly defined so as to respect Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Furthermore, the provision's relationship with Article 69.1 of the NBP Act is also unclear. The relevant provision of the Constitution is therefore incompatible and needs to be adapted in order to comply with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

6.1.3. Prohibition of monetary financing and privileged access

Article 42 in conjunction with Article 3(2)(5) of the NBP Act allow the NBP to extend refinancing loans to banks in order to replenish their funding and also extend refinancing to banks for the implementation of bank rehabilitation programmes, subject to conditionality under Article 42(4) of the same Act. Against this background, the current wording of Article 42(3) and (4) can be interpreted as allowing an extension of refinancing loans to banks experiencing rehabilitation proceedings which, however, could end in insolvency of the banks concerned. Effective preventive measures and more explicit safeguards should be provided in the NBP Act to clarify compatibility with Article 123 of the TFEU.

Article 43 of the NBP Act in conjunction with Articles 270 and 306 of the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring⁽⁹¹⁾ provides for NBP's

⁽⁸⁹⁾ State Tribunal Act, Dziennik Ustaw of 2019, item 2122.

⁽⁹⁰⁾ Judgment of the Court of Justice of the EU (Grand Chamber) of 26 February 2019 *Ilmārs Rimšēvičs and European Central Bank v Republic of Latvia*, Joined Cases C-202/18 and C-238/18, ECLI:EU:C:2019:139. In this ruling, the CJEU declared it has jurisdiction to hear and determine an action of annulment brought against a temporary measure like a suspension of performing duties as a Governor under Article 14.2 of the ESCB/ECB Statute.

⁽⁹¹⁾ system and forced restructuring of 10 June 2016. Consolidated version published in Dziennik Ustaw of 2020, item 842, with further amendments.

powers to grant short-term credit to the Bank Guarantee Fund related to the financing of its deposit guarantee function, if a threat to financial stability arises and in view of its urgent needs. The Bank Guarantee Fund qualifies as a “body governed by public law” within the meaning of Article 123(1) of the TFEU. The Bank Guarantee Fund is closely dependent on public sector entities referred to in Article 123(1) of the TFEU, as the majority of the members of the Bank Guarantee Fund’s Council are appointed by the Minister competent for financial institutions and the Chairman of the Financial Supervisory Authority (Article 7(4) of the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring). Therefore, the provisions laid down in the NBP Act and the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring regarding the possibility of NBP granting loans to the Bank Guarantee Fund are not compatible with the monetary financing prohibition and the relevant legal framework should be amended accordingly.

As such, there is also no direct reference to the prohibition on monetary financing in the NBP Act. While Article 220(2) of the Polish Constitution provides that the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State’s central bank, and this could be interpreted as a reference to the rationale of Article 123 of the TFEU, this provision is not compatible with Article 123 TFEU. At the occasion of a future amendment to the Polish Constitution the Polish authorities should seize the opportunity to clarify in the Constitution that the prohibition on monetary financing as enshrined in Article 123 of the TFEU and Article 21 of the ESCB/ECB Statute applies. Alternatively, or in addition, the NBP Act could be amended to ensure full compatibility with the aforementioned principle.

6.1.4. Integration in the ESCB

Objectives

Article 3(1) of the NBP Act sets the objectives of the NBP. It refers to the economic policies of the Government while it should make reference to the general economic policies in the Union, with the latter taking precedence over the former. This constitutes an imperfection with respect to Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute.

Tasks

The incompatibilities in the NBP Act and in the Polish Constitution in this area are linked to the following ESCB/ECB/EU tasks:

- limitation of the NBP's activities to the territory of the Republic of Poland (Article 2(3) of the NBP Act) and absence of a general reference to the BNB as an integral part of the ESCB (Article 227(1) of the Constitution and Article 1 of the NBP Act);
- definition and implementation of monetary policy (Articles 227(1) and (6) of the Constitution, Articles 3(2)(5), 12, 23, 38-50a, and 53 of the NBP Act);
- holding of foreign reserves; management of foreign exchange and the definition of foreign exchange policy (Articles 3(2)(2), 3(2)(3), 17(4)(2), 24 and 52 of the NBP Act);
- competences of the ECB and of the EU for banknotes and coins (Article 227(1), second sentence of the Constitution and Articles 4, 31-37 of the NBP Act). The NBP shall exercise its responsibility for issuing currency as part of the ESCB/Eurosystem;
- appointment of independent auditors - Article 69(1) of the NBP Act foresees that NBP accounts are examined by external auditors. The NBP Act does not take into account that the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the Council. It is incompatible with Article 27.1 of the ESCB/ECB Statute.

There are also some imperfections regarding:

- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 3(2)(1) of the NBP Act);
- incomplete recognition of the role of the ECB and of the EU in the collection of statistics (Article 3(2)(7) and 23 of the NBP Act);

Table 6.1:

Poland - Components of inflation	(percentage change) ¹⁾							weights in total
	2016	2017	2018	2019	2020	2021	Apr-22	2022
HICP	-0.2	1.6	1.2	2.1	3.7	5.2	7.0	1000
Non-energy industrial goods	-1.5	-1.0	-0.3	0.4	0.9	2.4	3.7	332
Energy	-3.7	2.9	3.7	0.0	-1.0	12.2	18.2	145
Unprocessed food	1.6	5.6	3.0	5.4	6.9	2.8	7.1	47
Processed food	0.7	2.7	1.8	3.7	3.9	2.7	4.5	200
Services	1.8	2.4	0.8	3.5	7.8	7.3	7.6	276
HICP excl. energy and unproc. food	0.3	1.2	0.6	2.3	4.2	4.2	5.3	808
HICP at constant tax rates	-0.2	1.6	1.2	2.1	3.5	5.1	7.8	1000
Administered prices HICP	2.1	1.2	0.8	1.2	6.7	5.9	7.0	124

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

Source: Eurostat, European Commission calculations.

- non-recognition of the role of the ECB in the field of international cooperation (Article 5(1) and 11(3) of the NBP Act).

6.1.5. Assessment of compatibility

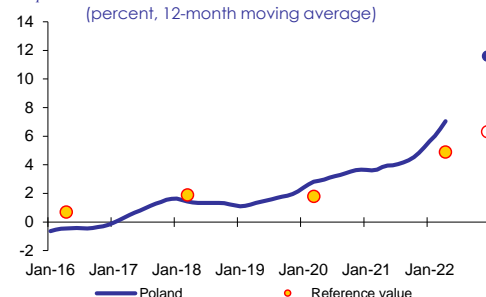
As regards the independence of the central bank, the prohibition on monetary financing and the central bank integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the NBP Act and the Constitution of the Republic of Poland are not fully compatible with the compliance duty under Article 131 of the TFEU. The Polish authorities are invited to remedy the abovementioned incompatibilities.

6.2. PRICE STABILITY

6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Poland in 2020. It then increased almost uninterruptedly to reach 3.7% by end 2020 and 5.2% by end-2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Poland was 7.0%, i.e. 2.1 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Graph 6.1: Poland - Inflation criterion
(percent, 12-month moving average)



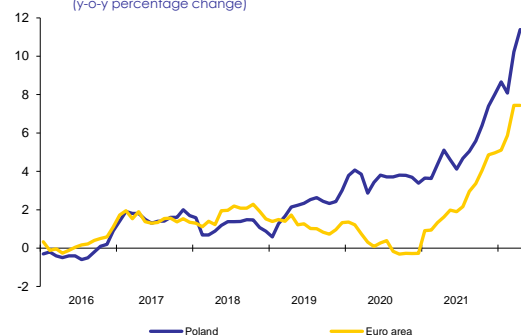
Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

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

6.2.2. Recent inflation developments

Poland recorded a significant and broad-based increase in annual HICP inflation over the past two years. Annual inflation fell to 2.9% in April following the first wave of the pandemic. It picked up to 3.8% in June and remained broadly constant until February 2021. Annual inflation then increased sharply throughout 2021, driven by rising energy and food prices as well as accelerating core inflation. Overall, headline inflation averaged 3.7% in 2020 and 5.2% in 2021. During the last two years, annual HICP inflation in Poland was consistently higher than in the euro area.

Graph 6.2: Poland - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) increased significantly in the first half of 2020, reaching 4.8% in June 2020. It remained significantly above headline inflation until February 2021, before decreasing until June 2021. Core inflation then increased steadily again, albeit staying below headline inflation, reaching 5.7% in December 2021. The upward trend on core inflation in the past two years was broadly spread across all HICP categories. Demand and supply factors such as rising wages, higher input prices and booming domestic demand following the end of the pandemic were the main contributors to this broad-based increase. Labour shortages also played a role, in particular for service inflation, which increased from 5.6% in March 2020 to 7.5% in December 2021. After several years of low inflation, prices of non-energy industrial goods also increased significantly, with annual inflation for this category reaching 4.2% in 2021, mainly due to global supply bottlenecks and rising production costs. Processed food inflation decreased steadily between March 2020 and May 2021, and then increased at a fast pace, reaching 5.7% in December 2021, reflecting increasing production costs, especially related to higher energy prices.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Following the start of the COVID-19 pandemic, Poland's real GDP dropped by 2.2% in 2020, the first recession in nearly two decades. It then rebounded by 5.9% in 2021. The main drivers of the recovery were domestic demand, in particular private consumption and investment. After a significant fall of 2.8% in 2020, private consumption recovered swiftly in 2021, growing

by 6.0%, supported by a high level of accumulated savings and a strong recovery in the labour market, which weathered the crisis well due to sizeable fiscal support. The recovery in investment was more gradual, with investment levels still below pre-crisis levels by the end of 2021. According to the Commission's Spring 2022 Economic Forecast, GDP is projected to increase by 3.7% in 2022, as the effects of the COVID-19 pandemic are expected to ease and economic activity is expected to normalize. In 2023, GDP is expected to continue decelerating, growing by a projected 3.0%.

The fiscal stance was strongly expansionary in 2020, driven by fiscal measures adopted to contain the economic impact of the pandemic, but it recovered in 2021 as the expenditure measures were partially withdrawn and revenues increased on the back of the economic recovery⁽⁹²⁾. According to the Commission's Spring 2022 Economic Forecast, the fiscal stance is expected to be supportive at -3.4% of GDP in 2022, due to growth in nationally-financed primary current expenditure, including the impact of measures compensating for high energy prices and the cost of aid to refugees.

Monetary policy, conducted within an inflation targeting framework⁽⁹³⁾ remained accommodative for most of the past two years, before tightening sharply from October 2021. The COVID-19 crisis led to a substantial monetary easing: after decreasing the policy rate twice by 50 basis points in March and in April 2020, the Monetary Policy Council (MPC) decreased the policy rate further to 0.1% in May 2020. In addition, the MPC launched the purchase of government securities and government-guaranteed debt securities on the secondary market. It also started the provisioning of additional liquidity to the banking sector through repo operations and a discount facility. Yet, as inflation accelerated, the Monetary Policy Council (MPC) increased the reference rate from

⁽⁹²⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

⁽⁹³⁾ Since the beginning of 2004, the NBP has pursued a continuous inflation target of 2.5% with a permissible fluctuation band of +/- 1 percentage point.

Table 6.2:

Poland - Other inflation and cost indicators	(annual percentage change)							
	2016	2017	2018	2019	2020	2021	2022 ¹⁾	2023 ¹⁾
HICP inflation								
Poland	-0.2	1.6	1.2	2.1	3.7	5.2	11.6	7.3
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Poland	-0.4	2.0	1.7	2.4	3.4	5.4	11.8	7.3
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Poland	4.8	5.8	8.1	7.3	5.6	5.0	9.5	8.0
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Poland	2.3	3.4	4.8	4.8	-2.1	4.4	3.3	2.7
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Poland	2.4	2.3	3.2	2.4	7.9	0.6	6.0	5.1
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Poland	-0.3	1.3	2.9	1.7	-0.4	11.5	15.5	5.0
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

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

October 2021, reaching 5.25% in May 2022, i.e. levels last seen at the end of 2008.

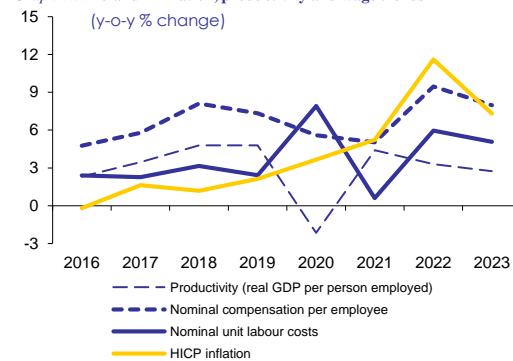
according to the Commission's Spring 2022 Economic Forecast.

Wages and labour costs

The impact of the crisis on the labour market was mostly reflected in declining hours worked, as public job retention schemes shielded employment. In line with this, the unemployment rate remained broadly stable around 3.0-3.5% for most of the past two years. As the recovery gathered pace, the labour market has been showing signs of overheating, with companies reporting significant labour shortages and wage growth rising strongly at the end of 2021 and beginning of 2022.

Labour productivity decreased by 2.1% in 2020 due to the sharp drop in economic activity following the COVID-19 crisis. It then increased sharply by 4.4% in 2021. Growth in compensation per employee decelerated in 2020 to 5.6% and to 5.0% in 2021. This translated into nominal ULC growth of 7.9% in 2020 and 0.6% in 2021. Acute labour shortages are expected to lead to a rapid increase in compensation per employee over the forecast horizon, with a projected increase of 9.5% in 2022 and 8.0% in 2023. Labour productivity is expected to continue posting strong growth rates, increasing by 3.3% in 2022 and 2.7% in 2023. This is expected to result in nominal ULC growth of 6.0% and 5.1% in 2022 and 2023, respectively,

Graph 6.3: Poland - Inflation, productivity and wage trends (y-o-y % change)



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

External factors

Although external trade represents a lower share of GDP in Poland than in regional peers like Hungary or Czechia, prices of imported goods and services play an important role in domestic price formation. After a small decrease in 2020, the imports of goods deflator raised by 11.5% in 2021, driven inter alia by an increase in global commodity prices. The zloty's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated on average by 2.1% in 2020 and 2.3% in 2021 contributing to push up import prices. Low inflation in Poland's trade partners in 2020

weighted on import price increases that year. However, as inflation accelerated in Poland's trade partners and the zloty kept depreciating in 2021, import prices excluding commodity prices also hiked. Imported inflation is forecast to increase strongly during 2022-2023.

Administered prices and taxes

The increase in administered prices, with a weight of around 12% in the HICP basket (similar to that of the euro area), was above HICP inflation both in 2020 and 2021. The average annual increase in administered prices was 6.7% in 2020 and 5.9% in 2021 against 3.7% and 5.2% for headline inflation, respectively. The fast growth of administered prices was the result of increased waste collection fees, sugar tax, capacity fees as well as higher regulated energy prices.

The impact of tax measures on overall price developments has been close to zero as constant tax inflation was in line with headline inflation in both 2020 and 2021.

Medium-term prospects

Looking ahead, inflation is expected to accelerate significantly in 2022, peaking in the first quarter of the year. Energy prices are expected to increase strongly amid a hike in regulated energy prices at the beginning of 2022, although the increase will be somewhat counterbalanced by a policy package put in place in November 2021 by the government to reduce rates paid in energy and food products. Processed and unprocessed food prices are projected to increase from mid-2022 onwards, as rising prices of fertilizers are set to increase production costs, especially for agricultural products. Core inflation is set to remain elevated on the back of acute labour shortages, which are set to put upward pressure on wage growth. The Commission's Spring 2022 Economic Forecast projects annual HICP inflation to average 11.6% in 2022 and 7.3% in 2023.

Despite a number of policy measures introduced to lower tax rates paid on certain goods, strong price dynamics are forecast to persist in 2022, mainly due to surging energy prices and unit labour costs. The inflation outlook remains highly uncertain, with risks appearing to be tilted to the upside. Wage growth is expected to be elevated over the forecast horizon, and risks of a stronger wage-price spiral cannot be ruled out, which could put significant upward pressure on core inflation.

More fiscal expansion could further fuel demand pressure and the risk of higher energy prices stemming from poor meteorological conditions could increase energy prices even further.

The level of consumer prices in Poland was at around 56% of the euro-area average in 2020. This suggests a significant potential for price level convergence in the long term, as GDP per capita in PPS (about 73% of the euro-area average in 2021) increases towards the euro-area average.

Medium-term inflation prospects in Poland will hinge upon wage and productivity trends as well as on the functioning of product markets. Further structural measures to increase labour supply, to make better use of increased labour immigration and to facilitate the effective allocation of labour market resources will play an important role in limiting wage pressures, resulting inter alia from negative demographic developments. As to product markets, there is scope to enhance the competitive environment, especially in the services and energy sectors. At the macro level, an appropriate monetary policy response to macroeconomic developments and a prudent fiscal stance will be essential to contain inflationary pressures.

6.3. PUBLIC FINANCES

6.3.1. Recent fiscal developments

The general government deficit increased sharply in 2020 to 6.9% of GDP. The economic recession triggered by the pandemic had a negative impact on public finances via two main channels: it slowed down the dynamics of the revenue due to lower economic activity, and it led to a sharp increase in expenditure. Fiscal measures to contain the economic impact of the pandemic played a significant role in this increase. They included amongst others non-refundable loans to companies, short-time work schemes, subsidies for businesses and a special allowance for parents. As a result, the total government expenditure increased from 41.8% of GDP in 2019 to 48.2% of GDP in 2020, an increase close to the EU average. However, it should be noted that in nominal terms Poland recorded a positive GDP growth in 2020, thus the increase in expenditure ratio was not driven by contracting nominal GDP. In turn, as a share of GDP the total general government revenue increased slightly as compared to 2019, despite the pandemic. In 2021, the general government headline deficit narrowed to 1.9% of

Table 6.3:

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

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022¹⁾	2023¹⁾
General government balance	-2.4	-1.5	-0.2	-0.7	-6.9	-1.9	-4.0	-4.4
- Total revenue	38.7	39.8	41.3	41.0	41.3	42.3	39.9	38.6
- Total expenditure	41.1	41.3	41.5	41.8	48.2	44.2	43.9	43.0
of which:								
- Interest expenditure	1.7	1.6	1.4	1.4	1.3	1.1	1.5	1.8
p.m.: Tax burden	34.3	35.0	36.0	36.0	36.4	37.7	35.4	34.4
Primary balance	-0.7	0.1	1.2	0.6	-5.6	-0.8	-2.5	-2.6
Fiscal stance ²⁾					0.1	1.7	-3.4	1.7
Government gross debt	54.2	50.6	48.8	45.6	57.1	53.8	50.8	49.8
p.m: Real GDP growth (%)	3.1	4.8	5.4	4.7	-2.2	5.9	3.7	3.0

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

GDP. Revenue (mainly from taxes and social contributions) increased, driven by the economic recovery, a good situation on the labour market and cyclical factors. On top of this, new taxes implemented in 2021 also contributed to the revenue growth. In turn, expenditure decreased. While the cost of fiscal measures to contain the impact of the pandemic was lower than in 2020, this was partly offset by some new expenditure items (for instance an additional one-off pension benefit payment in 2021).

The 2021 headline deficit (1.9% of GDP) turned out to be lower than forecast in the 2021 edition of the Convergence Programme (6.9% of GDP). This difference stemmed mainly from a significant decrease in public expenditure (by 4.0% of GDP) and an increase in revenues (by 1.0% of GDP).

The general government debt increased significantly in 2020, driven by a high deficit triggered by the pandemic-driven recession (see above). It reached 57.1% of GDP, as compared to 45.6% of GDP in 2019. It then decreased to 53.8% of GDP in 2021. The decrease of the debt-to-GDP ratio occurred despite a deficit of 1.9% of GDP in 2021. This is explained by a strong nominal GDP growth in 2021, reaching 12.1%. In terms of valuation effects, the falling share of Polish government debt denominated in foreign currencies was counterbalanced by weakening zloty.

6.3.2. Medium-term prospects

The 2022 budget was adopted on 17 December 2021. It targets a general government deficit of 2.9% of GDP. Following the budget law, the support to the economy to cushion the impact of the crisis will be substantially lower than in the two previous years. At the same time, while the so-called 14th pension benefit was only a one-off expenditure item in 2021, the budget law broadly assumes a continuation of major policies carried out in previous years, in particular in the area of social spending. On the revenue side, an implementation of a major tax overhaul is expected to lower the revenue from the personal income tax.

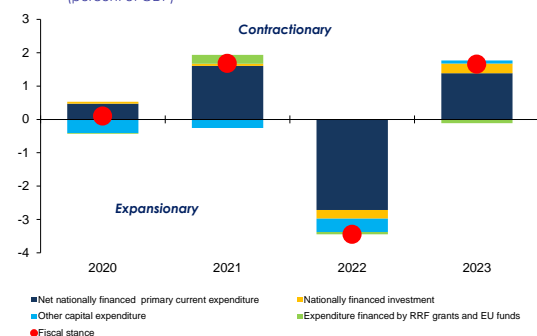
On 28 April 2022, Poland submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to increase to 4.3% of GDP in 2022 and decrease to 3.7% in 2023. The government deficit in 2022 is impacted by the additional measures taken by government to counter the social and economic impact of the increase in energy prices, as well as the humanitarian and security expenditure following the war in Ukraine. Based on the Commission's Spring 2022 Economic Forecast, the measures to cushion the impact of the increase in energy prices are estimated at 1.0% of GDP in 2022, most of which are currently expected to be temporary and to be withdrawn in 2023, while the annual cost of humanitarian assistance is assumed at 0.6% of GDP in 2022 and 0.8% of GDP in 2023.

The Programme targets a reduction of the government deficit to under 3% of GDP by 2025.

The Commission's Spring 2022 Economic Forecast, projects the general government headline deficit in 2022 at 4.0% of GDP. The deficit is set to increase to 4.4% of GDP in 2023. The ratio of general government debt to GDP is set to decrease to 49.8% in 2023. However, as above a quarter of the sovereign debt is denominated in foreign currencies, the debt projections are subject to uncertainty due to possible valuation effects.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to be supportive, at -3.4% of GDP⁽⁹⁴⁾. The positive contribution to economic activity of expenditure financed by RRF grants and other EU funds is projected at 0.1 percentage point of GDP in 2022, the first year of expected implementation of the Polish Recovery and Resilience Plan. Nationally financed investment is projected to provide expansionary contribution to the fiscal stance of -0.3 percentage points of GDP in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of -2.7 percentage points of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth.

Graph 6.4: Poland - Fiscal stance and its components (percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2023, the fiscal stance is projected to be contractionary at +1.7% of GDP. The expansionary contribution to economic activity of expenditure financed by RRF grants and other EU funds is projected to be -0.1 percentage points of GDP in 2023. Nationally financed investment is

projected to provide a contractionary contribution to the fiscal stance of 0.3 percentage points of GDP⁽⁹⁵⁾, whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 1.4 percentage points of GDP to the overall fiscal stance in 2023.

Debt sustainability risks appear low over the medium run. Government debt is projected to remain below 60% of GDP, albeit on an increasing path as from 2027, reaching around 54% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -2.3% of GDP, hence below the 2019 level.

The limited sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the improvforecastment in the structural primary balance projected for 2022-2023 were to occur, the debt ratio would be about 6 percentage points of GDP higher by 2032 compared with the baseline, reaching 60% of GDP.

Some factors mitigate risks, including the currency denomination of debt and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include a tightening of financing conditions, the share of non-performing loans and Poland's negative net international investment position⁽⁹⁶⁾.

The fiscal framework in Poland is overall strong, but recently it was slightly relaxed to take into account the pressures emerging from the COVID-19 pandemic. The numerical fiscal rules are at the centre of the framework. While the debt ceilings anchored in the Constitution cover the central government, a separate debt rule concerns local government units (LGUs). The latter rule was loosened in 2020 by allowing LGUs to exclude from their calculations liabilities equivalent to the loss of revenue linked to the pandemic; in addition, for 2020, the debt limit was lowered to 80% of the total revenue. The expenditure rule applied to the general government, which aims at preventing overspending, has been temporarily suspended, with a mechanism for an automatic return to the

⁽⁹⁴⁾ The measurement of the fiscal stance is explained in section 6.2.3 on underlying factors and sustainability of inflation.

⁽⁹⁵⁾ Other nationally financed capital expenditure is projected to provide a contractionary contribution of 0.1 percentage points of GDP.

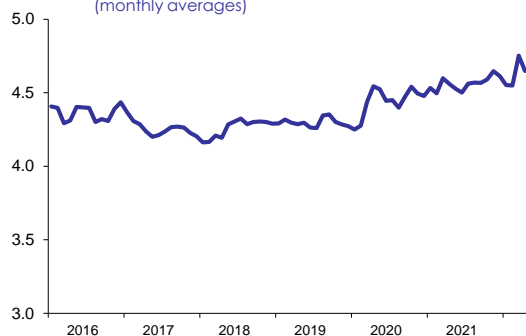
⁽⁹⁶⁾ For further details see the 2021 Fiscal Sustainability Report.

conventional rule over two to four years. Similarly, the budget balance rule applied to the LGUs has also been suspended. The constitutional debt limit was circumvented by channelling most of the pandemic economy support measures through a special off-the-budget fund. In turn, in 2021 the stabilising expenditure rule was strengthened by covering all special purpose funds but its effective implementation for the pandemic-specific fund was effectively delayed until 2022 (when a draft 2023 budget will be prepared). Medium-term budgetary planning is based on the four year Multiannual State Financial Plan, which serves as a basis for the preparation of annual budgets but does not provide targets for them. Poland does not have a fully-fledged fiscal council and activities related to the monitoring of fiscal rules are scattered among several bodies, with the Supreme Audit Office taking a more central role.

6.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. Since April 2000, Poland has been operating *de jure* a floating exchange rate regime, with the NBP preserving the right to intervene in the foreign exchange market, if it deems this necessary, in order to achieve the inflation target.

Graph 6.5: Poland - PLN/EUR exchange rate
(monthly averages)



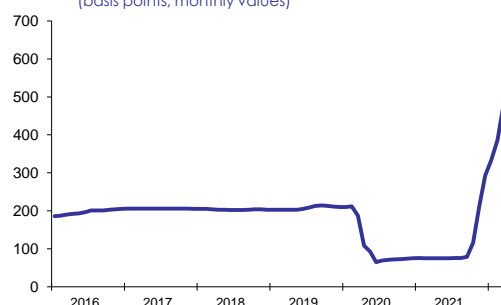
Source: ECB.

The zloty depreciated sharply after the onset of COVID-19 crisis in early 2020. This was reflected in large by the easing of monetary policy as NBP started to cut interest rates until levels unseen before and substantially enlarged amounts of open market operations. Afterwards it went through a period of fluctuations but indicated no clear trend. Tightening of the NBP's monetary policy strengthened the zloty from October 2021 up to February 2022. However, the outbreak of war in Ukraine weakened the zloty substantially as in some days in March 2022 it reached 5.0 against the

euro, i.e. the highest level for more than two decades. Moreover, at the end of March 2022 NBP entered a swap line arrangement with ECB in order to address potential euro liquidity needs.

International reserves held by the NBP increased from EUR 114 billion in early 2020 to around EUR 147 billion by end-2021. The reserve-to-GDP ratio was at around 26% at end-2021.

Graph 6.6: Poland - 3-M Wibor spread to 3-M Euribor
(basis points, monthly values)



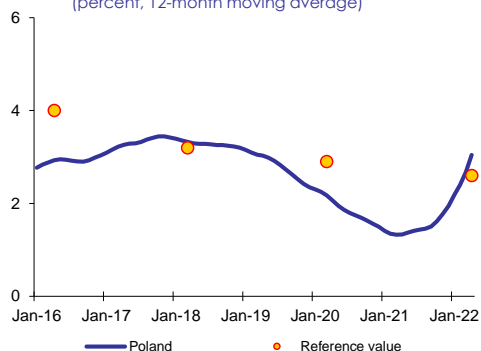
Source: Polish National Bank, Eurostat and Thomson Reuters.

Short-term interest rate differential vis-à-vis the euro area remained stable at around 210 basis points up to early 2020. In March, the NBP began to ease monetary policy and cut interest rates three consecutive times to levels unseen before. This fed into the Polish interbank market and three-month rate fell to the lowest levels on record. Changes in euro money market were more limited as the three-month euro rate picked-up only temporary in April and May and further continued its downward path to stabilise at historically low levels. Consequently, short-term interest rate differential shrank to 65 basis points in June and fluctuated at around 75 basis points until October 2021 when NBP started to tighten monetary policy. After seven consecutive increases of interest rates the short-term interest rate differential reached 593 basis points in April 2022.

6.5. LONG-TERM INTEREST RATES

Long-term interest rates in Poland used for the convergence assessment reflect secondary market yields on a single benchmark government bond with a residual maturity of around 9 years.

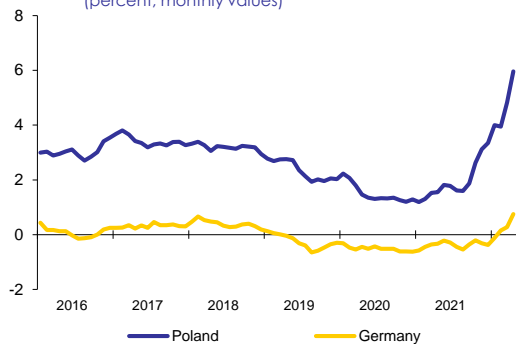
Graph 6.7: Poland - Long-term interest rate criterion
(percent, 12-month moving average)



Source: European Commission.

The Polish 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the last convergence assessment in 2020. It gradually decreased from 2.2% at that time to about 1.3% by April-2021 and started to increase reaching 2.0% by end-2021. In April 2022, the latest month for which data are available, the reference value, given by the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 3.0%, i.e. 0.4 percentage point above the reference value.

Graph 6.8: Poland - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

Developments in long-term interest rate in Poland since 2020 reflect in large part changes in the monetary policy stance of the NBP. The easing of monetary policy after the onset of the pandemic in 2020 contributed to a significant decrease of the long-term interest rates, which remained at the 1.3% level until the end of 2020. In January 2021 the long-term interest rate reached the lowest level on the record (1.2%) before starting to increase moderately until the summer. The tightening of monetary policy, which started in October 2021,

then contributed to a considerable increase in the long-term interest rate. Poland's long-term interest rate was around 6.0% in April 2022.

The long-term interest rate spread vis-à-vis the German benchmark bond narrowed strongly during the early months of the COVID-19 crisis and fluctuated around 180 basis points between April 2020 and April 2021. In mid-2021, it started to increase slightly and by October, when NBP began its tightening cycle, the spread started to widen. By the end-2021 the long-term interest rate spread reached around 373 basis points and during the first quarter of 2022 continued to widen up-to 521 basis points in April 2022.

6.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its eleventh Alert Mechanism Report (AMR 2021) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.7), which highlighted issues related to the international investment position (NIIP) and house price growth in Poland. However, since overall risks remain limited, the report concluded that no In-Depth Review (IDR) was warranted. External vulnerabilities remained contained, given that foreign direct investment accounted for a major part of foreign liabilities. The growth of house prices was strong in 2021, reaching 9.2% in the last quarter of 2021, but risks of overheating were seen as limited with price indicators suggesting almost no overvaluation. At the same time, household debt remains low at 55.3% of income. Significant labour shortages are limiting investment growth and putting upward pressure on unit labour costs, which might impact the competitiveness of Polish businesses over the medium term.

Poland submitted its recovery and resilience plan on 3 May 2021, which is equivalent to 4.5% in 2019 GDP⁽⁹⁷⁾. The plan has a total allocation of EUR 23.9 billion in grants and contains proposed

⁽⁹⁷⁾ 2019 GDP and RRP total amount in current prices.

Table 6.4:

Poland - Balance of payments		(percentage of GDP)				
	2016	2017	2018	2019	2020	2021
Current account	-0.8	-0.3	-1.3	0.5	2.9	-0.6
of which: Balance of trade in goods	0.5	-0.1	-1.2	0.3	2.4	-0.1
Balance of trade in services	3.2	3.8	4.3	4.5	4.3	4.6
Primary income balance	-4.1	-4.1	-4.0	-4.0	-3.5	-4.4
Secondary income balance	-0.3	0.0	-0.3	-0.3	-0.3	-0.7
Capital account	1.0	1.3	2.1	2.0	2.3	1.6
External balance ¹⁾	0.3	0.9	0.8	2.4	5.2	1.0
Financial account	0.3	-0.5	0.2	1.1	3.8	0.2
of which: Direct investment	-0.9	-1.4	-2.6	-2.0	-2.1	-3.6
Portfolio investment	-0.8	-0.9	0.8	2.0	1.3	1.7
Other investment ²⁾	-2.8	3.4	0.8	-0.7	1.6	-0.6
Change in reserves	4.8	-1.5	1.3	1.7	3.1	2.8
Financial account without reserves	-4.5	1.1	-1.0	-0.7	0.8	-2.6
Errors and omissions	0.1	-1.4	-0.5	-1.4	-1.4	-0.8
Gross capital formation	19.7	19.9	20.8	19.7	17.5	20.3
Gross saving	19.4	19.6	19.8	20.6	20.3	21.9
Net international investment position	-61.5	-61.2	-55.9	-49.8	-44.3	-39.9

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, National Bank of Poland.

investments and reforms to decarbonize the Polish economy, make the transport sector more sustainable, address challenges related to the investment climate, notably with regard to the Polish judicial system as well as decision- and law-making processes, improve IT connectivity and improve the resilience of the healthcare system.

6.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) stayed positive for most of 2020-2021, before turning slightly negative at the end of 2021. The current account increased visibly throughout 2020 due to a strong drop in imports, which boosted the trade balance. However, as domestic demand recovered, import growth hiked, causing the current account to turn negative from May 2021 onwards. The income balance turned even more negative over 2020-2021. The primary income balance stayed negative and deteriorated throughout 2021, partly driven by an improvement in the profitability of foreign companies. The secondary income balance remained negative and somewhat deteriorated as the high inflow of returning foreign workers,

mainly Ukrainians, led to significantly higher transfers abroad.

In the financial account of the balance of payments, the balance of direct investment stabilised in 2020 before rebounding in 2021 with a net inflow of 3.8% of GDP. The rebound was driven by a recovery of reinvested earnings, which has been the main source for new FDI inflows in recent years. In 2020, net portfolio investment recorded an outflow of 1.2% of GDP, most likely driven by non-residents' investment treasury bonds, and in 2021 it reached 1.7% of GDP. During the observed period, the other investment account switched from net outflow of 1.7% GDP in 2020 to a net inflow of 0.6% of GDP in 2021.

According to the Commission's Spring 2022 Economic Forecast, which is based on national accounts data, the external balance is expected to move into negative territory, with around -0.5% of GDP in 2022 and -0.2% in 2023.

Poland's external competitiveness has remained robust. Poland's export performance (as measured by the growth of its exports relative to its foreign markets) improved in 2020 and 2021, driven by

Table 6.5:
Poland - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness ¹⁾ (%)	51.4	53.5	54.8	54.2	53.3	59.5
Trade with EA in goods & services ²⁾⁺³⁾ (%)	29.2	30.4	31.0	30.4	30.5	33.9
World Bank's Ease of Doing Business Index rankings ⁴⁾	24	27	33	40	40	-
IMD World Competitiveness Ranking ⁵⁾	33	38	34	38	39	47
Internal Market Transposition Deficit ⁶⁾ (%)	1.5	1.4	1.0	0.8	1.8	-
Real house price index ⁷⁾	102.3	104.1	109.2	115.9	124.0	128.6

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Imports} + \text{Exports of goods with EA-19} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

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

5) International Institute for Management Development (IMD).

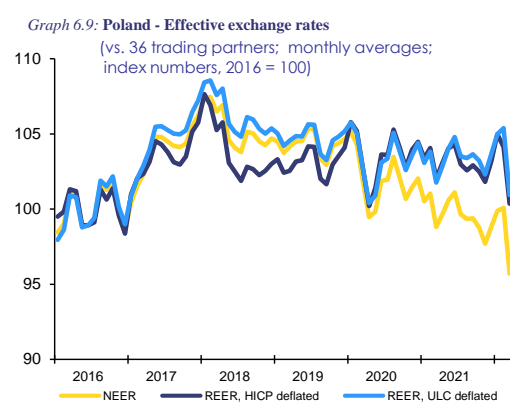
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.

(November data, as of 2016 date refers to the year of publication).

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

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

Poland's diversified export structure, which helped cushion the impact of the crisis. The nominal effective exchange rate depreciated throughout 2020 and 2021 but the real effective exchange rate remained broadly stable over the same period and can therefore not explain the good export performance⁽⁹⁸⁾.



The net international investment position (NIIP) improved significantly from -49.8% in 2019 to -39.9% in 2021. Although this remains beyond the indicative threshold set in the MIP scoreboard (-35% of GDP), external vulnerabilities remain contained, as major part of the NIIP consists of the accumulated stock of foreign direct investments.

6.6.2. Market integration

Poland's economy is well integrated with the euro area through both trade and investment linkages.

⁽⁹⁸⁾ The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Poland.

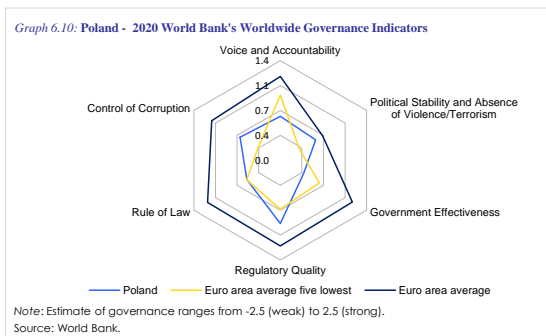
Trade openness increased from 51.4% in 2016 to 59.5% of GDP in 2021. The share of trade with euro-area partners expressed in percentage of GDP was broadly stable in recent years, although in 2021 it increased to around 34%. Poland's main goods trading partners in 2021 were Germany, China, the Netherlands, Czechia and Italy.

FDI inflows to Poland have mainly originated from the Netherlands, Germany, Luxembourg and France, which together provided nearly two-thirds of the FDI stock at the end of 2020. The significant size and growth of the domestic market as well as good access to large regional markets have supported the attractiveness of the country for FDI.

On the basis of selected indicators relating to the business environment, Poland ranks slightly below the average of euro-area Member States. In the 2020 World Bank's Ease of Doing Business index, Poland scored comparatively poorly with regard to starting a business, followed by the sub-index related to registering property⁽⁹⁹⁾. According to the World Bank's Worldwide Governance Indicators (2020), Poland ranks low in voice and accountability, and government effectiveness compared with the average of the five euro area Member States with the lowest scores. Poland ranks higher than the average five lowest euro area Member States for political stability and absence of violence, and control of corruption. According to the latest data, Poland lags behind in the

⁽⁹⁹⁾ The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

transposition of EU directives as the deficit was at 1.8% in 2020, which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011) ⁽¹⁰⁰⁾.



The legal and institutional framework to prevent and combat corruption is largely in place in Poland, although with some weaknesses. The 2021 Rule of Law Report points to several risks regarding the effectiveness of the fight against high-level corruption in Poland, including a risk of undue influence on corruption prosecutions for political purposes. Specifically, the Report mentions concerns over the independence of the main anti-corruption bodies, with, for instance, the subordination of the Central Anti-Corruption Bureau to the executive. Poland is lagging behind in addressing Sustainable Development Goal 16 – Peace, Justice and Strong Institutions, although it has seen some progress in recent years.

Poland has achieved a satisfactory level of transparency of legal persons, arrangements, and their beneficial ownership. However, more efforts are required to identify and assess certain ML/TF threats and vulnerabilities. The authorities should acknowledge and demonstrate with measures that terrorism financing is a stand-alone crime, not just a by-product of terrorism. The cash control mechanisms at the border should be strengthened by providing a legal basis to stop and restrain suspicious assets. A supervisory and sanctioning system on proliferation financing must be urgently put in place. Its transposition of the 5th AMLD is not yet complete and still under assessment by the European Commission.

Overall, the labour market appears flexible and employment protection legislation does not appear

to be very strict (as also measured by the OECD employment protection indicator). However, structural challenges include a low participation of certain groups, especially women, the low-skilled, older people and persons with disabilities and their careers. A lack of labour market flexibility in some areas, such as a limited use of part-time employment arrangements, is another important challenge. Disincentives to work stemming from the benefit system and limited access to long-term care and childcare are important barriers to labour market participation. Domestic labour mobility is hampered by sector-specific arrangements, such as the special social security system for farmers, as well as underdeveloped rental housing market and the transport infrastructure, in particular in rural areas. Non-EU workers, in particular from Ukraine, play an important role in the Polish labour market.

The financial sector in Poland is smaller and less developed than in the euro area. Relative to GDP, assets managed by the financial sector are a fifth of that of the euro area. The financial sector has increased slightly since 2016, but considerably less than in the euro area. Banking dominates the Polish financial sector and make up 58% of the financial sector's assets. The central bank is the second largest holder of financial assets with a share of 18%. Although these shares are larger and more dominating than in the euro area, they compare well with the five euro-area Member States with the smallest financial sectors.

Table 6.6:
Poland - Allocation of assets by financial sub-sector

Table 1 - Allocation of assets by financial sub-sector						
	PL		EA		Ratio to GDP (%)	
	2016	2020	2016	2020	EA 5 smallest	2020
Financial corporations (total)	163	167	722	796	177	215
Central bank	26	30	45	78	37	61
Monetary financial institutions	93	97	286	311	97	98
Other financial intermediaries	9	10	202	179	20	28
Non-MMF investment funds ¹⁾	16	14	100	127	4	5
Insurance co. and Pension Funds	19	16	90	102	18	23
	PL		EA		Share of total (%)	
	2016	2020	2016	2020	EA 5 smallest	2020
Central bank	16	18	6	10	21	29
Monetary financial institutions	57	58	40	39	55	46
Other financial intermediaries	6	6	28	22	11	12
Non-MMF investment funds	10	8	14	16	2	2
Insurance co. and Pension Funds	12	10	12	13	10	11

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

1) MMF stands for money market funds.

Source: Eurostat.

The insurance and the pension-fund sector in Poland is much smaller than in the euro area, relative to GDP and it has decreased contrary to the euro area. Since end-2016, it has decreased holdings of financial assets by 3.0 percentage points in relation to GDP, in the euro area it increased by 12.3 percentage points. The sector's share of the total financial sector has decreased as

⁽¹⁰⁰⁾ A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

well and widened the spread with the euro area. The investment-funds sector plays relevant role in the Polish financial system and its size is well above (by four times) to those of the five euro-area Member States with the smallest financial sectors.

Table 6.7:

Poland - Financing of the economy¹⁾

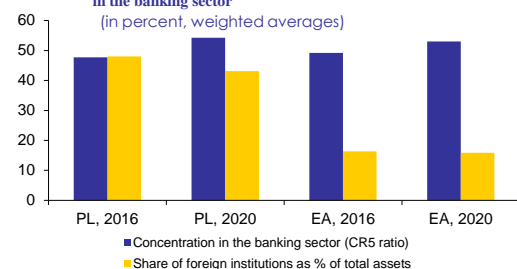
	PL		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	288	275	743	770	324	335
Loans	105	99	238	236	115	112
Non-financial co. debt securities	7	4	12	15	3	4
Financial co. debt securities	7	10	74	68	11	12
Government debt securities	48	52	83	95	51	57
Listed shares	29	22	65	73	17	18
Unlisted shares	27	24	186	193	55	56
Other equity	43	44	51	56	42	48
Trade credits and advances	23	21	33	35	29	29

	PL		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	37	36	32	31	35	33
Non-financial co. debt securities	2	1	2	2	1	1
Financial co. debt securities	3	4	10	9	3	3
Government debt securities	17	19	11	12	16	17
Listed shares	10	8	9	9	5	5
Unlisted shares	9	9	25	25	18	18
Other equity	15	16	7	7	13	14
Trade credits and advances	8	8	4	5	9	9

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

As to the financing of the economy, Poland has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (debt securities and listed shares) is relatively under developed. However, Poland is still fully comparable to the five euro-area Member States with the smallest national capital markets with only exception of the unlisted shares is it remained twice smaller in 2020.

Graph 6.11: Poland - Foreign ownership and concentration in the banking sector
(in percent, weighted averages)



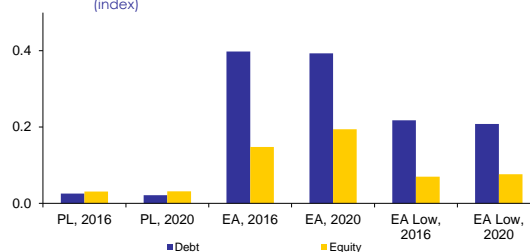
Source: ECB, Structural financial indicators.

Loans are the dominant source of funding and make up 99% of GDP in 2020, compared to 236% of GDP in the euro area. Equity and private sector debt markets are very small compared to those of the euro area and represent 36% of GDP altogether. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is almost twice less than in the euro area. In terms of share of the sum of

liabilities, loans in Poland are near to that of five euro-area Member States with the smallest financial sectors. For the securities, it is broadly in line with mentioned countries.

Poland's banking sector is well integrated into the euro-area financial sector, in particular through a high level of foreign ownership in its banking system. The share of foreign-owned institutions in total bank assets stood at 43% in 2020. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased since 2016, and reached 54% in 2020, which equals the same measure as of euro area.

Graph 6.12: Poland - Intra-EU integration in equity and debt portfolio investment
(index)



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

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

Intra-EU integration in equity and debt markets, as measured by the home bias⁽¹⁰¹⁾ in portfolio investments, are in general relatively low across EU Member States. The integration levels of these markets in Poland are even smaller if compared to euro-area Member states and to that of five euro-area Member States with the smallest financial sectors. Integration in the debt market segment has weakened somewhat between 2016 and 2020. Concerning portfolio investments in equity, the home bias is remained unchanged and very strong in Poland relative to euro-area Member States. Almost all investments in equity markets takes place domestically.

⁽¹⁰¹⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

7. ROMANIA

7.1. LEGAL COMPATIBILITY

7.1.1. Introduction

The Banca Națională a României (BNR – Romanian national bank, hereafter ‘BNR’) is governed by Law No. 312 on the Statute of the Bank of Romania of 28 June 2004 (hereinafter ‘the BNR Law’) which entered into force on 30 July 2004.

The BNR law has not been amended since the Commission’s 2020 Convergence Report. Therefore, the comments provided in the Commission’s 2020 Convergence Report are repeated also in this year’s assessment.

7.1.2. Central Bank independence

As regards central bank independence, a number of incompatibilities and imperfections have been identified with respect to the TFEU and the ESCB/ECB Statute.

According to Article 33(10) of the BNR Law, the Minister of Finance and one of the State Secretaries in the Ministry of Finance may participate, without voting rights, in the meetings of the BNR Board. Although a dialogue between a central bank and third parties is not prohibited as such, this dialogue should be constructed in such a way that the Government should not be in a position to influence the central bank’s decision-making in areas for which its independence is protected by the Treaty. The active participation of the Minister and one of the State Secretaries, even without voting right, in discussions of the BNR Board where BNR policy is set could structurally offer to the Government the possibility to influence the central bank when taking its key decisions. Against this background, Article 33(10) of the BNR Law is incompatible with Article 130 of the TFEU.

Article 3(1) of the BNR Law needs to be amended with a view to ensuring full compatibility with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Pursuant to Article 3(1) of the BNR Law, the members of the BNR’s decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority. First, for legal certainty reasons, it should be clarified that the BNR’s

institutional independence is also protected vis-à-vis national, foreign and EU institutions, bodies, offices or agencies. Moreover, Article 3 should expressly oblige the government not to seek to influence the members of the BNR’s decision-making bodies in the performance of their tasks.

The BNR Law should be supplemented by rules and procedures ensuring a smooth and continuous functioning of the BNR in case of the Governor’s termination of office (e.g. due to expiration of the term of office, resignation or dismissal). So far, Article 33(5) of the BNR Law provides that in case the Board of BNR becomes incomplete, the vacancies shall be filled following the procedure for the appointment of the members of the Board of BNR. Article 35(5) of the BNR Law stipulates that in case the Governor is absent or incapacitated to act, the First Deputy Governor shall replace the Governor.

Pursuant to Article 33(9) of the BNR Law, the decision to recall a member of the BNR Board (including the Governor) from office may be appealed to the Romanian High Court of Cassation and Justice. However, Article 33(9) of the BNR Law remains silent on the right of judicial review by the Court of Justice of the European Union in the event of the Governor’s dismissal provided in Article 14.2 of the ESCB/ECB Statute. This imperfection should be corrected.

Article 33(7) of the BNR Law provides that no member of the Board of BNR may be recalled from office for other reasons or following a procedure other than those provided in Article 33(6) of this Law. Law 161/2003 on certain measures for transparency in the exercise of public dignities, public functions and business relationships and for the prevention and sanctioning of corruption and the Law 176/2010 on the integrity in the exercise of public functions and dignities define the conflicts of interest incompatibilities applicable to the Governor and other members of the Board of the BNR and require them to report on their interests and wealth. For the sake of legal certainty, it is recommended to remove this imperfection and provide a clarification that the sanctions for the breach of obligations under those Laws do not constitute extra grounds for dismissal of the Governor of the

Board of BNR, in addition to those contained in Article 33 of the BNR Law.

According to Articles 21 and 23 of the Law concerning the organisation and functioning of the Court of Auditors (No 94/1992), the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including BNR's financial resources, and to audit the performance in the management of the funds of the BNR. Those provisions constitute an imperfection as regards Article 27.1 of the ESCB/ECB Statutes and thus, for legal certainty reasons, it is recommended to define clearly in the Law that the scope of audit by the Court of Auditors, is without prejudice to the activities of the BNR's independent external auditors.

Article 43 of the BNR Law provides that the BNR must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. Such a procedure could, in certain circumstances, be seen as an intra-year credit (see Section 7.1.3.), which negatively impacts on the financial independence of the BNR. A Member State may not put its central bank in a position where it has insufficient financial resources to carry out its ESCB tasks, and also its own national tasks, such as financing its administration and own operations. Article 43(3) of the BNR Law also provides that the BNR sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Finance. The central bank must be free to independently create financial provisions to safeguard the real value of its capital and assets. Article 43 of the BNR Law is incompatible with Article 130 of the TFEU and Article 7 of the ECB/ESCB Statute and should, therefore, be adapted, to ensure that the above arrangements do not undermine the ability of the BNR to carry out its tasks in an independent manner.

7.1.3. Prohibition of monetary financing and privileged access

According to Article 26 of the BNR Law, the BNR under exceptional circumstances and only on a case-by-case basis may grant loans to credit institutions which are unsecured or secured with assets other than assets eligible to collateralise the monetary or foreign exchange policy operations of the BNR. It cannot be excluded that such lending

results in the provision of solvency support to a credit institution that is facing financial difficulties and thereby would breach the prohibition of monetary financing and be incompatible with Article 123 of the TFEU. Article 26 of the BNR Law should be amended to avoid such a lending operation.

Articles 6(1) and 29(1) of the BNR Law prohibit the direct purchases by the BNR in the primary market of debt instruments issued by the State, national and local public authorities, autonomous public enterprises, national corporations, national companies and other majority state-owned companies. Article 6(2) of the BNR Law extends this prohibition to the debt instruments issued by other bodies governed by public law and public undertakings of other EU Member States. Article 7(2) of the BNR Law prohibits the BNR from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority state owned companies. Article 7(4) of the BNR Law extends this prohibition to other bodies governed by public law and public undertakings of Member States. These provisions do not fully mirror the entities listed in Article 123 of the TFEU (amongst others, a reference to Union institutions is missing) and, therefore, have to be amended.

Pursuant to Article 7(3) of the BNR Law, majority state-owned credit institutions are exempted from the prohibition on granting overdraft facilities and any other type of credit facility under Article 7(2) of the BNR Law and benefit from loans granted by the BNR in the same way as any other credit institution eligible under the BNR's regulations. The wording of Article 7(3) of the BNR Law is incompatible with the wording of Article 123(2) of the TFEU, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks", and should be aligned.

As noted above in point 7.1.2., Article 43 of the BNR Law provides that the BNR shall transfer to the State on a monthly basis 80% of its net revenues left after deduction of the expenses related to the financial year and the uncovered loss of the previous financial years. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year, but suffer losses during the

second half. The adjustment would be made by the State only after the closure of the financial year and would thus imply an intra-year credit to the State, which would breach the prohibition on monetary financing. This provision is, therefore, also incompatible with the Article 123 of the TFEU and has to be amended.

7.1.4. Integration in the ESCB

Objectives

Pursuant to Article 2(3) of the BNR Law, the secondary objective of the BNR is to support the State's general economic policy. Article 2(3) of the BNR Law contains an imperfection as it should contain a reference to the general economic policies in the Union as per Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute.

Tasks

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

- absence of a general reference to the BNR as an integral part of the ESCB (Article 1 of the BNR Law);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(2)(a), 5, 6(3), 7(1), 8, 19, 20, 21 (1) and (2), 22(3) and 33(1)(a) and (e) of the BNR Law);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)(a) and (d), 9 and 33(1)(a) of the BNR Law);
- holding and management of foreign reserves (Articles 2(2)(e), 9(2)(c), 30 and 31 of the BNR Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11 of the BNR Law);
- lack of reference to the role of the ECB in payment systems (Articles 2(2)(b), 22 and 33(1)(b) of the BNR Law).

There are also imperfections regarding the:

- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 49 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor (Article 36(1) of the BNR Law);
- absence of an obligation to comply with the ESCB/ECB regime for the financial reporting of NCB operations (Articles 37(3) and 40 of the BNR Law);
- non-recognition of the ECB's right to impose sanctions (Article 57 of the BNR Law).

7.1.5. Assessment of compatibility

As regards the independence of the BNR, the prohibition on monetary financing and the BNR's integration into the ESCB at the time of euro adoption, the legislation in Romania, in particular the BNR Law, is not fully compatible with the compliance duty under Article 131 of the TFEU. The Romanian authorities are invited to remedy the above-mentioned incompatibilities.

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

At the time of the last convergence assessment of Romania in 2020, the twelve-month average inflation rate, which is used for the convergence assessment, was above the reference value. From 3.6% in April 2020, the twelve-month average inflation rate decreased steadily to 2.1% by March 2021, but rose sharply to 4.1% by the end of 2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Romania was 6.4%, which was 1.5 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Table 7.1:

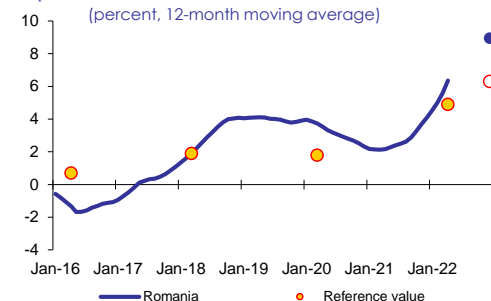
Romania - Components of inflation

	(percentage change) ¹⁾							weights in total
	2016	2017	2018	2019	2020	2021	Apr-22	2022
HICP	-1.1	1.1	4.1	3.9	2.3	4.1	6.4	1000
Non-energy industrial goods	-0.7	0.9	1.7	2.4	2.3	2.6	3.1	292
Energy	-4.4	0.4	12.2	2.7	-7.4	15.2	23.7	121
Unprocessed food	-2.5	3.9	5.3	6.2	5.3	1.8	5.3	113
Processed food	-0.9	2.2	3.7	5.5	5.0	4.0	6.2	251
Services	0.7	-0.5	2.7	3.6	2.7	2.7	3.8	223
HICP excl. energy and unproc. food	-0.2	0.9	2.7	3.8	3.3	3.1	4.3	766
HICP at constant tax rates	2.1	2.0	3.8	3.7	2.3	3.9	6.3	1000
Administered prices HICP	-2.5	0.5	4.2	2.6	1.2	1.8	3.0	94

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

Source: Eurostat, European Commission calculations.

Graph 7.1: Romania - Inflation criterion
(percent, 12-month moving average)



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

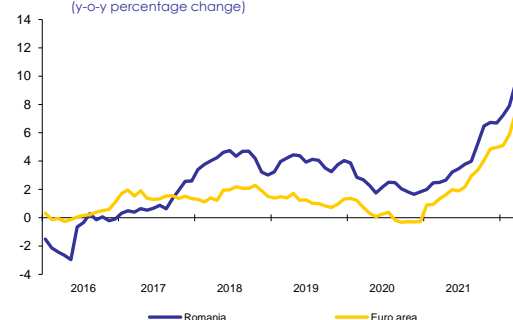
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

7.2.2. Recent inflation developments

Annual HICP inflation in Romania stood at 4.1% in 2021, up from 2.3% in 2020. The low annual average rate of inflation in 2020 reflected the effect of lockdown and mobility restriction measures, which were felt throughout the economy in terms of reduced demand for goods and services. The year-on-year inflation rate fell from 3.9% in January 2020 to 1.8% in May 2020, which was its lowest level since September 2017, also reflecting the sharp drop in the international price of crude oil in the first four months of 2020. After a temporary rise to 2.5% in July 2020, reflecting strong food price inflation, it decreased to 1.7% by November 2020. Subsequently, inflation rose uninterruptedly, reaching 3.5% in June 2021, 5.2% in September 2021 and 6.7% in November 2021, driven by high energy price inflation throughout 2021 and, in the later part of 2021, also sustained by higher inflation for processed food and, to a lesser extent, non-energy industrial goods and services. Over the past two years, annual HICP inflation in Romania was higher than in the euro area by around 1.75 percentage points on average.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) declined slightly from 3.3% in 2020 to 3.1% in 2021. It fell from a high of 4.0% in January 2020 to 2.4% by July 2021, before increasing sharply during the subsequent months to 4.5% in November 2021. Higher prices for processed food, which increased by more than 4% in both years, contributed significantly to core inflation, while the annual price changes for non-energy industrial goods (2.3% and 2.6% in 2020 and 2021 respectively) and services (2.7% for both 2020 and 2021) were more muted. Wage growth was moderate in 2020 due to falling economic activity, but went up again in 2021 against the background of a robust economic recovery and high inflation.

Graph 7.2: Romania - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

While lower energy demand resulted in a decrease in the energy component of HICP inflation of almost 7.5% in 2020, relatively high increases were recorded in the prices for processed and unprocessed food that year, by 5% and 5.3% respectively. In 2021 when the economy fully recovered and pent-up demand was released, inflation picked up again. Energy price inflation was particularly high in the second half of the year,

Table 7.2:

Romania - Other inflation and cost indicators						(annual percentage change)		
	2016	2017	2018	2019	2020	2021	2022 ¹⁾	2023 ¹⁾
HICP inflation								
Romania	-1.1	1.1	4.1	3.9	2.3	4.1	8.9	5.1
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Romania	0.7	2.7	3.8	5.4	2.4	5.5	9.1	5.3
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Romania	15.5	14.8	12.9	10.9	2.6	5.7	8.3	7.0
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity ²⁾								
Romania	5.9	4.8	4.4	4.1	-2.0	16.2	1.7	2.8
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs ²⁾								
Romania	9.1	9.6	8.2	6.6	4.7	-9.0	6.4	4.1
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Romania	-7.2	5.3	4.8	0.2	-2.3	10.5	12.0	4.0
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission's Spring 2022 Economic Forecast.

2) Due to a break in the historical employment data for Romania in 2021, employment-related variables have been affected.

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

up from 13.5% y-o-y in June to 25% in December. The support measures addressed to vulnerable consumers, households and SMEs moderated to a certain extent the increase in energy prices, as prices for electricity, gas, and heating energy were capped. Nevertheless, energy prices registered a 12-month average increase of 21.7% in March 2022. This was partly due to the fact that the HICP sub-component for liquid fuels and fuels and lubricants for personal transport equipment was not capped and recorded a 12-month average increase of 29.5% in March. International trade bottlenecks affecting supply-chains, as well as higher energy prices translated into marked increases in producer prices in manufacturing, averaging about 10.4% in 2021.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Real GDP dropped by 3.7% in 2020, but recovered in 2021 with a 5.9% increase. In 2020, due to the COVID-19 crisis, private consumption, imports and exports were particularly negatively affected, but investments and government consumption continued to grow. In 2021, real GDP was back to pre-pandemic levels by the end of the first half of

the year, but the growth momentum declined in the third quarter and turned negative in the final one.

Private consumption and investment represented the main growth drivers in 2021. After a 5.1% drop in the preceding year, private consumption grew at 7.9% in 2021. Gross fixed capital formation maintained a steady positive trend, even during the COVID-19 crisis. In particular, equipment investments were a strong growth driver as the economy quickly adapted to the new pandemic environment. Construction, on the other side, moderated its growth in 2020, but recorded a 6.1% increase the next year. Strong domestic demand in 2021 fuelled import growth. As a consequence, despite a relatively strong export performance, net exports made a negative contribution to real GDP growth that year. The growing trade deficit worsened the current account balance. According to the Commission's Spring 2022 Economic Forecast, real GDP growth is expected to increase by 2.6% this year, as private consumption is projected to be more subdued on account of higher inflation and uncertainty. At the same time, investment, supported by the RRF and other EU funds, is set to increase robustly. For 2023, real output growth is projected at 3.6%, as inflationary pressures and supply-side bottlenecks are expected to gradually abate.

In 2020-2021, as part of the policy response to the COVID-19 crisis, the government provided support to the healthcare sector and to households and companies hit by the pandemic, including incentives to retain the workforce. This response was facilitated by new European instruments, namely loans from SURE (Support to mitigate Unemployment Risks in an Emergency) and loans and grants from NextGenerationEU/RRF.

In 2021, the fiscal stance ⁽¹⁰²⁾, was contractionary, at 0.5% of GDP, after a supportive stance of -1.6% in 2020. Going forward, the Commission's Spring 2022 Economic Forecast projects a supportive fiscal stance at -1.0% of GDP in 2022, driven by higher nationally-financed investment, expenditure financed through the RRF and other EU grants and the temporary support to mitigate the impact of high energy prices (estimated around 0.7% of GDP). The budgetary costs related to assisting people fleeing Ukraine is assumed at close to 0.1% of GDP. The no policy-change forecast for 2023 shows a contractionary stance (1.3% of GDP) reflecting the withdrawal of the support measures introduced in response to the increase in energy prices.

The BNR, operating within an inflation targeting framework ⁽¹⁰³⁾, gradually reduced the key policy rate by 125 basis points between March 2020 and January 2021, as part of the measures taken in response to COVID-19 crisis. The policy rate remained stable at 1.25% until October 2021. In response to rising inflation, the BNR tightened its monetary policy stance by steadily raising the policy rate by a total of 250 basis points between October 2021 and May 2022. In May 2022, the policy rate stood at 3.75%.

In April 2020, the BNR also started purchasing government bonds in the secondary market to consolidate the structural liquidity in the banking system, thereby supporting favourable financing conditions for the economy. It continued to purchase government securities on an irregular

basis throughout 2020, 2021 and in the first months of 2022. The reserve requirement ratio on accounts opened with BNR for the foreign currency holdings of the credit institutions, which stood at 6% in February 2020, has been reduced to 5% since November of the same year. The reserve requirement ratio for leu denominated holdings has been unchanged since May 2015 at 8%.

The overall credit to the economy continued to expand in 2020 and 2021, sustained by government support measures. These increases were primarily supported by the expansion of credit to households for housing (9.9% in 2020 and 12.9% in 2021) and to Non-Financial Corporations (5.3% in 2020 and 19.8% in 2021). Consumer loans to households were down by 2.2% at the end of 2020 compared to the preceding year, before rebounding by 4.9% by the end of 2021. Loans to the general government grew by close to 116% in 2021, reflecting the overall need of the government to finance its sizeable budget deficit.

Wages and labour costs

Labour market conditions improved in the second half of 2020 and in 2021 after the initial deterioration due to the COVID-19 shock in early 2020, in line with robust economic growth and government's support measures. Also through the help of measures financed from SURE, the employment rate improved, from a low of 64% in the second quarter of 2020 to more than 67% at the end of 2021, while the unemployment rate continued to decrease from 6.7% in June 2020 to 5.7% in December 2021. Unemployment is projected to decrease and stay at levels close to 5.5% in the next two years, as the economy continues to grow ⁽¹⁰⁴⁾. Undeclared work remains a challenge, but its negative impact on social contribution system and government revenues is expected to be partly addressed by RRP reforms such as the introduction of work cards for domestic work and improvements of tax administration processes.

The increase in labour market slack, coupled with the relatively low inflation and the drop in productivity that took place in 2020, toned down wage pressures. As a result, nominal compensation per employee increased by only 2.6%. In 2021, wage growth remained stable, also as a result of the freezing of public sector wages (expected to

⁽¹⁰²⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

⁽¹⁰³⁾ As from 2013, the BNR follows a flat multi-annual inflation target of 2.5% (± 1 percentage point).

⁽¹⁰⁴⁾ Due to the change in the Labour Force Survey methodology, the figures in the 2022 Convergence Report are not comparable with the ones in the 2020 Report.

continue in 2022), whereas for 2022 the combination of a tighter labour market, skill shortages, higher productivity and inflationary pressures are expected to push wages up again, especially in the services sector. On the other hand, supply chain bottlenecks could negatively affect wages in the manufacturing sector. Minimum wage increases of 3.1% in mid-2021 and 10.9% in January 2022 were legislated to compensate households for the loss of purchasing power due to higher inflation. As of 2024, Romania committed in the RRP to create a new mechanism formula to objectively set the minimum wage level.

Labour productivity per person contracted by 2.2% in 2020, reflecting efforts to retain workers in employment notwithstanding the contraction in economic activity, but recorded an increase in the year after. In 2022, labour productivity is forecast to improve by just 2%, in line with the more subdued output growth. During the pandemic, while wage growth moderated, labour compensation still grew more than productivity, resulting in an increase in nominal unit labour costs (ULC). According to the Commission's Spring 2022 Economic Forecast, the ULC growth rate in Romania is expected to slowly pick-up in 2022 and 2023 and to remain above the average growth rates in the euro area, mirroring the projected growth in wages continuing to outpace productivity increases.



External factors

Due to the openness of the Romanian economy and its deep integration into the global and the EU economy, developments in import prices play a significant role in domestic price formation. In particular, energy and food import prices have been a significant determinant of price inflation in

Romania, given the large weight of these categories in the Romanian HICP and the fact that Romania is a net importer of energy. Import price inflation (measured by the imports of goods deflator) was significantly lower than consumer price inflation in 2020, reflecting the reduction in the price of fuel commodities. In 2021, however, import price inflation exceeded by almost 6.4 percentage points the HICP inflation, reflecting the sudden increase in the prices of the same commodities.

The leu's nominal effective exchange rate (measured against a group of 36 trading partners) remained broadly stable in the past two years, depreciating only moderately, by less than 1% between the beginning of 2020 and the end of 2021. Looking ahead, imported inflation is expected to remain high and above HICP inflation, in line with expected developments in global commodity and energy prices.

Administered prices and taxes

The weight of administered prices in the 2021 Romanian HICP basket (9.4%) is below the euro area average (15.5%). The average annual change in administered prices was 1.2% in 2020, below the headline inflation rate by 1.1 percentage points. In 2021, administered prices increased by just 1.8%, which was much below the 4.1% headline figure, mainly reflecting the slow increase in the non-energy administered prices component and decreases of the energy one in the first half of the year. Following legislative changes adopted at the beginning of 2020, the liberalisation of gas and electricity prices for households has been completed as of 1 July 2020 and 1 January 2021, respectively. However, in the context of marked price increases in late 2021, the government adopted legislation capping gas and electricity prices, with reduced tariffs for lower energy consumption brackets. The support measures were extended until April 2023.

Tax changes had a marginal influence on inflation in Romania in the last two years. HICP inflation measured at constant taxes was similar to headline HICP inflation. For 2020, the former stood at 2.3%, equal to the headline inflation figure, whereas it was 3.9% in 2021, 0.2 percentage point lower than the headline HICP inflation rate.

Table 7.3:

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

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022¹⁾	2023¹⁾
General government balance	-2.6	-2.6	-2.8	-4.3	-9.3	-7.1	-7.5	-6.3
- Total revenue	32.0	30.8	32.0	31.9	32.7	32.8	33.6	33.3
- Total expenditure	34.6	33.5	34.8	36.2	42.0	39.9	41.1	39.6
of which:								
- Interest expenditure	1.5	1.3	1.0	1.1	1.4	1.4	1.5	1.6
p.m.: Tax burden	26.7	25.8	26.8	26.8	27.1	27.3	27.9	27.7
Primary balance	-1.1	-1.4	-1.8	-3.2	-8.0	-5.7	-6.0	-4.7
Fiscal stance ²⁾					-1.6	0.5	-1.0	1.3
Government gross debt	37.3	35.1	34.7	35.3	47.2	48.8	50.9	52.6
p.m: Real GDP growth (%)	4.7	7.3	4.5	4.2	-3.7	5.9	2.6	3.6

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

Medium-term prospects

According to the Commission's Spring 2022 Economic Forecast, annual HICP inflation is projected to increase further to 8.9% in 2022 before falling to 5.1% in 2023. The significant increase in 2022 is mainly due to the hike in energy prices, with pass-through into other components, but also due to a rise in food prices. Services' inflation is also projected to pick-up, reflecting a surge in transport services inflation due to higher fuel prices. Inflation in non-energy industrial goods is projected to show a similar dynamic as HICP energy inflation, but of a considerably lower magnitude.

Risks to the inflation outlook are mainly on the upside, stemming from the implications of Russian's invasion of Ukraine for global food and energy prices. Other aspects, such as an increasingly tight labour market, contribute to the uncertainty of the inflation forecast.

In 2020, the level of consumer prices in Romania was about 52% of the euro area average. The GDP per capita was around 70% of the euro area average in PPS terms in 2021. Due to the process of catching-up of the Romanian economy, price level convergence is expected over the next years.

7.3. PUBLIC FINANCES

7.3.1. Recent fiscal developments

The general government deficit decreased from 9.3% of GDP in 2020 to 7.1% in 2021. The markedly high deficit in 2020 was mainly driven by a combination of additional expenditure due to the COVID-19 outbreak (healthcare spending and support measures to the economy and labour market) and a denominator effect given the 3.9% drop in real output. In 2021, the government enacted some limited consolidation measures, including a freeze in public sector wages, while revenues increased due to the economic recovery. Still, COVID-19 support measures continued in 2021.

Romania is subject to an excessive deficit procedure ⁽¹⁰⁵⁾. On 18 June 2021, the Council adopted a recommendation under Article 126(7) of the Treaty (TFEU), with a view to bringing an end to the situation of an excessive government deficit in Romania by 2024 at the latest. Romania was recommended to reduce the general government deficit to 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023, and 2.9% of GDP in 2024. On 23 May 2022, the Commission concluded that Romania's deficit outturn of 7.1% of GDP in 2021 and the fiscal effort are in line with the Article 126(7) recommendation of the

⁽¹⁰⁵⁾ Following the expansionary fiscal stance and the high fiscal deficit recorded in 2019 and previous years, Romania entered an Excessive Deficit Procedure (EDP) in the spring of 2020.

Council and, therefore, the excessive deficit procedure was kept in abeyance.

The general government debt-to-GDP ratio rose from 35.3% of GDP in 2019 to 47.2% in 2020 and 48.8% in 2021. The increases in 2020 and 2021 were mainly driven by the high primary deficit. The snow-ball effect and stock-flow adjustments both contributed to the increase in the debt ratio in 2020, whereas in 2021 they had a diminishing effect on the debt ratio. Liquidity support for households and companies in the form of guarantees and tax deferrals did not have a direct budgetary impact, but the guarantees represent contingent liabilities, estimated by the Commission services at around 3.2% of GDP as of December 2021.

7.3.2. Medium-term prospects

The 2022 budget, published on 28 December 2021, targets a reduction of the general government deficit to 6.2% of GDP in 2022. Several deficit-increasing expenditure measures were announced, such as an increase in the pension point value, an increase in minimum pensions by 20%, the one-off top-up of pensions in the RON 1,600-2,200 bracket for people with disabilities and the growth of children's allowance by 16%. The planned improvement of the headline budget balance for 2022 is mainly due to automatic stabilisers, as the economy's growth is set to stay robust, and to the expiry of the emergency health and labour market support measures. Moreover, a number of deficit-reducing measures will come into effect in 2022, such as the levying of social security contributions for health for pensions higher than RON 4,000.

In light of the increase in energy prices, the government approved measures to support measures to particular groups, such as poorer households and SMEs, to shield them against the increase in energy prices. These measures amounted to 0.7 of GDP in 2022 and consisted of allowances to vulnerable consumers, compensation schemes for households' energy bills, and energy and gas price caps on the expenditure side, and a measure to tax the energy and gas domestic producers' windfall revenues on the revenue side. In view of the humanitarian crisis following the invasion of Ukraine by Russia, the Commission estimates a budgetary cost of the support measures adopted by the Romanian government of 0.1% of GDP in 2022 and 0.1% in 2023.

On 5 May 2022, Romania submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to decline steadily to 6.2% of GDP in 2022 and 4.4% in 2023. The Programme targets a reduction of the government deficit to under 3% of GDP by 2024, in line with the Council recommendation.

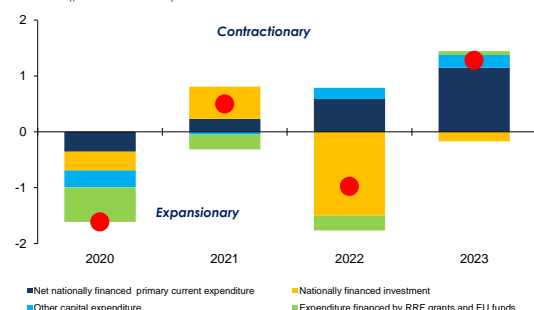
The Commission Spring 2022 Economic Forecast, which is based on a no-policy change assumption, projects a general government deficit of around 7.5% of GDP in 2022. The difference from the planned deficit in the Convergence Programme stems, in particular, from a difference in the underlying macroeconomic projections, an increase of some revenue items in the 2022 budget (and the Convergence Programme) that are not fully supported by enacted measures and therefore not taken into account in the Commission's forecast, increased social expenditure and support to the economy and the measures to deal with the surge in energy prices and the flow of refugees. The Commission projects the general government deficit to further decrease to around 6.3% of GDP in 2023, as revenues are expected to grow strongly on the back of the economic recovery, while COVID-19 temporary emergency measures are expected to be phased out and the cost of the measures to deal with the surge of energy price are assumed to decrease. Romania is at risk of non-compliance with the fiscal targets for 2022 established in the Council Recommendation of 18 June 2021.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to be supportive, at -1.0% of GDP⁽¹⁰⁶⁾. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.3 percentage point of GDP in 2022. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 1.5 percentage points of GDP in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide a contractionary contribution of 0.6 percentage point of GDP to the overall fiscal stance, as current expenditure is set to grow at a slower pace than medium-term potential growth. This contribution is contractionary notwithstanding

⁽¹⁰⁶⁾ For a definition of the fiscal stance used in this report, see footnote in Section 7.2.3 on underlying factors and sustainability of inflation.

the expansionary impact of the measures related to the energy crisis (0.7% of GDP) and the assistance to those fleeing Ukraine (less than 0.1% of GDP).

Graph 7.4: Romania - Fiscal stance and its components
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2023, the fiscal stance is projected to be contractionary at 1.3% of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to decrease by 0.1 percentage points of GDP. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.2 percentage point of GDP⁽¹⁰⁷⁾, whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 1.1 percentage point of GDP to the overall fiscal stance in 2023, as the support measures to face the energy crisis in 2022 are assumed to be phased out.

The government debt-to-GDP ratio is forecast by the Commission to increase to 50.9% in 2022 and 52.6% in 2023. Debt sustainability risks appear medium over the medium term. Government debt is projected to increase reaching around 73% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -3.8% of GDP, which is the same compared to the 2019 level.

The sensitivity to possible macro-fiscal shocks contributes to this assessment. In particular, if only half of the projected percentage point improvement in the structural primary balance in 2022-2023 were to occur, the projected debt ratio in 2032 would be about 5 percentage points of GDP higher than in the baseline.

⁽¹⁰⁷⁾ Other nationally financed capital expenditure is projected to provide a contractionary contribution of 0.2 percentage point of GDP each year in 2022 and in 2023.

Some factors mitigate risks, including the lengthening of debt maturity in recent years and relatively stable financing sources and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include the share of debt held by non-residents, the currency denomination of debt, and the country's negative net international investment position. An additional risk-increasing factor is the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis, though this risk remains currently limited due to relatively low take-up⁽¹⁰⁸⁾.

Romania has a strong fiscal framework in place, consisting of in principle well-designed fiscal rules, a medium-term budgetary framework and an independent fiscal council. However, the track record in the application of the framework has been generally poor, as noted in previous Convergence Reports (2020 and 2018). In particular, the annual budget laws have repeatedly been in contradiction with national fiscal rules and not guided by the medium-term budgetary strategies following significant delays in the adoption of the latter. Faced with the COVID-19 shock in 2020, fiscal rules were equipped with the required flexibility to allow for a large deviation from targets.

7.4. EXCHANGE RATE STABILITY

The Romanian leu does not participate in ERM II. Romania has been operating a *de jure* managed floating exchange rate regime since 1991 with no preannounced path for the exchange rate⁽¹⁰⁹⁾. De facto, the exchange rate regime moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2005, Romania shifted to a direct inflation targeting framework combined with a floating exchange rate regime. The BNR has, nonetheless, stressed that currency intervention remains available as a policy instrument and has actively used this instrument.

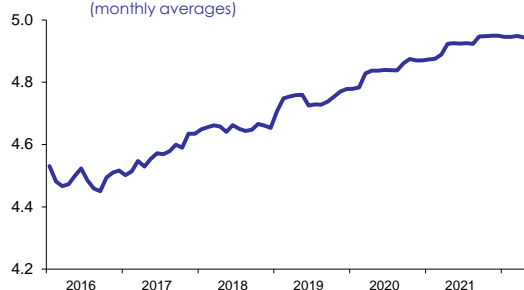
The leu has depreciated steadily against the euro since 2017. Between the beginning of 2020 and

⁽¹⁰⁸⁾ For further details see the 2021 Fiscal Sustainability Report.

⁽¹⁰⁹⁾ On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion factor of 1 RON = 10,000 ROL. For convenience, however, the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.

April 2022, the leu weakened against the euro by around 3.5%. Over this period, the volatility of the leu's inter-day exchange rate was moderate compared to that of other floating currencies in Member States with a derogation. The leu weakened against the euro by around 1.0% between January and April 2021. It remained relatively stable on average in the subsequent four months, but in October 2021 the leu depreciated against the euro by 0.5%. It averaged around a RON/EUR level of 4.95 during the rest of 2021 and the first four months of 2022. In April 2022, the leu's exchange rate against the euro averaged around 4.94.

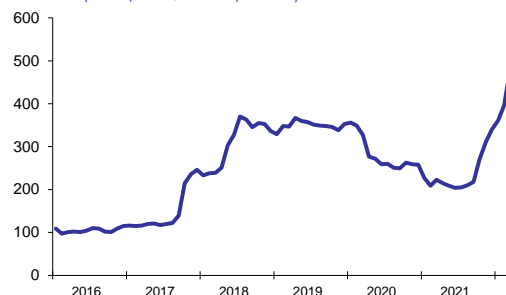
Graph 7.5: Romania - RON/EUR exchange rate
(monthly averages)



Source: ECB.

The gross international reserves held by the BNR declined to a low of around EUR 38bn in the third quarter of 2020 and recovered to around EUR 43bn at the end of 2020. The reserves continued to increase throughout most of 2021 to close to EUR 46bn at the end of 2021, reaching close to 19% of GDP and stood at around EUR 46bn in the first quarter of 2022. Over this period, movements in the level of international reserves were influenced by changes in the foreign exchange reserve requirements of credit institutions, sovereign debt management decisions, such as euro-denominated government bond issuances and, towards the end of 2021 and beginning of 2022, the first pre-financing payments under the EU's Recovery and Resilience Facility.

Graph 7.6: Romania - 3-M Robor spread to 3-M Euribor
(basis points, monthly values)



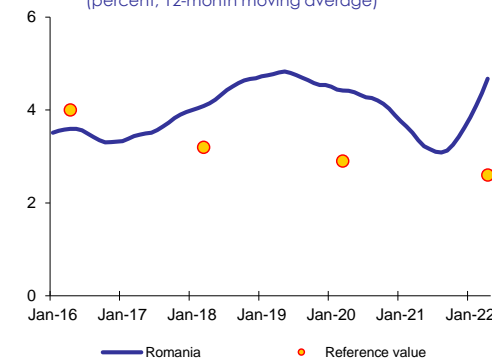
Source: National Bank of Romania, Eurostat and Thomson Reuters

Short-term interest rate spreads vis-à-vis the euro area decreased by around 120 basis points between March 2020 and February 2021, mirroring the above-mentioned policy rate cuts by the Romanian central bank over this period. The three-month interest rate spread stabilised at around 210 basis points until September 2021, before steadily increasing to almost 500 basis points by March 2022. These developments in part reflected the tightening of monetary policy by the BNR in response to the increasing inflation, with the key policy rate raised from 1.25% in September 2021 to 3.75% in May 2022. The three-month interest rate spread relative to the euro stood at around 520 basis points in April 2022, well above its pre-pandemic levels.

7.5. LONG-TERM INTEREST RATES

The long-term interest rates in Romania used for the purpose of the convergence examination reflect secondary market yields on a single government benchmark bond with a residual maturity of around 10 years.

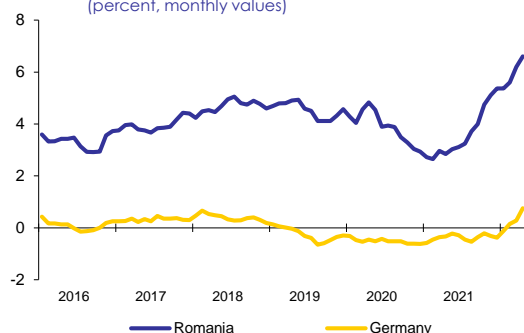
Graph 7.7: Romania - Long-term interest rate criterion
(percent, 12-month moving average)



Source: European Commission.

The Romanian twelve-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the time of the last convergence assessment of Romania in 2020. From 4.4% in April 2020, it fell to around 3.1% by July 2021 but increased again throughout the rest of 2021. In April 2022, the reference value, which is measured as the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. In that month, the twelve-month moving average of the yield on the Romanian benchmark bond was at 4.7%, i.e. 2.1 percentage points above the reference value.

Graph 7.8: Romania - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

At the outset of the COVID-19 crisis, the long-term interest rate in Romania increased sharply from 4.0% in February 2020 to 4.8% in April 2020. Subsequently, the long-term interest rate decreased steadily, reaching a trough of 2.7% in February 2021. The decline reflected the widespread monetary policy loosening measures by central banks, which depressed long-term yields. Interest rates started to increase again in March 2021 and were on an upward path throughout 2021, rising to 5.4% in December 2021, reflecting higher inflationary pressures and, as from October 2021, monetary policy tightening in Romania. The long-term interest rate of Romania increased further during the first four months of 2022, in the context of continued inflationary pressures, further monetary policy tightening, and heightened risk aversion following Russia's invasion of Ukraine. It reached 6.6% in April 2022 and the long-term spread versus the German benchmark bond reached 586 basis points in that month, up from 310 basis points in February 2021.

7.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its eleventh Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review (IDR) was warranted for Romania. In May 2022, the Commission published its annual country report on Romania and separately an In-Depth Review. These reports confirmed the existence of macroeconomic imbalances in Romania. Vulnerabilities relate to external accounts, linked to large fiscal deficits, and to competitiveness issues that are re-emerging.

The high current account deficit further worsened in 2021 and is not forecast to improve in 2022 or 2023. Large fiscal deficits pre-date the COVID-19 crisis and have driven up the current account deficit which poses risks to external debt sustainability. Sovereign borrowing costs have increased since early 2021. The expected acceleration in wages could weigh further on cost competitiveness. Nominal depreciation could mitigate competitiveness losses but add to inflationary pressures and increase the burden of serving debts in foreign currencies, which are significant for the government and the private sector. The negative net international investment position is expected to remain below its pre-pandemic levels. The external position is expected to benefit from significant RRF funds but external financing can otherwise become more challenging amid tighter global financial conditions. Recent policy initiatives, including the successful implementation of Romania's RRP, can address some vulnerabilities, still further action is needed to improve competitiveness and potential growth.

Romania submitted its recovery and resilience plan (RRP) on 31 May 2021. The Commission's positive assessment on 27 September 2021 and the Council's approval on 29 October 2021 paved the way for the implementation of the RRP and the disbursement of EUR 14.25 billion in grants and

Table 7.4:

Romania - Balance of payments		(percentage of GDP)				
	2016	2017	2018	2019	2020	2021
Current account	-1.6	-3.1	-4.6	-4.9	-5.0	-7.0
of which: Balance of trade in goods	-5.7	-6.8	-7.5	-8.0	-8.7	-9.6
Balance of trade in services	4.6	4.4	4.1	3.9	4.3	4.0
Primary income balance	-1.3	-1.4	-1.8	-1.4	-1.5	-1.7
Secondary income balance	0.8	0.8	0.6	0.7	0.9	0.4
Capital account	2.5	1.2	1.2	1.3	1.9	2.2
External balance ¹⁾	0.9	-1.9	-3.4	-3.6	-3.1	-4.8
Financial account	1.6	-1.7	-2.5	-2.3	-3.6	-5.4
of which: Direct investment	-2.7	-2.6	-2.4	-2.2	-1.4	-3.0
Portfolio investment	-0.6	-1.6	-1.4	-1.1	-6.1	-1.3
Other investment ²⁾	3.5	2.3	1.7	1.1	1.3	-2.0
Change in reserves	1.3	0.2	-0.4	-0.1	2.6	0.9
Financial account without reserves	0.2	-1.9	-2.1	-2.2	-6.1	-6.3
Errors and omissions	0.6	0.3	0.9	1.3	-0.5	-0.6
Gross capital formation	23.4	23.4	22.8	23.6	24.4	25.9
Gross saving	22.2	20.3	18.3	18.4	18.6	18.9
Net international investment position	-49.2	-47.4	-43.8	-43.6	-47.9	-45.7

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, National Bank of Romania.

14.97 billion in loans over the period 2021-2026, which is equivalent to 13.1% in 2019 GDP.

Romania's plan includes an extensive set of mutually reinforcing reforms and investments (107 investments and 64 reforms) that should contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations (CSRs) addressed to Romania by the Council in the European Semester in 2019 and 2020. The plan will address key macro-economic challenges such as the sustainability of public finances, education, increasing greenhouse gas emissions and the lack of digital connectivity. Key investments are included for railway modernisation, the energy efficiency of buildings, the digitalisation of public administration and making the health system more resilient. Investments will also focus on increasing the quality and access to education, including digitalisation and overall infrastructure. Key reforms aim at addressing fiscal sustainability, improving access to financing, strengthening the public administration and modernising the social benefits system. By strengthening the independence and increasing the efficiency of the judiciary, improving access to justice, and stepping up the fight against corruption, the plan aims to

address the main issues related to respect of the rule of law in Romania in accordance with the relevant case-law of the Court of Justice of the European Union and taking into account recommendations made in the Cooperation and Verification Mechanism (CVM) reports, the reports by the Group of States against Corruption (GRECO), the opinions of the Venice Commission, and the Rule of Law Reports.

The plan devotes 41% of its total allocation to measures supporting climate objectives, 20.5% to the digital transition and 25% on social expenditure, all while respecting the 'do no significant harm' principle.

The implementation of the investments in the Romanian plan, along with other investments under Next Generation EU (NGEU), is estimated to raise Romania's GDP by 2.9% by 2026, of which 0.2% due to the positive spillover effects of the coordinated implementation of NGEU across Member States ⁽¹¹⁰⁾. This does not take into

⁽¹¹⁰⁾ See Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery

account the positive impact of structural reforms on growth.

7.6.1. Developments of the balance of payments

Romania's external balance (i.e. the combined current and capital account) improved from -3.6% of GDP in 2019 to -3.1% in 2020, before deteriorating to -4.8% in 2021. In 2021, the capital account remained in surplus and actually increased, but this was more than offset by the worsening of the current account deficit, which increased from -5.0% of GDP in 2020 to -7.0% of GDP in 2021.

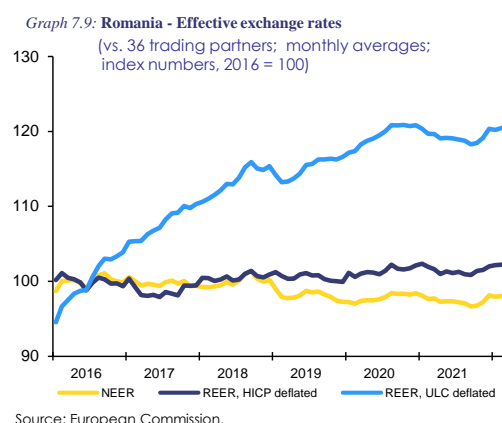
Despite growth in export market shares in 2021, the growth of imports spurred by booming private consumption has outpaced that of exports. The balance of trade in goods deteriorated markedly, particularly in 2020 and 2021 when it reached -8.7% of GDP and -9.6%, respectively. The balance of trade in services, driven mainly by exports of transportation and IT services, remained positive at 4.3% of GDP in 2020 and 4.0% in 2021, but did not offset the negative and widening deficit in the trade in goods.

The balance of primary income remained negative, slightly more so in 2020 compared to 2019, reflecting mainly the outflow of investment income linked to the country's negative net international investment position. The balance of secondary income, which consists mainly of remittances, continues to be positive, with a slight increase in 2020. The latter was outweighed however by the negative balance of primary income. The capital account surplus stood at 1.9% of GDP in 2020, an improvement compared to 2019, reflecting the slight increase in 2020 of the uptake of projects financed by EU funds under the 2014-2020 programming period. In 2021, the capital account surplus benefited from the positive impact of the RRP pre-financing flows received at the end of the year, thus increasing slightly to 2.2% of GDP.

Net FDI inflows took a hit in 2020 due to the COVID crisis, and the net portfolio inflows accounted for the largest contribution to the external financing of the current account. Over 2020, net FDI inflows amounted to 1.3% of GDP, while the portfolio investments represented 6.1%.

In 2021, however, the mix between the two sources of financing reversed again, with FDI amounting to 3.0% of GDP and portfolio investments 1.3%. Other investments including financial derivatives continued to record net outflows. Against the background of a slight widening current account deficit in 2020 and due to a denominator effect, Romania's net international investment position as a share of GDP deteriorated by more the 4 percentage points. In 2021, however, and despite the larger current account deficit, the net international investment position (NIIP) marginally improved due to the denominator effect of a high GDP growth rate. It rose from -47.8% of GDP in 2020 to -45.7% in 2021.

Romania's external cost competitiveness, as measured by ULC-deflated real effective exchange rate (REER), plateaued and even recorded periods of improvement between 2020 and 2021, after a span of rapid deterioration from 2016 to 2019⁽¹¹⁾. This came as a result of a toning down of wage pressures, as public sector wages were frozen and the private sector suffered reductions in earnings in the context of the pandemic. At the same time, the HICP-based REER indicates broadly stable external price competitiveness, although maintaining a spread with respect to the nominal effective exchange rate, reflecting Romania's positive inflation differential relative to its trading partners broadly offsetting the gain in competitiveness from the moderate nominal RON depreciation.



According to the Commission's Spring 2022 Economic Forecast, the external deficit is expected to widen in 2022, mainly due to price increase for

and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

⁽¹¹⁾ The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Romania.

Table 7.5:
Romania - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness ¹⁾ (%)	45.4	46.4	46.5	45.0	41.1	45.0
Trade with EA in goods & services ²⁾⁺³⁾ (%)	25.7	26.2	26.3	25.1	23.0	24.6
World Bank's Ease of Doing Business Index rankings ⁴⁾	36	45	52	55	55	-
IMD World Competitiveness Ranking ⁵⁾	49	50	49	49	51	48
Internal Market Transposition Deficit ⁶⁾ (%)	2.0	1.5	1.1	1.1	1.1	-
Real house price index ⁷⁾	105.2	108.6	110.5	108.4	110.8	109.6

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Imports} + \text{Exports of goods with EA-19} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

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

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.

(November data, as of 2016 date refers to the year of publication).

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

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

energy commodities, such as gas and oil, for which Romania is a net importer. These negative dynamics are set to be partially offset by dynamics in the capital account, as the RRP funds will start flowing in.

7.6.2. Market integration

Romania's economy is well integrated with the euro area through both trade, including through participation in supply chains, and foreign investment. The relatively low trade openness (see Table 7.5 for a definition) of Romania decreased further in 2020, reflecting the domestic and global contraction in demand due to the COVID-19 crisis. Trade openness in 2020 stood at 41.1% of GDP and increased in 2021 to around 45% of GDP. In 2021, Romania's main trading partners within the euro area were Germany, Italy and France, while outside the euro area Romania mainly traded with Hungary, Poland, China and Turkey. Trade with the euro area increased from 23% of GDP in 2020 to 24.6% of GDP in 2021.

Romania attracted substantial amounts of FDI in the past decade. Net FDI inflows, originating mainly from euro-area Member States, such as the Netherlands, Germany and Austria, decreased markedly by close to 40% in 2020, but made a strong comeback in 2021, recording an increase of almost 150%.

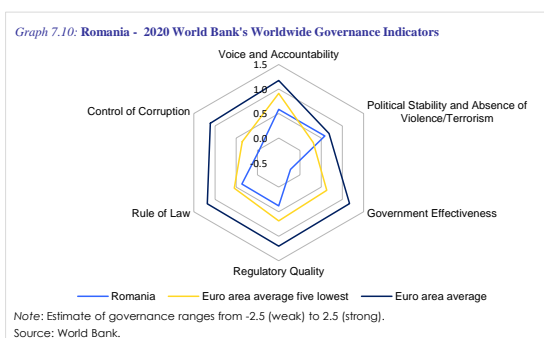
Romania's regulatory framework has scope for improvements. The use of Government Emergency Ordinances (GEOs) - for which there is neither mandatory ex-ante impact assessment nor public consultations - is still widespread: their number increased from 91 in 2019 to 226 in 2020 (also due

to the extraordinary measures that had to be taken against the pandemic) and decreased to 145 in 2021. Frequent legislative changes coupled with inadequate impact assessments harm investments and the business environment. The recovery and resilience plan foresees measures enhancing the capacity of the central government to better steer and monitor the legislative process, the quality of the laws, as well as coherence and transparency throughout the regulatory framework.

Romania's performance in international rankings of competitiveness and ease of doing business is relatively weak compared to many euro-area Member States. In the IMD's World Competitiveness Index, Romania's position is still low although it has slightly improved lately, moving from a placing of 51 in 2020 to 48 in 2021 from a total of 64 surveyed economies. A patchy legal and regulatory framework, an inefficient justice system and at times opaque corporate governance of State Owned Enterprises are some of the main obstacles to competitiveness. According to the World Bank's Ease of Doing Business indicator, Romania maintained the same rank in 2020, as in 2019, i.e. 55, but a relative worsening can be noticed with respect to 2018, when it ranked 52 ⁽¹¹²⁾. According to the World Bank's Worldwide Governance Indicators (2020), Romania ranks low in voice and accountability, government effectiveness, regulatory quality and control of corruption compared with the average of the five euro area Member States with the lowest

⁽¹¹²⁾ The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

scores. Romania ranks higher than the average five lowest euro area Member States for political stability and absence of violence⁽¹¹³⁾. On a more positive note, according to the 2020 Single Market Scoreboard, Romania's transposition deficit of EU Directives was at 1.1%, a stable result for the 3rd consecutive year, very close to the EU average (1%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011).



As part of the 2022 Country Report, the Commission has identified four main obstacles undermining Romania's competitiveness and capacity to innovate. First, services markets, in particular many professions servicing companies (such as lawyers, accountants and notaries) remain highly regulated. This may translate into high prices for low quality services. Second, the fragmented coordination of Research and Development and Innovation policy at the central level and weak linkages between science and industry discourage entrepreneurship and catching up. Third, the cadastre is underdeveloped and can result in insufficient protection of property rights. Finally, access to credit especially for SMEs and start-ups remains problematic, both because of companies' weak balance sheets and relatively underdeveloped capital markets.

The 2022 Country Report highlights that some concerns remain on the rule of law. In particular, the justice system is facing efficiency challenges, and there are concerns about judicial independence. This reflects on lengthy administrative proceedings and low clearance rates, and a relatively low trust in courts. Furthermore, frequent changes in legislation undermine the protection of companies'

investments by the law and courts. The RRP aims to address these issues by increasing the independence and efficiency of the justice system, and the quality of legislative process.

The 4th Anti-Money Laundering Directive (AML) imposed transposition by 26 June 2017. After being referred before the Court of Justice for not having notified any transposition measures on July 2018 (Case C-2018/549), Romania has communicated to the Commission the adoption of transposition measures, which ensure a complete transposition of the Directive. An assessment of the concrete implementation and effective application of the 4th Anti money Laundering Directive in Romania is at present ongoing.

As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, a letter of formal notice from the Commission was sent in February 2020 regarding the absence of notification of national transposition measures by the expected date. Since then, further transposition measures have been notified, enabling the Commission to conclude that transposition is now complete. As regards the conformity of this transposition, a letter of formal notice was sent on 18 February 2021 concerning the transposition of the provisions related to beneficial ownership registers (Articles 30(1) and 30(3) AMLD5). Romania formally responded on 18 June 2021. The Commission is currently analysing this reply and the formal follow-up to be proposed. At the same time, the Commission is assessing whether there are any potential conformity issues regarding the other provisions of the 5th AML Directive or effectiveness issues in the transposition or implementation of the entire legal act.

The Romanian labour market continues to face significant structural challenges. Adverse demographics are expected to worsen. Aging population, limited internal labour mobility and continued emigration are a drag on potential economic growth. Despite recent improvements, employment and activity rates remain below EU averages. Skills shortages and mismatches also continue to affect the labour market. Although the latest minimum wage increases in 2020, 2021 and 2022 were based on several economic indicators, an objective mechanism has not yet been properly established. The Romanian recovery and resilience plan contains a reform setting a new mechanism for determining the minimum wage, based on

⁽¹¹³⁾ A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

objective criteria, consistent with job creation and competitiveness. The functioning of social dialogue remains weak and social partners' involvement in policymaking continues to be very limited.

The financial sector in Romania is smaller and less developed than in the euro area. Relative to GDP, assets managed by the financial sector are around 12% of that of the euro area. The size of the financial sector has remained broadly unchanged since 2016. Banking dominates the Romanian financial sector and makes up around 56% of the financial sector's assets in 2020. The central bank is the second largest holder of financial assets with a share of 21%. Although these shares are larger than in the euro area, they are relatively similar to those of the five euro-area Member States with the smallest financial sectors. Non-money-market funds and other financial intermediaries hold a small share of total financial assets.

Table 7.6:

Romania - Allocation of assets by financial sub-sector

	RO		EA		Ratio to GDP (%) EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	97	97	722	796	177	215
Central bank	23	21	45	78	37	61
Monetary financial institutions	54	54	286	311	97	98
Other financial intermediaries	7	8	202	179	20	28
Non-MMF investment funds ¹⁾	6	4	100	127	4	5
Insurance co. and Pension Funds	7	10	90	102	18	23
Share of total (%)						
	RO		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	24	21	6	10	21	29
Monetary financial institutions	56	56	40	39	55	46
Other financial intermediaries	7	8	28	22	11	12
Non-MMF investment funds	6	4	14	16	2	2
Insurance co. and Pension Funds	7	10	12	13	10	11

1) MMF stands for money market funds.

Source: Eurostat.

The insurance and the pension-fund sector in Romania is much smaller than in the euro area, relative to GDP. However, the sector's share of the total financial sector assets, at around 10%, is only slightly less than in the euro area (13%) and comparable with the five euro-area Member States with the smallest financial sectors. Since end-2016, the Romanian sector has increased its holdings of financial assets relative to GDP by 2.7 percentage points, compared to an increase by 12.3 percentage points in the euro area. The investment-funds sector plays a very small role in the Romanian financial system, but its size relative to GDP is comparable to that of the five euro-area Member States with the smallest financial sectors.

As to the financing of the economy, Romania has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (debt securities and listed shares) is

relatively underdeveloped. However, Romania is still comparable to the five euro-area Member States with the smallest financial sectors. Loans are the dominant source of funding and make up 60% of GDP in 2020, compared to 240% of GDP in the euro area. Trade credits and advances are another important source of funding and stand at 41% of GDP in 2020, compared to 35% in the euro area. Financing through private debt markets is practically inexistent, while equity markets are very small compared to those of the euro area and represent 9% of GDP. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is also lower than in the euro area. In terms of the share of the sum of liabilities, loans in Romania are comparable to that of the euro area, while the government debt and trade credits and advances are higher than in the euro area. For security and equity financing, the large differences reflect the smaller share of market funding available in Romania compared to the euro area.

Table 7.7:

Romania - Financing of the economy¹⁾

	RO		EA		Ratio to GDP (%) EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	204	220	743	770	324	335
Loans	68	60	238	236	115	112
Non-financial co. debt securities	0	0	12	15	3	4
Financial co. debt securities	0	0	74	68	11	12
Government debt securities	31	44	83	95	51	57
Listed shares	9	9	65	73	17	18
Unlisted shares	30	29	186	193	55	56
Other equity	27	37	51	56	42	48
Trade credits and advances	39	41	33	35	29	29
Share of total (%)						
	RO		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	33	27	32	31	35	33
Non-financial co. debt securities	0	0	2	2	1	1
Financial co. debt securities	0	0	10	9	3	3
Government debt securities	15	20	11	12	16	17
Listed shares	4	4	9	9	5	5
Unlisted shares	15	13	25	25	18	18
Other equity	13	17	7	7	13	14
Trade credits and advances	19	19	4	5	9	9

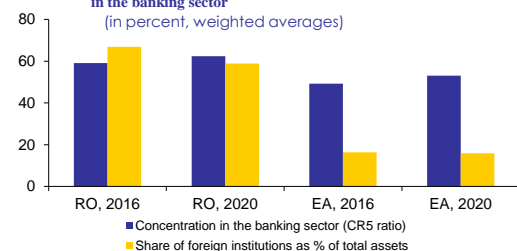
1) The table focuses on the financing needs of a country and how these are met by the financial system.

The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.

Source: Eurostat.

Romania's banking sector is well integrated with the euro area financial sector, in particular through a high level of foreign ownership in its banking system. Foreign-owned banks, the majority of which are subsidiaries of parent banks based in the euro area, had a share of assets in the total held by the Romanian banking sector of 58.9% in 2020, well above the euro area average of nearly 16%. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased since 2016, and reached almost 62% in 2020. This is 9 percentage points above the euro area average in 2020.

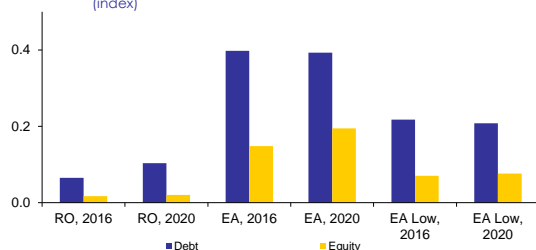
Graph 7.11: Romania - Foreign ownership and concentration in the banking sector
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Although intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, Romania has levels of integration in debt markets below that of the average euro-area Member State⁽¹¹⁴⁾. However, integration in this market segment has improved between 2016 and 2020. Concerning portfolio investments in equity, the home bias is also significantly stronger in Romania relative to euro-area Member States. The very large home bias indicates that almost all investments in equity markets take place domestically.

Graph 7.12: Romania - Intra-EU integration in equity and debt portfolio investment
(index)



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

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

⁽¹¹⁴⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

8. SWEDEN

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

The legal rules governing the Swedish Central Bank (Riksbank) are laid down in the Instrument of Government (as part of the Swedish Constitution), the Riksbank Act from 1988, as amended, and the Law on Exchange Rate Policy from 1998. No amendments to these legal acts were passed with regard to the incompatibilities and the imperfections mentioned in the Commission's 2020 Convergence Report. Therefore, this year's assessment repeats the comments provided in the previous report.

8.1.2. Central Bank independence

Article 3 of Chapter 6 of the Riksbank Act obliges the Riksbank to inform the minister appointed by the Swedish Government about a monetary policy decision of major importance prior to its approval by the Riksbank. A dialogue between a central bank and third parties is not prohibited as such, but regular upfront information of government representatives about monetary policy decisions, especially when the Riksbank would consider them as of major importance, could structurally offer to the government an incentive and the possibility to influence the Riksbank when taking key decisions. Therefore, the obligation to inform the minister about a monetary policy decision of major importance prior to its approval by the Riksbank limits the possibility for the Riksbank to take decisions independently and offers the possibility for the Government to seek to influence them. Such procedure is incompatible with the prohibition on giving instructions to the Central Bank, pursuant to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Article 3 of Chapter 6 should be revised in order to ensure that monetary policy decisions of major importance are communicated to the minister, if ever, only after its approval by the Riksbank and for information purposes only.

Pursuant to Article 2 of Chapter 3 of the Riksbank Act and Article 13 of Chapter 9 of the Instrument of Government, the prohibition on the members of the Executive Board to seek or take instructions only covers monetary policy issues. The provisions do not provide for their independence in the performance of ESCB-related tasks directly

entrusted by the Treaties. By means of broad interpretation through reference to the explanatory memorandum to the Law (the memorandum extends the coverage to all ESCB tasks), one could consider these tasks as tacitly encompassed by the principle of central bank independence. However, the principle of the Riksbank's institutional independence cannot be considered as fully respected as long as the legal text itself does not contain a clear reference to them. Both provisions, therefore, are considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Pursuant to Article 4 of Chapter 10 of the Riksbank Act, the Swedish Parliament approves the Central Bank's profit and loss account and its balance sheet and determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and is incompatible with Article 130 of the TFEU. The Parliament must not be involved in the relevant decision-making process. Its right should be limited to approving the Central Bank's decision on the profit allocation. ⁽¹¹⁵⁾

Article 4 of Chapter 1 of the Riksbank Act provides for the replacement of the Governor, in case of absence or incapacity, by the Vice-Governors nominated by the General Council. It is unclear whether the notion "absence" in Article 4 also refers to cases such as the expiry of the term of office, resignation, dismissal or other cause of termination of office. To ensure the smooth and continuous functioning of the Riksbank, the Riksbank Act would benefit from some improvement and should provide for clear procedures and rules regarding the succession of the Governor in case the notion "absence" also refers to instances of termination of office as well as in case the Governor is incapacitated.

8.1.3. Prohibition of monetary financing and privileged access

Under Article 8 of Chapter 6 of the Riksbank Act, the Riksbank may, in exceptional circumstances,

⁽¹¹⁵⁾ Legislative proposals to tackle the flaw have been submitted by the Swedish legislator since 2013 but those still provided for a decisive role of the Parliament in profit distribution and budget allocation, which are incompatible with the principle of financial independence as enshrined in Article 130 of the TFEU.

grant credits or provide guarantees on special terms to banking institutions and Swedish companies that are under the supervision of the Financial Services Authority. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU it should be clearly specified that the loan is granted against adequate collateral to ensure that the Riksbank would not suffer any loss in case of the debtor's default. When the Swedish Parliament inserted a new article 8a in Chapter 6 of the Riksbank Act obliging the Riksbank to provide information to the Government and a number of relevant public authorities on implemented liquidity support, the occasion was not seized to amend Article 8 as suggested above. Therefore, it continues to constitute an incompatibility with the prohibition on monetary financing under Article 123 of the TFEU.

Pursuant to Article 1(3) of Chapter 8 of the Riksbank Act, the Riksbank shall not extend credits or purchase debt instruments "directly from the State, another public body or institution of the European Union". The Article does not enumerate the entities covered by the prohibition of monetary financing correctly. Therefore, Article 1 is incompatible with the wording of Article 123(1) of the TFEU and 21(1) of the ESCB/ECB Statute.

According to Article 1(4) of Chapter 8 of the Riksbank Act, the Riksbank may grant credit to and purchase debt instruments from financial institutions owned by the State or another public body. This provision of Article 1 does not fully comply with Article 123(2) of the TFEU and Article 21.3 of the ESCB/ECB Statute because the exemption only covers publicly owned institutions. For the sake of legal certainty it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

The provisions of Article 4 of Chapter 10 on the allocation of the Riksbank's profit are supplemented by non-statutory guidelines on profit distribution, according to which the Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its contingency and balancing funds. Although these guidelines are not legally binding but accepted as a practice by Parliament for calculating profit

allocation and as there is no statutory provision limiting the amount of profit that may be paid out, such practice could constitute an incompatibility with the principle on the prohibition of monetary financing under Article 123 of the TFEU. The law should ensure that the reserve capital of Riksbank is left unaffected in any case and that the actual contribution to the State budget does not exceed the amount of the net distributable profit.

8.1.4. Integration in the ESCB

Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system as a task should be subordinated to the primary and secondary objectives of the ESCB.

Tasks

The incompatibilities of the Riksbank Act with regard to the ESCB/ECB tasks are as follows:

- absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1, Articles 1 and 2 of the Act and Chapter 9, Article 13 of the Instrument of Government);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Chapter 1, Article 2 and Chapter 6, Articles 2, 3 and 5 and 6, Chapter 11, Article 1 and 2a of the Act; Chapter 9, Article 13 of the Instrument of Government);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 of the Act; Chapter 8, Article 13 and Chapter 9, Article 12 of the Instrument of Government); Articles 1 to 4 of the Law on Exchange Rate Policy of 1998;
- right to authorise the issue of banknotes and the volume of coins and definition of the monetary unit (Chapter 5 of the Act; Chapter 9, Article 14 of the Instrument of Government);
- ECB's right to impose sanctions (Chapter 11, Articles 2a, 3 and 5 of the Act).

There are furthermore some imperfections regarding the:

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Chapter 6, Articles 4(2) and Article 9, 10 and 11 of the Act);
- non-recognition of the role of the ECB in the functioning of payment systems (Chapter 1, Article 2; Chapter 6, Article 7 of the Act);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor;
- non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Article 6).

8.1.5. Assessment of compatibility

As regards the prohibition on monetary financing, the independence of the Riksbank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Riksbank Act and the Instrument of Government as part of the Swedish Constitution, is not fully compatible with the compliance duty under Article 131 of the TFEU.

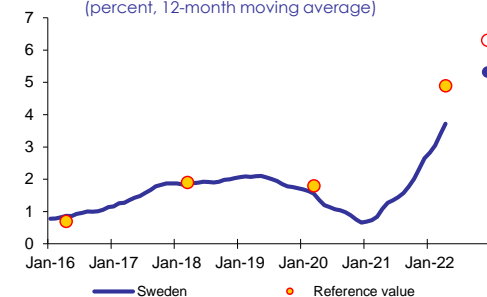
The Swedish authorities are invited to remedy the abovementioned incompatibilities.

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

The twelve-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Sweden in 2020. The twelve-month average inflation rate in Sweden then gradually decreased to a low of 0.7% in December 2020, after which it increased throughout 2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Sweden was 3.7%, i.e. below the reference value. The 12-month average inflation rate is projected to increase, but stay below the reference value in the months ahead.

Graph 8.1: Sweden - Inflation criterion
(percent, 12-month moving average)



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

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

8.2.2. Recent inflation developments

HICP inflation in Sweden dropped markedly at the beginning of 2020 as COVID-19 took hold, driven down by declining energy prices and moderating services inflation. This resulted in an average inflation rate of 0.7% in 2020. In 2021, HICP inflation rose to 2.7% on average. The pick-up in headline inflation began in early 2021, mainly due to the combined impact of markedly higher energy prices dominating strong negative base effects for unprocessed food prices, while other inflation components showed marked volatility. After a few months of declining inflation in the middle of 2021, the inflation rate accelerated from August onwards, initially mainly driven by sharply higher energy prices — foremost electricity prices. In the second half of 2021, price increases broadened across various categories of the consumer price index, lifting core inflation. In the first part of 2022 headline HICP inflation picked up, with more broadly entrenched price increases for a wide range of other goods and services. In April 2022, HICP inflation reached 6.6%, the highest rate on record since the harmonised consumer price index was first published in 1996, on the back of strong increases across a wide range of goods and services in the consumption basket.

In 2020 and 2021, core inflation (measured as HICP inflation excluding energy and unprocessed food) remained relatively subdued at around 1.5%, despite pandemic-induced sharp swings in import prices and nominal unit labour costs, the latter affected by the impact of temporary unemployment support schemes. Underlying labour costs remained muted on the back of moderate multi-annual wage agreements, which extend, into 2023. Firms absorbed part of the cost increases caused by supply chain disruptions in their margins, while the rate of increase of

Table 8.1:

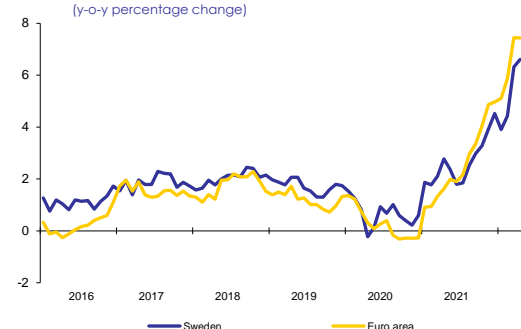
Sweden - Components of inflation	(percentage change) ¹⁾							weights in total
	2016	2017	2018	2019	2020	2021	Apr-22	2022
HICP	1.1	1.9	2.0	1.7	0.7	2.7	3.7	1000
Non-energy industrial goods	1.1	0.0	0.0	0.3	0.9	1.0	1.4	322
Energy	1.0	5.3	9.6	2.9	-8.8	15.3	22.7	96
Unprocessed food	2.6	2.0	4.5	2.3	2.6	-0.4	2.1	34
Processed food	0.5	2.0	1.8	2.8	1.9	0.9	1.8	163
Services	1.3	2.3	1.8	2.0	1.8	2.5	2.7	385
HICP excl. energy and unproc. food	1.1	1.5	1.2	1.6	1.5	1.6	2.0	870
HICP at constant tax rates	1.0	1.7	1.8	1.6	0.6	2.6	3.7	1000
Administered prices HICP	0.9	2.2	1.3	2.0	2.4	1.7	1.9	160

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

Source: Eurostat, European Commission calculations.

administered prices fluctuated around 2%, a similar rate as before the onset of the pandemic.

Graph 8.2: Sweden - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

From the second quarter of 2020 to the first quarter of 2022, the behaviour of inflation components exhibited larger-than-usual volatility, reflecting the impact of the pandemic on supply chains, consumption patterns (which in turn affected index weights) and seasonal patterns. The lagged impact of the strengthening of the effective exchange rate of the krona during most of 2020 helped achieve a moderate increase in prices for non-energy industrial goods. In 2020, unprocessed food prices registered strong gains as the pandemic started, while in 2021 demand for and prices of contact-related services received impetus from the easing of restrictions. The strong initial downturn and subsequent acceleration in energy prices accounted for the largest part of the marked swings in HICP inflation from 2020 through 2021. These dynamics were also a key determinant of the observed pattern for import and producer prices. In the first months of 2022, inflation rates increased markedly to the highest harmonised inflation rate on record, with price increases across a broad range of goods and services, mirrored in rising core inflation.

8.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

The Swedish economy experienced an unprecedented, but relatively short-lived decline in real GDP in the immediate wake of the COVID-19 pandemic, followed by a strong but unevenly paced recovery from the third quarter of 2020 onwards, as the initial recovery was interrupted by new COVID waves. Overall, the economy contracted by 2.9% in 2020, driven by a simultaneous fall in domestic demand and exports, as disruptions in global supply chains aggravated the initial downturn. Sweden's real GDP rebounded strongly in the second half of 2020 with the recovery continuing in 2021, mainly driven by strong gains in private consumption and investment, while exports also recovered markedly and helped lift economic growth. Sweden returned to the pre-crisis output level in the second quarter of 2021. In the second half of 2021 demand picked up for contact-related services such as restaurant and hotel services with the lifting of restrictions, facilitated by the progress in vaccination. Real GDP growth reached 4.8% for the year 2021. The slowdown at the beginning of 2022 reflects the combined impact of another wave of the pandemic, elevated inflation, the war in Ukraine and coincident persistent supply chain problems that had its roots in the pandemic affecting purchasing power, business and consumer confidence. This further lifted inflation with negative consequences for household purchasing power and costs to businesses. Moreover, it also induced further supply bottlenecks and falls in confidence among households and businesses. Real GDP growth is poised to recover in the course of 2022, as the Swedish economy adjusts to the changed global

Table 8.2:

Sweden - Other inflation and cost indicators		(annual percentage change)						
	2016	2017	2018	2019	2020	2021	2022 ¹⁾	2023 ¹⁾
HICP inflation								
Sweden	1.1	1.9	2.0	1.7	0.7	2.7	5.3	3.0
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Sweden	0.9	1.8	2.5	2.1	1.1	1.9	5.7	4.0
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Sweden	2.6	2.1	3.8	3.0	2.5	4.3	2.7	3.7
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Sweden	0.2	0.1	0.3	1.4	-1.7	3.5	0.1	0.5
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Sweden	2.4	1.9	3.5	1.5	4.3	0.8	2.6	3.2
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Sweden	-2.2	4.6	6.7	2.3	-5.4	5.1	14.5	5.5
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

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

environment. However, the pace of expansion, would remain comparatively modest in 2023. Overall, real GDP is forecast to grow by around 2¼% in 2022 and 1½% in 2023.

The fiscal stance turned contractionary in 2020 and remained broadly neutral in 2021⁽¹¹⁶⁾. It is expected to turn expansionary in 2022, due to additional expenditure aimed at addressing the economic impact of the pandemic, strengthening health care, easing some of the consequences of higher energy prices, and strengthening the military defence. In 2023, the fiscal stance is expected to be contractionary.

Monetary policy, conducted within an inflation targeting framework⁽¹¹⁷⁾, has remained expansionary in the period covered by the report.

⁽¹¹⁶⁾ The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

⁽¹¹⁷⁾ Since 1995, the Riksbank has targeted increases in the domestic CPI with the aim of keeping inflation at 2%. In September 2017, the Riksbank changed its target from measuring inflation in terms of CPI to CPIF (CPI with the interest rate component kept unchanged).

The Riksbank raised its main policy rate to 0% in January 2020, and has not changed it since. However, in response to the COVID crisis, the Riksbank cut the interest rate on the standing loan facility, which is defined in terms of a deviation above the policy rate, i.e. the repo rate plus 0.2 of a percentage point to the repo rate plus 0.1 of a percentage point. However, at its latest meeting on 28 April 2022, the Riksbank raised its main policy rate, the repo rate, by 25 basis points to 0.25%. The Executive Board's forecast is that the repo rate will be raised gradually going forward, and that it will be somewhat below 2 % in three year's time.

The Riksbank maintained an expansionary policy, also in view of its extensive purchases of government bonds. In order to limit the impact of the COVID-19 crisis, the Riksbank took a series of measures in several monetary policy meetings in March 2020. These decisions involved: (i) further purchases of securities up to SEK 300 billion in 2020, including government, municipal and mortgage bonds; (ii) a first reduction in the lending rate for overnight loans to banks from 0.75 to 0.20 percentage points above the repo rate; (iii) allowing banks to borrow unlimited amounts on a weekly basis against collateral at three months' maturity at an interest rate of 0.20 percentage points above the repo rate; (iv) purchasing commercial paper issued in Swedish kronor by Swedish non-financial corporations; and (v) offering loans in dollars thanks to the swap

arrangement of up to 60 billion USD that the Riksbank agreed with the US Federal Reserve⁽¹¹⁸⁾. The Riksbank also increased the flexibility of the collateral framework, giving banks more scope to use mortgage bonds as collateral and subsequently temporarily enlarged the circle of monetary policy counterparties. The Riksbank extended the framework for asset purchases from SEK 300 billion to SEK 500 billion in July 2020, and again to SEK 700 billion in November 2020. The Riksbank's total holdings of domestic government bills and bonds amounted to a cumulative SEK 415 billion in January 2022, more than 40% of the outstanding stock of central government debt instruments. The Riksbank also held SEK 420 billion of covered bonds, about one fifth of the market. However, on 28 April 2022, the Executive Board decided to reduce the pace of the Riksbank's asset purchases during the second half of 2022, so that the holdings starts to decrease. Moreover, the Riksbank ceased purchasing treasury bills as of 28 April 2022.

Wages and labour costs

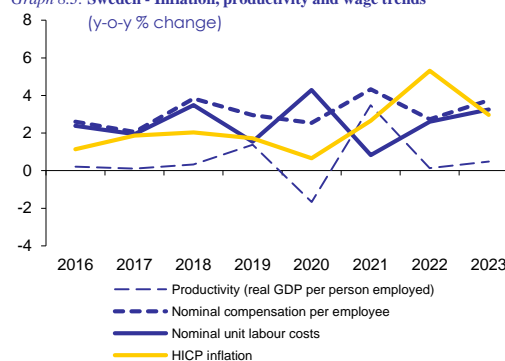
In the years before 2019, employment growth had been quite strong. However, this did not lead to a marked decline in the unemployment rate, due to the relatively strong growth of the labour force. The initial slump in the labour market after the pandemic had started was countered by sizable and frontloaded policy support, including support to households affected by temporary unemployment and to businesses suffering from turnover losses. During the recovery from the pandemic, employment growth picked up markedly, unemployment fell, and the number of vacancies rose to all-time highs by the first quarter of 2022 as employed shifted away from contact-intensive services to other branches of activity. The unemployment rate is expected to fall to 7% on average in 2023, around the 2019 level.

The growth in nominal compensation per employee stood at close to 3% on average in 2019. In Sweden, social partners typically first negotiate a benchmark agreement for exporting sectors aimed at maintaining cost competitiveness vis-à-vis major trading partners; other sectors, including services, tend to follow this benchmark rather closely. Against the backdrop of the COVID-19 crisis, social partners deferred the collective bargaining round foreseen for the first half of 2020. With a delay, a new multi-annual wage

agreement was reached, which extends into 2023 and provides for relatively moderate overall compensation growth. The current collective agreements should be a dampening factor for underlying inflation in 2022 and into the first months of 2023. Notwithstanding this, wage demands and wage drift might rise in response to the tightening labour market and the sharp increase in inflation that started in the second half of 2021, and gathered pace in the first months of 2022. Overall, the risks of significant second round effects of wage increases on inflation appears to be contained.

Sweden had moderate labour productivity growth in the years before 2019. In 2020 and 2021, the pandemic induced strong swings in economic activity while employment was supported by temporary unemployment schemes and various support schemes. As a result, aggregate measures of changes in labour productivity and unit labour costs for 2020 and 2021 are distorted.

Graph 8.3: Sweden - Inflation, productivity and wage trends
(y-o-y % change)



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

External factors

Given the openness of the Swedish economy, developments in import prices traditionally play an important role in domestic price formation. Import price growth (measured by the deflator of imports of goods) has fluctuated markedly over the past years. This was chiefly due to large swings in energy and other commodity prices, but also mirrors the price effects of pandemic-related trade, supply and demand disruptions, as well as exchange rate fluctuations. In 2020, the import deflator for goods fell sharply by 5.4%, due to lower commodity prices. This development was reversed in 2021, as import prices grew by 5.1%, largely because of energy prices, even though the rate of increase stayed below that in the euro area, which in turn was partly due to the lagged effect of

⁽¹¹⁸⁾ The Riksbank has a standing swap line with the ECB.

exchange rate appreciation. The impact of changes in import prices on consumer price inflation is difficult to gauge. There is evidence that the pass-through had been weakening before the pandemic in view of, for instance, changes in competitive conditions related to the rise of global value chains. However, during the pandemic it became very difficult to assess the pass-through of trade prices to consumer price inflation, given their high volatility and complex interactions with price effects of supply chain disruptions, exchange rate movements, inventory adjustments, sales restrictions, and other pandemic-related factors. Nevertheless, the recent marked increase in inflation indicates that import prices have been among the significant determinants of consumer price increases.

After an initial weakening at the onset of the COVID-19 crisis, the real effective exchange rate of the krona (measured against a group of 36 trading partners) strengthened in the course of 2020, having fallen over a number of previous years. The real effective exchange rate then slightly weakened in the course of 2021. For both years, there were no major discrepancies between the growth in domestic prices and the growth in domestic prices of Sweden's main trading partners. Likewise, for 2022 and 2023, major discrepancies between nominal and real effective exchange rates are not expected to occur. Overall, Swedish cost developments do not pose major challenges to competitiveness.

Administered prices and taxes

The share of administered prices in the Swedish HICP basket amounts to just above 15%, a value more than 2 percentage points above the euro-area average. The most important item in the administered price basket is rents. In 2020, at 2.4%, administered price inflation exceeded headline HICP inflation. By contrast, in 2021 administered price increases were more subdued at 1.7% and fell appreciably below the overall inflation rate. The changes in this component are largely accounted for by a marked increase in fully administered prices.

Tax changes contributed only marginally to in headline inflation in both 2020 and 2021, as the pace at which HICP at constant taxes increased over these two years was just below the headline number.

Medium-term prospects

According to the Commission's Spring 2022 Economic Forecast, inflation is set to remain elevated in 2022, mirroring broad-based price increases across a range of goods and services as trade and production bottlenecks persist. Domestic wage pressures are projected to remain relatively contained over the forecast period, despite the sharp increase in headline inflation, and some expected rise in compensation growth in 2023, reflecting the upcoming round of collective wage bargaining. Risks to the labour cost outlook appear skewed to the upside. However, the country has a long tradition of social partners taking into account competitiveness in their wage agreements. Overall, Sweden should not experience major changes in cost competitiveness. However, increases in energy and food prices in particular, along with broad-based increases in other components of core inflation are expected to keep headline inflation at a relatively elevated rate. In all, HICP inflation is forecast to average 5.3% in 2022 and decrease to 3% in 2023. Underlying inflation is set to rise markedly from 1.6% in 2021 to 4.1% in 2022, before decreasing to 3% in 2023 on the back of base effects.

The amending budgets for 2022 contain measures to compensate households and, in particular, the agricultural sector for increases in energy prices (energy tax deductions as well as an electricity allowance) amounting to 0.4% of GDP.

Overall, as of 2023 inflation is expected to meet the Riksbank's target, as the economy is normalising, despite some persistence in underlying price pressures. Risks to the inflation outlook are on the upside, in view of a stronger-than-expected pass-through of cost increases and war-related supply disruptions, possibly coupled with higher wage increases due to the tight labour market. While it is hard to interpret surveys on inflation expectations at this juncture, market expectations show a progressive rise of inflation above the Riksbank's target over the medium term.

Table 8.3:

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

Outturn and forecast ¹⁾	2016	2017	2018	2019	2020	2021	2022¹⁾	2023¹⁾
General government balance	1.0	1.4	0.8	0.6	-2.7	-0.2	-0.5	0.5
- Total revenue	50.7	50.6	50.7	49.7	49.9	50.0	48.7	47.7
- Total expenditure	49.7	49.2	49.8	49.1	52.6	50.2	49.1	47.2
of which:								
- Interest expenditure	0.5	0.4	0.5	0.4	0.3	0.2	0.1	0.2
p.m.: Tax burden	44.7	44.7	44.4	43.5	43.6	43.7	42.7	42.2
Primary balance	1.5	1.9	1.3	1.0	-2.4	0.0	-0.3	0.7
Fiscal stance ²⁾					1.5	0.1	-0.6	1.3
Government gross debt	42.3	40.7	38.9	34.9	39.6	36.7	33.8	30.5
p.m: Real GDP growth (%)	2.1	2.6	2.0	2.0	-2.9	4.8	2.3	1.4

1) Commission's Spring 2022 Economic Forecast.

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

Source: European Commission.

The level of consumer prices in Sweden relative to the euro area has increased since Sweden joined the EU in 1995. In 2020, the Swedish price level stood at 123% of the euro-area average. At the same time, the relative real GDP per capita level in Sweden has risen since 2019, reaching about 117% of the euro-area average in PPS terms in 2021.

In the medium term, inflation could prove to remain relatively high for longer, given the size and possible persistence of price and cost pressures (also reflecting the energy transition), possible persistence of supply constraints, weak productivity trends, high vacancy rates, and reported skill shortages. However, as resource utilisation is expected to abate somewhat over the forecast period, there is uncertainty on how resource pressures will feed into inflation. In particular, if wage expectations would remain relatively moderate in their response to upside inflation surprises, which has been the case in the prevailing wage bargaining system, there is no reason to believe that wage increases will add a push towards higher inflation.

8.3. PUBLIC FINANCES

8.3.1. Recent fiscal developments

Sweden's general government balance improved from a deficit of 2.7% of GDP in 2020 to a deficit of 0.2% of GDP in 2021. The expenditure-to-GDP ratio decreased from 52.6% of GDP in 2020 to 50.2% in 2021, whereas the revenues-to-GDP ratio stabilised at around 50% of GDP during the same

period. This reflected mainly the phasing out of several COVID-19 measures during the autumn of 2021, dominating continued expenditure support in some areas, as well as a denominator effect as growth rebounded strongly in 2021.

After an increase of close to 5 percentage points in the public debt-to-GDP ratio from 2019 to 2020, the debt level resumed its downward path in 2021, falling back to 36.7% of GDP, which is lower than what it was in 2018. Apart from the impact of an improving nominal balance with the recovery in economic activity, some of the decrease reflects the stepwise debt-reducing repayment of a Riksbank loan for foreign currency reserves during the 2021-2023 period, equivalent to around 3.5% of GDP.

8.3.2. Medium-term prospects

The 2022 budget, adopted in November 2021, includes new spending and revenue measures amounting to around 1.5% of GDP. On the expenditure side, it contains measures to strengthen social benefits (notably during sick leave), increased grants to local governments and regions (to cover pandemic-related costs), strengthened active labour market policies (focused on the young and the long-term unemployed), and measures to strengthen law enforcement. Significant outlays also stem from extended COVID support in the first months of the year, including in sick pay. In addition, the 2022 budget includes spending on green and digital items financed by grants from the Recovery and

Resilience Facility, amounting to 0.2% of GDP. On the revenue side, the draft budget entails a generalised income tax cut as well as targeted reductions for people on sickness and disability benefits. Nevertheless, tax receipts are expected to hold up, in line with the resilient labour market and healthy corporate profitability.

In addition, the parliament adopted a set of amending budgets in the first months of the year. Further measures were announced on 19 April 2022 in the Spring amending budget bill, which remains to be adopted. On balance, these additional measures amount to an increase in net expenditures of close to 1.5% of GDP to address the continuing impact of the pandemic, introduce extraordinary compensation to households and firms for soaring energy prices, cover the costs of refugees from Ukraine, and provide for structurally higher spending on defence. In all, the general government balance is expected to register a small deficit of 0.5% of GDP in 2022, in light of the planned expenditure increases.

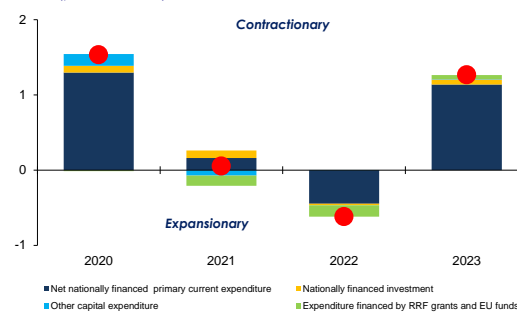
On 29 April 2022, Sweden submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to increase somewhat to 0.5% of GDP in 2022 and turn into a surplus of 0.7% of GDP in 2023. The government deficit in 2022 is impacted by the additional measures taken by the government to counter the social and economic impact of the pandemic and the increase in energy prices. Based on the Commission's Spring 2022 Economic Forecast, the measures to cushion the impact of the increase in energy prices are estimated at 0.4% of GDP in 2022, which are currently expected to be temporary and to be withdrawn in 2023. The annual cost of humanitarian assistance is projected at 0.1% of GDP in 2022 and 2023.

The Commission's Spring 2022 Economic Forecast projects the general government deficit to reach 0.5% of GDP in 2022 and turn into a surplus of 0.5% of GDP in 2023. The projections for public finances in the 2022 Convergence Programme are thus close to the Commission's Spring 2022 forecast.

For 2022, the Commission's Spring 2022 Economic Forecast projects the fiscal stance to be supportive at 0.6% of GDP⁽¹¹⁹⁾. The Forecast

projects that expenditures financed by the Recovery and Resilience Facility grants and other EU funds will contribute positively to economic activity at 0.2 of a percentage point of GDP in 2022, higher by 0.1 of a percentage point of GDP compared to 2021. Nationally financed investment is projected to provide a neutral contribution to the fiscal stance. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of 0.4 of a percentage point of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, much of this expansion is due to temporary measures to support the economy in facing current headwinds.

Graph 8.4: Sweden - Fiscal stance and its components (percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2023, the fiscal stance is projected to turn contractionary at 1.3% of GDP. The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected at 0.1 of a percentage point of GDP in 2023, reflecting the frontloaded financial support from the Recovery and Resilience Facility in 2021 and 2022. Nationally financed investment is projected to provide a slightly contractionary contribution to the fiscal stance⁽¹²⁰⁾. The growth in nationally financed primary current expenditure is projected to provide a contractionary GDP contribution to the overall fiscal stance in 2023.

Debt sustainability risks appear low over the medium term. Government debt is projected to decrease reaching around 11% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of 1.3% of

⁽¹¹⁹⁾ For a definition of the fiscal stance used in this report, see footnote in Section 8.2.3 on underlying factors and sustainability of inflation.

⁽¹²⁰⁾ Other nationally financed capital expenditure is projected to provide a neutral GDP contribution.

GDP, which constitutes an improvement compared to the 2019 level.

The low sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the projected improvement in the structural primary balance in 2022-2023 were to occur, the projected debt ratio in 2032 would be only some 1 percentage points of GDP higher than in the baseline, i.e. still substantially below 60% of GDP.

Some factors mitigate risks, including the stability of debt maturity in recent years, relatively stable financing sources (with a diversified and large investor base), historically low borrowing costs reflecting a long-standing strong creditor status, Sweden's positive net international investment position and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis, though currently this risk remains limited due to relatively low take-up ⁽¹²¹⁾.

Building on a strong institutional set-up and a robust fiscal track-record, revisions to the fiscal framework took effect in 2019. Among the novelties, the government introduced a debt anchor, set at 35% of GDP with a 5-percentage-point tolerance margin, and the net lending target was lowered from 1% of GDP over the cycle to 0.33% of GDP. The expenditure ceiling and the balanced budget requirement for local authorities were left unchanged. The fulfilment of the net lending target will be assessed based on a single indicator, the structural balance in the current and subsequent year, replacing a system of several indicators with undefined weights. The government also decided to conduct regular reviews of the adequacy of the framework every eight years, in the final year of every second parliament. Despite the relaxation of the target, the authorities still consider there to be an adequate safety margin to allow for normal economic fluctuations without breaching the 3% of GDP deficit benchmark of the Stability and Growth Pact.

The revisions to the fiscal framework also entailed a widened mandate for the Fiscal Policy Council (Finanspolitiska rådet), set up in 2007. The

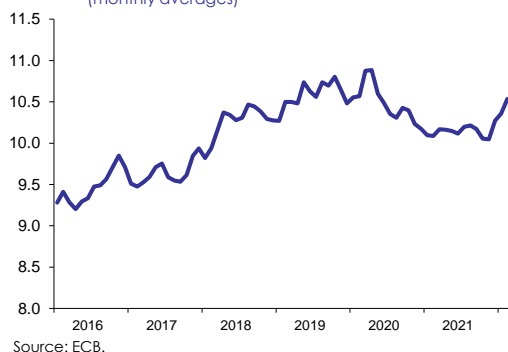
Council was tasked to evaluate the official macroeconomic forecasts and to perform costing of reform proposals. It also received the explicit task to assess whether there is a deviation from the net lending target and, if so, to assess the reasons for the deviation, and to propose how fast the government should eliminate it. Furthermore, in order to increase the diversity of the Council, the member selection process was changed. Instead of current Council members nominating new candidates, this task now resides with a nomination committee, which among its members has the Chair and Deputy Chair of the parliamentary Finance Committee. It is still the government that formally appoints the new members.

Some of the new elements in the fiscal framework contribute to bringing the framework in line with the Budgetary Frameworks Directive ⁽¹²²⁾, such as introducing the debt anchor as an explicit multi-annual debt objective, or mandating the Fiscal Council with the regular assessment of the government's economic forecasts.

8.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. As indicated above, the Riksbank pursues inflation targeting under a *de jure* floating exchange rate regime.

Graph 8.5: Sweden - SEK/EUR exchange rate
(monthly averages)



The long-term trend of the krona depreciating against the euro started in 2013 and ended in early April 2020, after a cumulated depreciation of more than 30%. With the onset of the COVID-19 crisis, the krona first weakened, but then started to appreciate, on the back of the resilience of the economy, with Sweden implementing less strict

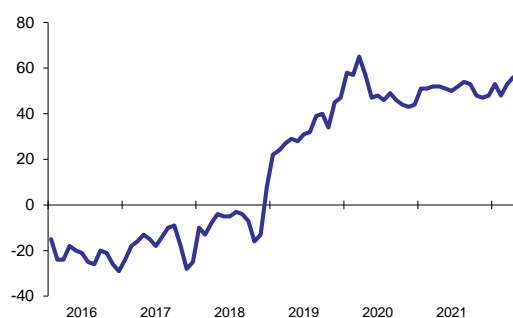
⁽¹²¹⁾ For further details see the 2021 Fiscal Sustainability Report.

⁽¹²²⁾ The Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, available at: <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32011L0085>

measures than most euro-area Member States in response to the pandemic. Between April 2020 and November 2021, the krona appreciated by almost 8% against the euro, and reached a new peak at 10.05 SEK/EUR. As the euro-area economy recovered, and Member States gradually loosened their restrictions, the krona fell back by 3% in December 2021 and January 2022. In February and March 2022, the krona depreciated by another 1.8%, as Russia's invasion of Ukraine spurred safe-haven flows. This was followed by a 2.2% reversal in April. Volatility in the exchange rate is significant, where short-term fluctuations reflect changes in risk appetite and short-term funding flows, as well as changing perceptions of the future direction of monetary policy.

The 3-month STIBOR-EURIBOR spread has remained broadly stable since June 2020. The spread averaged 50 basis points in 2020 and 51 basis points in 2021. Since June 2020, the spread has remained in a range of 43-56 basis points, without any large swings. Thus, the episode of appreciation and subsequent depreciation of the Swedish krona between 2020 and early 2022 cannot be accounted for by changes in the spreads on short-term interest rates.

Graph 8.6: Sweden - 3-M Stibor spread to 3-M Euribor
(basis points, monthly values)



Source: Eurostat and Thomson Reuters.

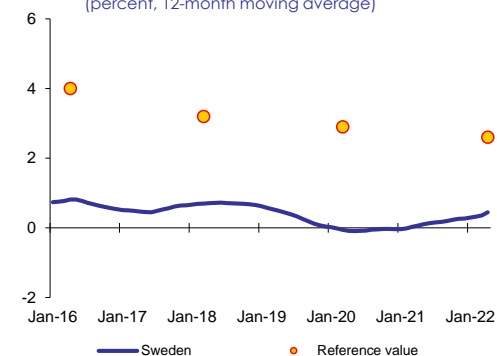
Since December 2015, the Riksbank can intervene on foreign exchange markets in order to prevent a de-anchoring of inflation expectations due to a strengthening krona. The level of foreign currency reserves and gold decreased by almost 9% in krona between December 2019 and December 2020 and increased by more than 5% between December 2020 and December 2021, when it stood at around SEK 461 billion. At the beginning of 2022, international reserves stood just below the level of SEK 460 billion, or around 8.5% of GDP. The change in 2020 reflects changes in the exchange rate and the Riksbank decisions to lower the level

of foreign exchange reserves, which had increased substantially after the global financial crisis. The post-crisis increase was financed by loans from the Swedish National Debt Office. However, the Riksbank has decided to repay the loans and instead obtain dollars and euros using Swedish krona.

8.5. LONG-TERM INTEREST RATES

Long-term interest rates used to assess adherence to the convergence criterion reflect secondary market yields on a single benchmark government bond with a residual maturity of around ten years.

Graph 8.7: Sweden - Long-term interest rate criterion
(percent, 12-month moving average)



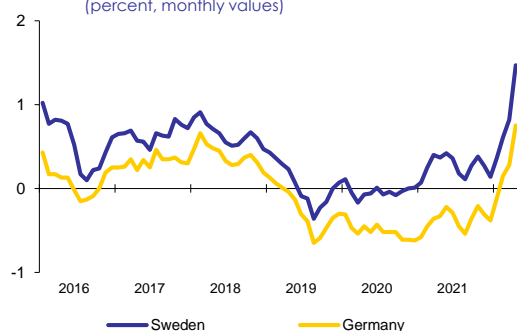
Source: European Commission.

The Swedish 12-month moving average long-term interest rate, relevant for the assessment of the Treaty criterion was well below the reference value at the time of the 2020 convergence assessment of Sweden. The 12-months average continued to stay below 1% over the last two years, where it has been since June 2015. It remained stable during 2020, and the first quarter of 2021 at around -0.04%. Since March 2021, the 12-month average interest rate has edged up into positive territory and reached 0.3% in January 2022. In April 2022, the latest month for which data are available, the reference value, given by the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the Swedish benchmark bond stood at 0.4%, i.e. 2.2 percentage points below the reference value.

As regards monthly data, long-term interest rates were very stable during 2020, with small fluctuations around 0%. The highest rate in 2020 was 0.1% and the lowest was -0.2%. Since the beginning of 2021, the interest rate has been fluctuating around a slightly higher level of 0.3%.

Volatility increased somewhat in 2021, but overall the long-term interest rate continued to be broadly stable in a range of 0.1-0.4%. The compression of Swedish long-term interest rates in 2020-2021 reflected the continuation of the non-standard monetary policy measures, with continued acquisition and reinvestment of governments bonds as a response to the low domestic inflation environment. The Riksbank decided to increase its asset-purchase programme in response to the COVID-19 crisis. The yields of the Swedish benchmark government bond remained relatively closely aligned to the German benchmark bond, in line with the safe-haven status of Swedish government bonds. However, long-term interest spreads vis-à-vis the German benchmark bond increased during 2020 and 2021, from a low of 37 basis points to a high of 76 basis points in March 2021. Since then the spread declined until February 2022, before increasing to 72 basis points in April 2022.

Graph 8.8: Sweden - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

8.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its latest Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review was warranted for Sweden. Taking into account the assessment in its In-Depth

Review, the Commission, in its Communication 'European Semester – 2022 Spring Package' ⁽¹²³⁾, considers that Sweden is experiencing imbalances with vulnerabilities that relate to high and rising house prices and high household indebtedness. In 2021, house prices moved further away from fundamental values with supportive financial conditions continuing to fuel housing demand. High household debt exposes Sweden to the risk of adverse shocks and a disorderly correction of housing prices, with potential harmful implications for the real economy and the banking sector. Private debt has risen further, a large share of which is concentrated in real estate, both commercial and housing, and most of household mortgage debt is at variable interest rates. Policy measures have not sufficiently addressed vulnerabilities relating to housing debt and potential house price overvaluations. Tax incentives for debt-financed housing remain, along with shortages in supply and identified shortcomings in the functioning of the rental market. Measures in the RRP only address the vulnerabilities in a partially satisfactory manner.

Sweden submitted its recovery and resilience plan (RRP) on 28 May 2021. The Commission's positive assessment on 29 March 2022 and Council's approval on 4 May 2022 paved the way for the implementation of the RRP and the disbursement of EUR 3.3 billion in grants, which is equivalent to 0.7% of 2019 GDP, over the period 2022-2026.

Sweden's plan includes a set of mutually reinforcing reforms and investments (12 investments and 15 reforms) that contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations (CSRs) addressed to Sweden by the Council in the European Semester in 2019 and 2020.

The plan addresses among others key macro-economic challenges such as green and digital transition, demographic change, and strengthening the education and healthcare systems. Key investments are included to support the low carbon and energy transitions, as well as sustainable infrastructure, such as broad subsidy schemes aimed at speeding up the decarbonisation of industry and transport via the promotion of investment in the development and application of innovative technologies for fossil-free solutions,

⁽¹²³⁾ COM(2022)600 final.

Table 8.4:

Sweden - Balance of payments		(percentage of GDP)				
	2016	2017	2018	2019	2020	2021
Current account	2.4	3.0	2.7	5.5	6.1	5.5
of which: Balance of trade in goods	1.6	2.1	2.0	3.9	4.6	4.5
Balance of trade in services	1.5	0.6	0.3	0.6	0.0	-0.1
Primary income balance	0.5	1.7	2.0	2.9	3.5	3.0
Secondary income balance	-1.3	-1.5	-1.6	-1.9	-2.1	-1.9
Capital account	0.0	0.0	0.0	0.0	0.1	0.2
External balance ¹⁾	2.3	2.9	2.8	5.5	6.1	5.7
Financial account	-4.9	4.1	1.6	4.5	-9.5	1.7
of which: Direct investment	-2.8	2.7	2.5	1.3	0.9	-1.1
Portfolio investment	1.1	0.6	-1.8	2.2	-11.0	7.1
Other investment ²⁾	-4.0	0.7	0.9	2.2	0.5	-5.2
Change in reserves	0.8	0.1	-0.1	-1.2	0.1	1.0
Financial account without reserves	-5.7	4.1	1.6	5.7	-9.7	0.8
Errors and omissions	-7.2	1.2	-1.2	-1.0	-15.7	-3.9
Gross capital formation	24.7	25.7	26.0	25.1	24.8	25.6
Gross saving	27.1	28.5	28.6	30.3	30.8	31.1
Net international investment position	-3.5	-0.9	8.1	16.2	14.1	17.8

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Statistics Sweden, European Commission calculations.

acceleration of the roll out of high-speed broadband in sparsely populated areas and investing in continuous learning and digital skills. Key reforms include promoting decarbonisation by requiring fuel suppliers to blend in sustainable biofuels in petrol, diesel and jet fuel, improving the sustainability of the pension and social security system, combating money laundering, increasing the accessibility and capacity of the health care system, in particular through training of elderly care providers, as well as measures that aim to promote housing supply by reducing bottlenecks in permit procedures.

The plan devotes 44.4% of its total allocation to measures supporting climate objectives, 20.5% to the digital transition and 38.1% on social expenditure, all while respecting the do no significant harm principle.

The implementation of the investments in the Swedish plan, along with other investments under NextGenerationEU, is estimated to raise Sweden's GDP by 0.6% by 2026, of which 0.3% due to the positive spillover effects of the coordinated implementation of NextGenerationEU across

Member States (Pfeiffer et al. 2021) ⁽¹²⁴⁾. This does not take into account the positive impact of structural reforms on growth.

8.6.1. Developments of the balance of payments

According to Balance of Payments data, Sweden's current account surplus increased to 6% of GDP in 2020, as domestic demand retrenched and goods trade held up comparatively well, despite plant closures and other supply and production disruptions in the wake of the pandemic. A decline in the balance on services offset the further increase in the primary income balance that had trended up from 2015 onwards. In 2021, the current account broadly stabilised at 5.5% of GDP, driven by high surpluses in the goods and the primary income balances. The solid export performance in goods was supported by the strong competitive position of Swedish exporters. By contrast, as in 2020, current transfers delivered a negative impact on the current account balance,

⁽¹²⁴⁾ See Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

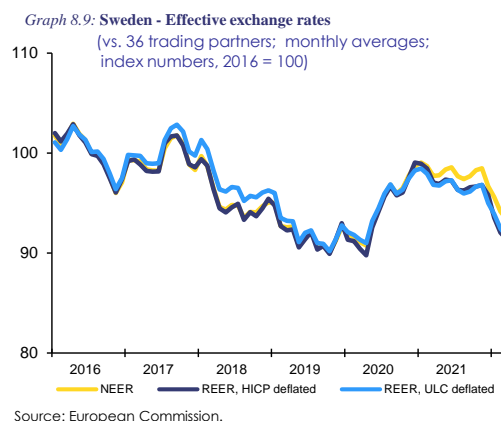
reflecting Sweden's foreign aid and positive net contributions to international organisations, as well as remittances transferred by foreign workers in Sweden to their home countries.

Sweden's net international investment position improved markedly to nearly 15% of GDP in 2020, and is expected to have improved further in 2021. Sweden's financial account shows relatively large fluctuations over time. However, seen over a longer period, the financial account balance has been mostly in surplus and mainly reflects Sweden's role as a net FDI investor abroad. Similarly, the balance of portfolio investments fluctuated appreciably from year to year, mirroring the interplay of financial market conditions and perceptions, exchange rates and relative cyclical positions but remained mostly in surplus. External debt was on a declining trend, and decreased by more than 20 percentage points between 2014 and 2019, to around 170% of GDP in the latter year. The strong fiscal position with the concurrent decline in gross government debt has been a factor behind this decline. In 2020 and 2021, the ratio of external debt to GDP remained broadly stable.

Sweden's export market share has been declining overall since the early 2000s, a phenomenon shared with several other high-income countries. The trend decline in the export market shares is linked to changing global trade patterns, which affect most mature, industrialised economies with a similar focus on high-value-added exports. Thus, this downward trend does not suggest any underlying competitiveness issues per se. It is difficult to assess short-term fluctuations in export shares given the high degree of volatility in global trade since 2020. These make it even harder than in more stable phases of the cycle to separate specific factors that impact trade performance from cyclical composition effects of export specialisation and from changes in structural features.

This benign conclusion on competitiveness is buttressed by the developments in cost competitiveness indicators. The nominal and real effective exchange rates strengthened over 2020, but fell slightly in 2021. Unit labour costs exhibited large swings in 2020 and 2021 in view of the disparate behaviour of economic activity and employment metrics, all affected heavily by the pandemic as well as large-scale policy

intervention⁽¹²⁵⁾. Allowing for such volatility, the underlying trend is that unit labour costs have been growing fairly moderately over the past number of years and broadly in line with Sweden's main trading partners.



According to the Commission's Spring 2022 Economic Forecast, which is based on National Accounts data, the current account surplus is projected to fall further in 2022, to 4.8% of GDP, in National Account terms, before rising again to 5.8% of GDP in 2023.

8.6.2. Market integration

Sweden is well integrated with the euro area through trade and investment linkages. Trade openness of the Swedish economy has been high, at over 40% (except in 2016, when it was just below that level) or more every year since 2005, although falling back in 2020 to somewhat over the 2016 level. However, trade openness recovered in 2021. The main euro-area trading partners are Germany, the Netherlands and Finland, while among non-euro-area countries Norway and Denmark are the main trade partners.

The stock of inward FDI has remained fairly stable relative to GDP in recent years (equivalent to 92.2% of GDP in 2020 and 92.9% in 2021). As regards net inward FDI in 2021, close to 56% originated from the euro area, whereas substantial flows originate from non-euro-area countries, primarily Denmark, Norway and the UK, a well-established pattern over a longer period.

Regarding the business environment, Sweden regularly scores top positions in international

⁽¹²⁵⁾ The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Sweden.

Table 8.5:
Sweden - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness ¹⁾ (%)	39.8	41.2	43.4	44.3	40.7	42.4
Trade with EA in goods & services ²⁾⁺³⁾ (%)	17.4	18.2	19.0	19.2	17.7	18.6
World Bank's Ease of Doing Business Index rankings ⁴⁾	9	10	12	10	10	-
IMD World Competitiveness Ranking ⁵⁾	5	9	9	9	6	2
Internal Market Transposition Deficit ⁶⁾ (%)	1.4	0.3	0.1	0.7	0.7	-
Real house price index ⁷⁾	107.3	112.4	108.7	109.1	112.4	121.5

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Imports} + \text{Exports of goods with EA-19} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

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

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.

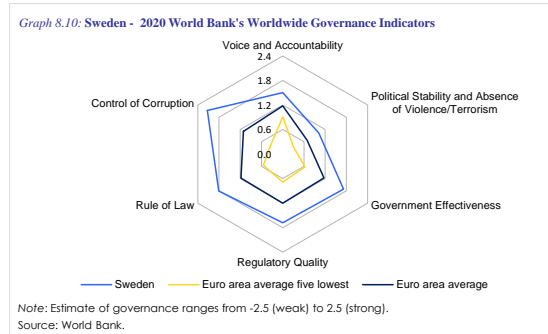
(November data, as of 2016 date refers to the year of publication).

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

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

rankings, well above most euro-area Member State and currently ranks in the top ten at global level, with respect to the World Bank's Ease of Doing Business indicator and to the IMD World Competitiveness Ranking⁽¹²⁶⁾. According to the World Bank's Worldwide Governance Indicators (2020), Sweden ranks higher than the average of the euro-area Member States in all six categories, notably voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption.⁽¹²⁷⁾ Sweden's deficit in the transposition of EU directives in 2020 was at 0.7%, below the EU average and just above the 0.5% target as proposed by the European Commission in the Single Market Act (2011).

Sweden has notified a complete transposition of the 5th Anti-Money Laundering Directive, and the Commission is currently assessing whether there are any potential conformity or effectiveness issues in the transposition or implementation of the legal act.



The Swedish labour market, largely governed by negotiations between social partners at sectorial level, is characterised by high employment rates. Sweden has the largest labour force participation rate in the EU. Low nominal wage increases in recent years have been a factor behind muted underlying inflation. In the wake of the COVID-pandemic, modest multi-year wage agreements among social partners (which extend into 2023) have helped contain wage-induced inflation risks. Sweden has one of the lowest wage dispersions in the EU, with high entry wages and relatively little wage progression. According to the 2019 OECD employment protection indicator, the employment protection of permanent workers is rather high compared to that of temporary workers. The dispersion of regional unemployment rates is relatively low, but persistent imbalances in the housing market and high costs of housing, not only in the larger cities but also in new development poles, like in the north of the country, pose challenges to labour mobility. The integration of low-skilled workers and those born outside the EU remain a key challenge for the Swedish labour market, though, as the employment rate of both groups is significantly below the overall

⁽¹²⁶⁾ The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

⁽¹²⁷⁾ A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

employment rate. During the recovery from the initial COVID-19 shock, the number of unfilled vacancies rose sharply. In the first quarter of 2022, the vacancy ratio rose to the highest level on record since the statistic reporting on this variable started in 2009. While this high ratio partly reflects transitory shortages, given the high rate of labour market turnover and job-switching in the wake of the pandemic, it also points at mismatches extending to a wide range of branches of economic activity. Skills shortages remain particularly pronounced in education, health care, social work, information and communication technology, industry and construction.

The financial sector in Sweden is highly developed and is commensurate to that of the average in the euro area. Relative to GDP, assets managed by the financial sector are about 85% of that of the euro area. Since 2016, the Swedish financial sector has grown significantly more than it has in the euro area. Banking dominates the Swedish financial sector and makes up around 45% of the assets of the financial sector, which is more than in the euro area. Non-money-market funds are at par with the euro area, and despite the Riksbank's extensive asset-purchase programme, it only holds a relatively small share of total financial assets (less than half of what the ECB accounts for).

Table 8.6:
Sweden - Allocation of assets by financial sub-sector

	SE		EA		Ratio to GDP (%)	
	2016		2020		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	577	677	722	796	177	215
Central bank	19	26	45	78	37	61
Monetary financial institutions	285	302	286	311	97	98
Other financial intermediaries	65	83	202	179	20	28
Non-MMF investment funds ¹⁾	81	108	100	127	4	5
Insurance co. and Pension Funds	126	158	90	102	18	23
Share of total (%)						
	SE		EA		EA 5 smallest	
	2016		2020		2016	
	2016	2020	2016	2020	2016	2020
Central bank	3	4	6	10	21	29
Monetary financial institutions	49	45	40	39	55	46
Other financial intermediaries	11	12	28	22	11	12
Non-MMF investment funds	14	16	14	16	2	2
Insurance co. and Pension Funds	22	23	12	13	10	11

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

The insurance and pension-fund sector in Sweden is the second largest manager of financial assets. It is almost twice as big as it is in the euro area, relative to GDP. This reflects the high degree of development of the funded pension system. Since end-2016, the sector has increased its holdings of financial assets by almost 29 percentage points in relation to GDP, while in the euro area it increased by only 12 percentage points. However, as a share of total assets managed by all financial corporations in the economy, the insurance and pension fund sector has been broadly stable. The

investment-funds sector is of roughly equal size as in the euro area, and plays a similar role.

As to the financing of the economy, Sweden has among the most developed credit and equity markets relative to GDP, and market financing (debt securities and listed shares) is among the highest in the EU. Loans are still an important source of funding and make up 276% of GDP in 2020, compared to 240% of GDP in the euro area. This partially reflect the high degree of household indebtedness. Equity and private-sector-debt markets are very large compared to those of the euro area. Private-sector debt markets represent 134% of GDP, and listed stocks represents 182% of GDP. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is significantly lower than in the euro area. In terms of share of the sum of liabilities, loans in Sweden are comparable to that of the euro area. For securities, the differences reflect the larger share of market funding available in Sweden, and the traditional recourse to this type of funding.

Table 8.7:

Sweden - Financing of the economy¹⁾

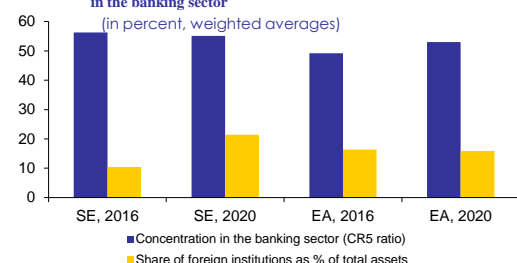
	SE		EA		Ratio to GDP (%)	
	2016		2020		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	893	1016	743	770	324	335
Loans	247	278	238	236	115	112
Non-financial co. debt securities	21	30	12	15	3	4
Financial co. debt securities	115	112	74	68	11	12
Government debt securities	36	30	83	95	51	57
Listed shares	139	182	65	73	17	18
Unlisted shares	250	291	186	193	55	56
Other equity	64	73	51	56	42	48
Trade credits and advances	21	22	33	35	29	29
Share of total (%)						
	SE		EA		EA 5 smallest	
	2016		2020		2016	
	2016	2020	2016	2020	2016	2020
Loans	28	27	32	31	35	33
Non-financial co. debt securities	2	3	2	2	1	1
Financial co. debt securities	13	11	10	9	3	3
Government debt securities	4	3	11	12	16	17
Listed shares	16	18	9	9	5	5
Unlisted shares	28	29	25	25	18	18
Other equity	7	7	7	7	13	14
Trade credits and advances	2	2	4	5	9	9

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

Sweden's banking sector is well integrated into the euro-area financial sector, through a high level of foreign ownership in its banking system, and because Stockholm acts as regional financial hub. The share of foreign-owned institutions in total bank assets stood at 21% in 2020, surpassing the euro-area average by 5 percentage points. The share more than doubled between 2016 and 2020, when Nordea's headquarter moved to Finland in 2018. Bank concentration, as measured by the market share of the five largest credit institutions

in total assets, has remained broadly stable at 55%, slightly above the euro-area average, which was 53% at the end of 2020.

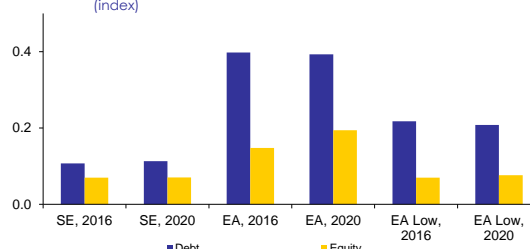
Graph 8.11: Sweden - Foreign ownership and concentration in the banking sector
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, but Sweden scores well below the euro-area averages for both equity and debt holdings.⁽¹²⁸⁾ In terms of equity-market integration, Sweden reaches a comparable level of integration to those of the five euro-area Member States with the lowest level of integration. Concerning portfolio investments in debt, the home bias is very strong in Sweden relative to euro-area Member States. The level of home bias in Sweden has not changed by much between 2016 and 2020. To some extent, these results reflect the high degree of development of Swedish financial markets and the country's large and diverse industry sector. This allows Swedish investors to hold liquid assets in a broad set of companies operating on world markets, letting them hold diversified portfolios exposed to world market risk without investing abroad.

Graph 8.12: Sweden - Intra-EU integration in equity and debt portfolio investment
(index)



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

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

⁽¹²⁸⁾ Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.