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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

CONVERGENCE REPORT 2022

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

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1. PURPOSE OF THE REPORT

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

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

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

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

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

Russia's invasion of Ukraine on 24 February 2022 forced a re-assessment of the outlook for the EU economy, which had been expected to expand strongly in 2022

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[1] The Member States that have not yet fulfilled the necessary conditions for the adoption of the euro are referred to as 'Member States with a derogation'. Denmark negotiated an opt-out before the adoption of the Maastricht Treaty and does not participate in the third stage of economic and monetary union.

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

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

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

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

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

The 2020 economic recession and fiscal response to the COVID-19 pandemic led to a sharp increase in general government deficits and debt. In 2020, the deficit was above the 3% of GDP Treaty reference value in 25 Member States, with an EU aggregate deficit of 6.8% of GDP. In 2021, the strong economic recovery contributed to an improvement in government deficits and debt improved, with fifteen Member States recording deficits higher than 3% of GDP and the EU aggregate deficit declining to 4.7% of GDP. In March 2020, the European Commission, with the agreement of the EU Ministers of Finance, activated the general escape clause of the Stability and Growth Pact. On 23 May 2022, in its Communication on the 2022 European Semester spring package, the Commission considered that the Union was not yet out of a period of severe economic downturn and that the conditions to maintain the general escape clause in 2023 and to deactivate it as of 2024 were met.

The Commission invited the Council to endorse this conclusion to provide clarity to Member States. In spring 2020, 2021 and 2022, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken, taking into account the extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic that, together with the geopolitical situation in spring 2022, create exceptional uncertainty, including for designing a detailed path for fiscal policy[4]. These conclusions have straightforward implications for the assessment of the criterion on the government budgetary position presented in this report.

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

Convergence criteria

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

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

Article 1 of the Protocol on the convergence criteria further provides that *'the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions'*[5].

The requirement of sustainability implies that the satisfactory inflation performance must be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary

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

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

factors. The convergence examination therefore includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a reference to the most recent Commission forecast of inflation[6]. Related to this, the report also assesses whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 4.9% in April 2022, with France, Finland and Greece as the three 'best-performing Member States'[7].

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

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

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

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[6] All forecasts for inflation and other variables in the current report are from the Commission's Spring 2022 Economic Forecast. The forecasts are based on a set of common assumptions for external variables and on a 'no policy change' assumption while taking into consideration measures that are known in sufficient detail.

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

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

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

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

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

Article 3 of the Protocol on the convergence criteria provides that: '*'The criterion on participation in the exchange rate mechanism of the European Monetary System […] shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period''*[9].

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

The fourth indent of Article 140(1) TFEU requires that '*the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism' is 'reflected in the* ***long-term interest rate levels***'. Article 4 of the Protocol on the convergence criteria further states that *'the criterion on the convergence of interest rates […] shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions'*.

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

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

The interest rate reference value was calculated to be 2.6% in April 2022[11].

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

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

2. BULGARIA

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

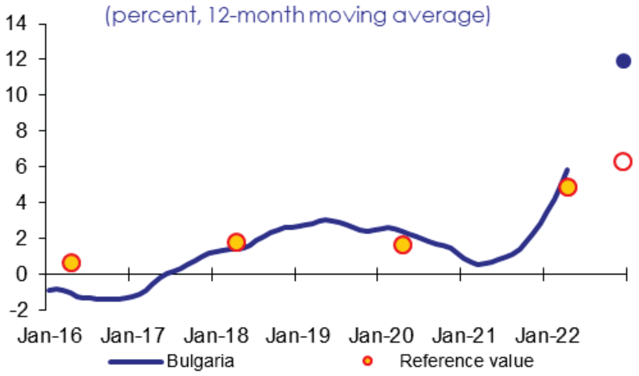
Legislation in Bulgaria — in particular the Law on the Bulgarian National Bank — **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of central bank independence, the prohibition of monetary financing and central bank integration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

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

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

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

Graph 2a: **Bulgaria - Inflation criterion since 2016**



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

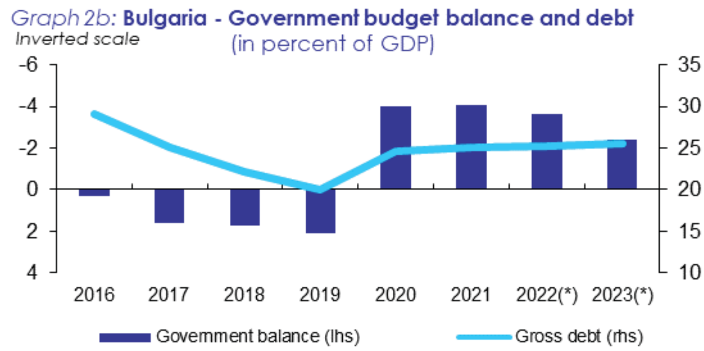
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

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

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

Bulgaria fulfils the criterion on public finances. Bulgaria is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance remained broadly stable with a deficit of 4.0% of GDP in 2020 and a deficit of 4.1% of GDP in 2021. After a period of budget surpluses, these deficits are the result of the pandemic-induced shock and the measures taken by the Bulgarian government in response to it. The Commission's Spring 2022 Economic Forecast expects the general government balance is projected to improve to -3.7% of GDP in 2022. Fiscal costs associated with people fleeing the war in Ukraine as well as measures in light of higher energy prices weigh on the deficit's recovery path. The deficit is expected to reach -2.4% of GDP in 2023 under a 'no policy change' assumption. On 23 May 2022, the Commission adopted a report prepared in accordance with Article 126(3) of the TFEU for 18 Member States, including Bulgaria. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggested that Bulgaria did not fulfil the deficit criterion. In line with its

Communication of 2 March 2022[13], the Commission did not propose opening new excessive deficit procedures. It noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with Russia's invasion of Ukraine, creates exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken in spring 2022. The public debt-to-GDP ratio increased from just below 25% in 2020 to 25.1% in 2021, and is expected to remain broadly the same in 2022, before increasing slowly towards 26% in 2023. Despite the low projected debt level by 2032 (37% of GDP), debt sustainability risks for Bulgaria appear medium in the medium term. The projection is subject to considerable uncertainty. Bulgaria has developed a strong fiscal framework in recent years, and now has a better track record in compliance. The system of rules, however, appears complex, which increases the need to streamline the process.



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

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

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

insolvency framework, the anti-money laundering framework, and governance of state-owned enterprises. Bulgaria is currently working towards completing these post-entry commitments, in cooperation with the Commission, which monitors its progress.

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

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

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

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

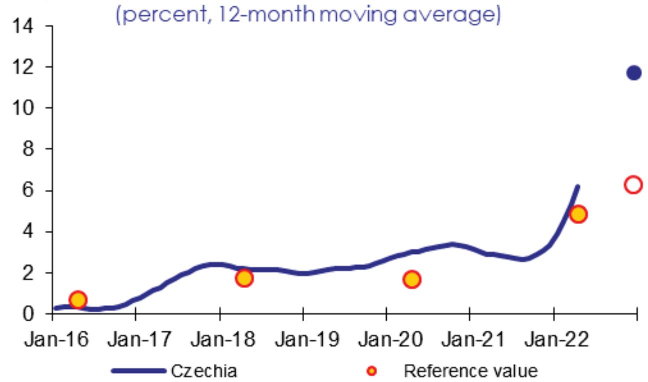
3. CZECHIA

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

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

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

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



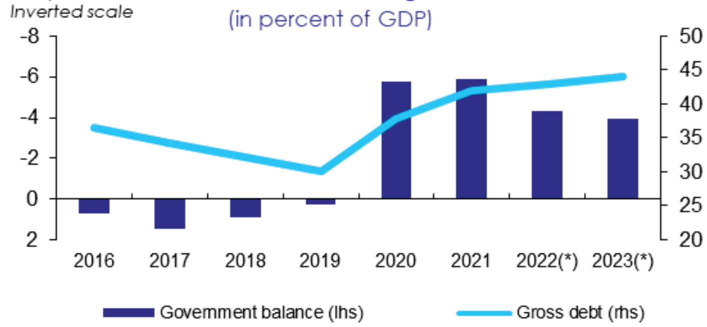
Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.
Source: Eurostat, Commission's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

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

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

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

Graph 3b: **Czechia - Government budget balance and debt**
(in percent of GDP)



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

Czechia does not fulfil the exchange rate criterion. The Czech koruna does not participate in ERM II. Czechia operates a de jure floating exchange rate regime, allowing the central bank to make foreign exchange market interventions . Following

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

the lock-down measures taken in the early stages of the COVID-19 pandemic, the koruna depreciated significantly by about 6% in April 2020 (year-on-year). From June 2020 it fluctuated at slightly higher levels until December 2020, when it entered an appreciation phase that ended abruptly in early 2022. The appreciation was mostly driven by a sharp monetary tightening by the ČNB. However, in the wake of Russia's invasion of Ukraine the Czech koruna experienced strong depreciation pressures, which triggered short-lasting stabilising interventions by the ČNB in the foreign exchange market in early March 2022. In April 2022, the Czech koruna was about 12% stronger against the euro than 2 years earlier. Short-term interest rate differentials vis-à-vis the euro area increased from around 90 basis points in May 2021 to around 580 basis points by April 2022, following the strong tightening cycle that the ČNB started in August 2021.

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

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

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

4. CROATIA

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

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

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

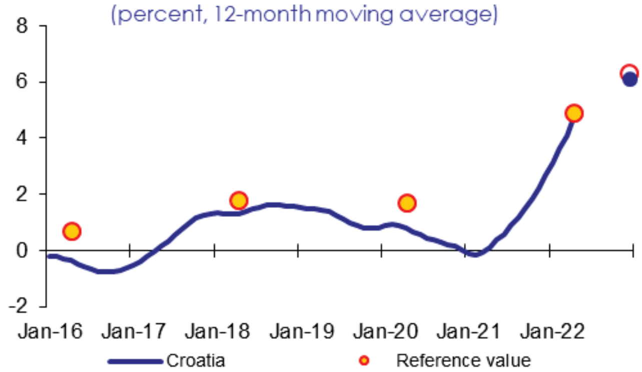
In 2021, the annual HICP inflation rate averaged 2.7%, increasing significantly compared to 2020, when it averaged 0%. Inflation was slightly negative in Croatia between April 2020 and January 2021, mostly due very low and negative energy and non-energy industrial goods inflation. It then accelerated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

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

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

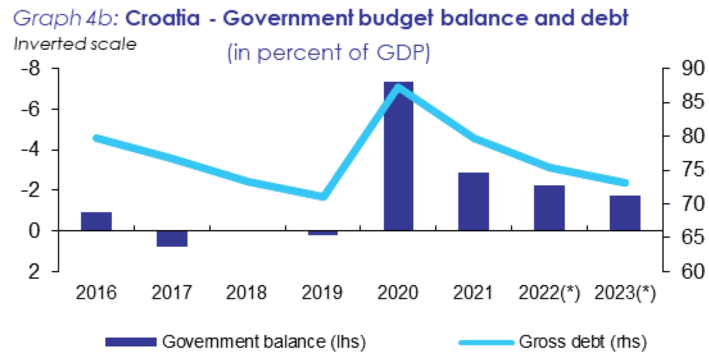
In the longer-term, inflation prospects will hinge in particular on wages growing in line with productivity. Inflation cycles in Croatia are already highly synchronised with the inflation cycle of the euro area and wage developments are expected to continue to underpin this synchronisation. However,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

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



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

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



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

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

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

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

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

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

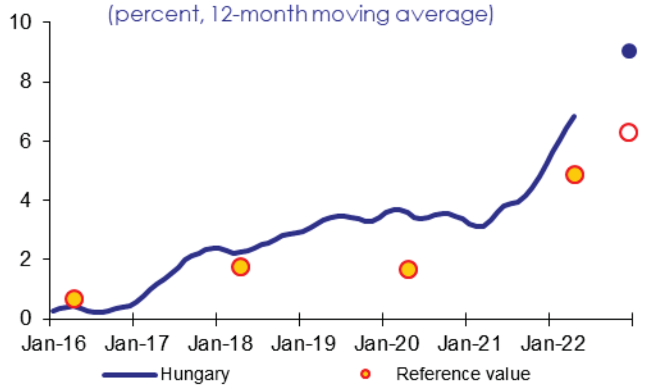
5. HUNGARY

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

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

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

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



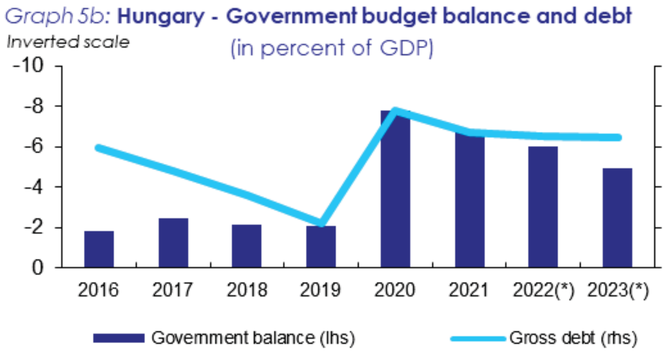
Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.
Source: Eurostat, Commission's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

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

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

Hungary fulfils the criterion on public finances. Hungary is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit reached 7.8% of GDP in 2020, before declining to 6.8% of GDP in 2021. The Commission's Spring 2022 Economic Forecast expects that, on the back of better-than-expected output growth, the general government deficit will decrease to 6.0% of GDP in 2022, notwithstanding the measures taken by the government to reduce the economic and social impact of the increase in energy prices and the costs of assistance to those fleeing Ukraine. It is forecast to further decrease to 4.9% of GDP in 2023, under a 'no policy change' assumption. On 23 May 2022, the Commission adopted a report prepared in accordance with Article 126(3) of the TFEU for 18 Member States, including Hungary. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggested that the Hungary did not fulfil the deficit and debt criteria. In line with its Communication of 2 March 2022[15], the Commission did not propose to open new excessive deficit procedures. The Commission considered, within its assessment of all relevant factors, that compliance with the debt reduction benchmark would imply a too demanding frontloaded fiscal effort that risks to jeopardise growth. Therefore, in the view of the Commission, compliance with the debt reduction benchmark is not warranted under the current exceptional economic conditions. The Commission noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with Russia's invasion of Ukraine, create exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken in spring 2022. The public debt-to-GDP ratio decreased from around 80% in 2020 to 76.8% in 2021 and is forecast to increase to 76.4% in 2022 and decrease to 76.1 % in 2023. Debt sustainability risks for Hungary appear medium in the medium term. The projection is subject to particularly large uncertainty and is sensitive to adverse macro-financial developments. The Hungarian fiscal framework has been improved through reforms that began in 2011, but there is still room for improvement. The Fiscal Council's role in fiscal policy making could be strengthened and the volatility of the medium-term framework could still be reduced.

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



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

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

Hungary does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate stood at 4.1% in April 2022, above the reference value of 2.6%. Hungary's long-term interest rate, which stood at around 2.5% in April 2020, decreased until the end of 2020, reflecting the monetary easing conducted by major central banks. Hungary's long-term interest rate started to increase again in 2021, in particular from September 2021 onwards, reflecting the tightening of monetary policy, to surpass 4% in November 2021. The increase in long-term rates continued, and accelerated further in March 2022, on the back of Russia's invasion of Ukraine. Despite the increase in rates on the German benchmark bond over the same period, the long-term spread vis-à-vis the German benchmark bond has increased over the last 2 years and reached 584 basis points in April 2022.

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

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

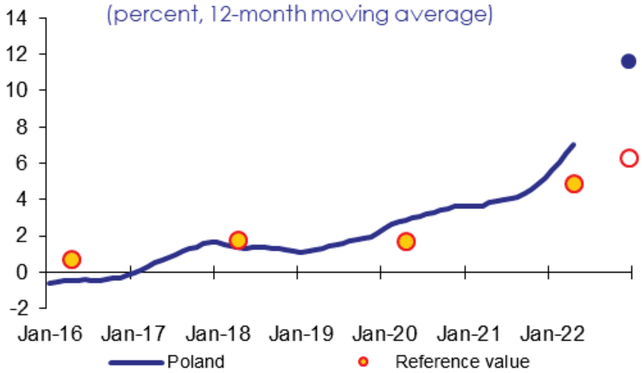
6. POLAND

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

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

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

Graph 6a: **Poland - Inflation criterion since 2016**
(percent, 12-month moving average)



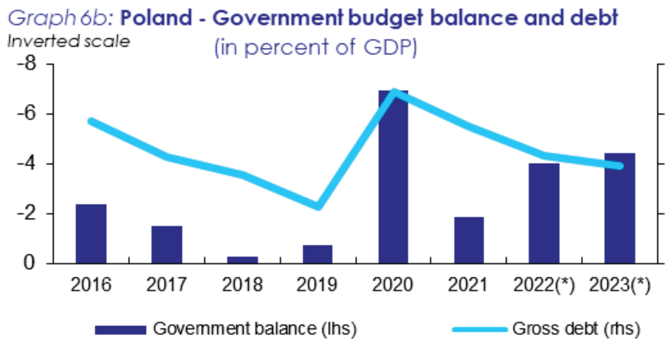
Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.
Source: Eurostat, Commission's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

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

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

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

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



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

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

Poland does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2022 was 3.0%, above the reference value of 2.6%. The easing of monetary policy after the onset of the pandemic in 2020 contributed to a significant decrease in the long-term interest rates, which remained at 1.3% until the end of 2020. In January 2021, the long-term interest rate reached its lowest level on record (1.2%) before starting to increase moderately until the summer. The tightening of monetary policy, which started in October 2021, then contributed to a considerable increase in the long-term interest rate reaching 3.0% in April 2022. The long-term interest rate spread vis-à-vis the German benchmark bond narrowed strongly during the early months of the COVID-19 crisis and fluctuated around 180 basis points up-to April 2021. In mid-2021, it started to increase slightly and by October 2021 the spread had started to widen. By the end of 2021, the long-term interest rate spread reached around 373 basis points and continued to widen to 521 basis points in April 2022.

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

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

7. ROMANIA

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

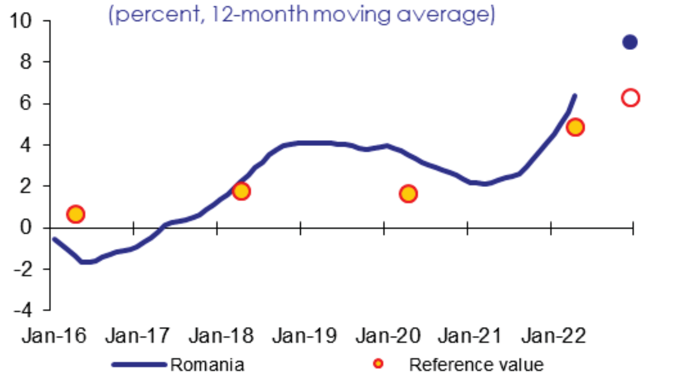
Legislation in Romania – in particular Law No. 312 on the Statute of the Bank of Romania (the BNR Law) – **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities relate to the independence of the central bank, the prohibition of monetary financing and central bank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

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

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

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

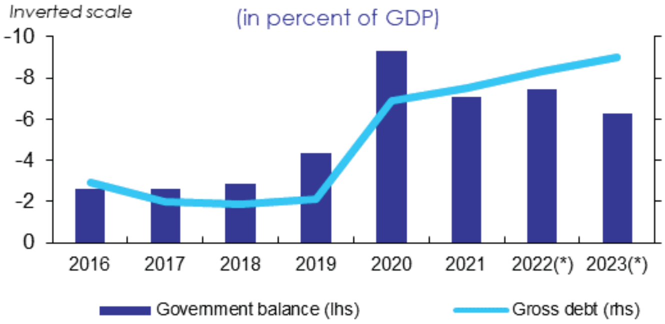
Graph 7a: **Romania - Inflation criterion since 2016**
(percent, 12-month moving average)



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

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

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



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

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

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

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

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

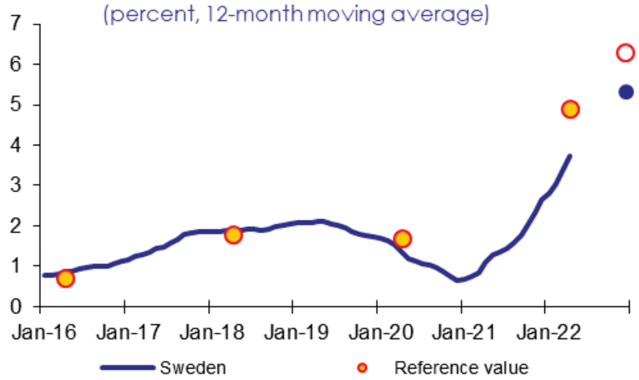
8. SWEDEN

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

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

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

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



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

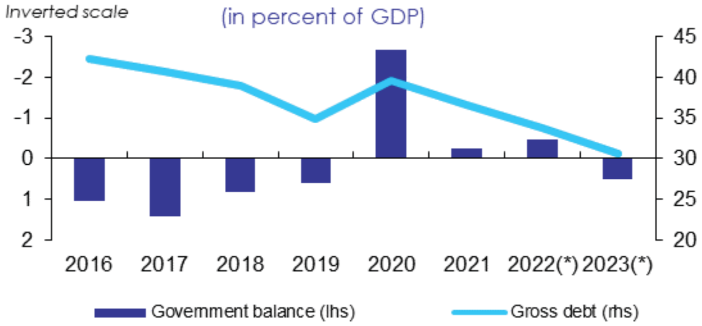
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

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

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

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

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



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

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

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

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

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