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**COMMISSION STAFF WORKING DOCUMENT**

**CONVERGENCE REPORT 2024**

*Accompanying the document*

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

**CONVERGENCE REPORT 2024**

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

{COM(2024) 270 final}

European Commission

Directorate-General for Economic and Financial Affairs

# Convergence Report

2024

EUROPEAN ECONOMY

Institutional Paper XXX



## ABBREVIATIONS

### *Member States*

BG	Bulgaria
CZ	Czechia
HU	Hungary
PL	Poland
RO	Romania
SE	Sweden
EA	Euro area
EA-20	Euro area, 20 Member States
EA-19	Euro area, 19 Member States before 2023
EA-18	Euro area, 18 Member States before 2015
EA-17	Euro area, 17 Member States before 2014
EU-28	European Union, 28 Member States
EU-27	European Union, 27 Member States before July 2013 (i.e. EU-28 excl. HR) and from February 2020 (i.e. EU-28 excl. UK)
EU-25	European Union, 25 Member States before 2007 (i.e. EU-28 excl. BG, RO and HR)
EU-15	European Union, 15 Member States before 2004

### *Currencies*

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

### *Central Banks*

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

### *Other abbreviations*

AML	Anti-money laundering
AMR	Alert Mechanism Report
BoP	Balance of Payments
CAR	Capital adequacy ratio
CBA	Currency board arrangement
CEE	Central and Eastern Europe
CIT	Corporate Income Tax
CPI	Consumer price index
CR5	Concentration ratio (aggregated market share of five banks with the largest market share)
EC	European Community
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMU	Economic and monetary union
ERM II	Exchange rate mechanism II
ESA	European System of Accounts
ESCB	European System of Central Banks

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

## ACKNOWLEDGEMENTS

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# Convergence Report 2024

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



## Report

# Convergence Report 2024

## Technical annex



# 1. INTRODUCTION

## 1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States, namely by Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Subsequently, Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014), Lithuania (2015) and Croatia (2023) also adopted the euro.

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

In 2022, the Commission and the ECB adopted their latest regular Convergence Reports <sup>(2)</sup>. Croatia was the only Member State assessed as meeting the necessary conditions for adopting the euro. Following those convergence reports and on the basis of a proposal by the Commission, the Council decided in July 2022 that Croatia fulfilled the necessary conditions for adopting the euro. Croatia adopted the euro on 1 January 2023 and became the 20th member of the euro area <sup>(3)</sup>. This was the first enlargement since Lithuania joined in 2015.

In 2024, two years have elapsed since the last regular reports were prepared. Denmark has not expressed a wish to enter the third stage of EMU. Therefore, this convergence assessment covers Bulgaria, Czechia, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2024 and includes a detailed assessment of the progress with convergence, as required by Article 140(1) of the Treaty.

The convergence assessment presented in this report has been influenced by several major economic shocks and policy developments over the past 2 years. Russia's full-scale invasion of Ukraine on 24 February 2022 and the subsequent use of energy as a political weapon disrupted the global energy market and supply chains. Energy prices reached record highs in August 2022. The EU economy has shown remarkable resilience in this challenging environment. It has successfully reduced its dependence on Russian fossil fuels and limited the adverse impact on economic activity. Nonetheless, under the pressure of energy, food and other commodity prices, headline inflation in the EU peaked at 11.5% year-on-year in October 2022, while inflation divergences across the EU Member States also reached historic highs. The EU economy lost momentum in 2023, weakened by the erosion of households' purchasing power, a subdued external environment and tighter financing conditions. As energy prices retreated from their peaks and monetary tightening worked its way through the economy, annual HICP inflation fell sharply, reaching 2.7% in May 2024. The surge in energy prices in 2022 also led many Member States to take emergency energy support measures to cushion its economic and social effects. In 2023, the cost for the government deficit of those emergency measures is estimated at almost 1%

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<sup>(1)</sup> Protocol (No 16) on certain provisions relating to Denmark.

<sup>(2)</sup> European Commission, Convergence Report 2022, COM(2022) 280 final, 1 June 2022; European Central Bank, Convergence Report 2022, June 2022.

<sup>(3)</sup> Council Decision of 12 July 2022 (OJ L 187, 14.7.2022, p. 31–34).

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

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

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

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

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

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

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

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

of GDP for the EU as a whole, but a sizeable reduction in energy-related measures is projected in 2024 (by 0.8 percentage point to 0.2% of GDP).

At the same time, the steady implementation of the Recovery and Resilience Facility (RRF) and the Cohesion Policy programmes is continuing to support major reforms and investments across a wide range of policy areas in the EU and support fiscal sustainability.

Designed as a response to the economic and social fall-out from the COVID-19 pandemic and established in February 2021, the RRF is the centrepiece of NextGenerationEU (NGEU), the EU's recovery instrument. It has also proven to be an agile instrument, helping Member States to deal with the above-mentioned challenges and circumstances. In the context of the REPowerEU plan, Member States benefitted from additional resources

through the introduction of REPowerEU chapters in their Recovery and Resilience Plans (RRP), including reforms and investments that diversify the EU's energy supplies, accelerate the green transition and support vulnerable households. By early June 2024, EUR 240.3 billion had been disbursed against the fulfilment of milestones and targets for ambitious reforms and investments. Commission modelling suggests that NGEU has the potential to increase EU real GDP by up to 1.4% in 2026 above a no-NGEU scenario <sup>(4)</sup>.

EU Cohesion Policy funds provide EUR 378 billion to Member States for the 2021-2027 period. Cohesion policy concentrates in fields that are critical for promoting convergence and competitiveness through long-term investment in line with EU priorities. Its interventions aim particularly to improve productivity, foster sustainable growth, boost innovation and develop the skills of the labour force, as well as grant better access to public services and foster the integration in the single market through better infrastructure.

Cohesion Policy has a strong positive impact on the structure of the EU economies. Recent model simulations suggest that the 2014–2020 and 2021–2027 programmes, taken together, could increase EU GDP by close to 1% at the end of their implementation. The impact of the policy is particularly high in the main beneficiaries of the policy, thereby supporting convergence of these countries.

The general escape clause in the Stability and Growth Pact was deactivated at the end of 2023. In April 2024, the European Parliament and the Council adopted the legislation reforming the EU fiscal rules <sup>(5)</sup>. Over the next months, the Member States will prepare their first medium-term fiscal-structural plans, outlining fiscal, structural and investment policies for the next 4 to 5 years. The reformed framework promotes debt sustainability and economic growth. On 19 June 2024, as part of its European Semester spring 2024 package, the Commission published a report under Article 126(3) TFEU assessing compliance with the deficit criterion of the Stability and Growth Pact in twelve EU Member States, including Czechia, Hungary and Poland. On the basis of the conclusions of its report, the Commission confirmed that in July, and after considering the opinion of the Economic and Financial Committee, it will propose to the Council to adopt decisions establishing the existence of excessive deficit situations for the Member States for which this is warranted. The assessment of the convergence criterion dealing with the government budgetary position presented in this report therefore takes into account the conclusions of the report under Article 126(3) TFEU.

The remainder of the first chapter presents the methodology used for the application of the assessment criteria. Chapters 2 to 7 examine, on a country-by-country basis, the fulfilment of the convergence criteria and other requirements in the order in which they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 18 June 2024.

## 1.2. APPLICATION OF THE CRITERIA

In accordance with Article 140(1) of the Treaty, the Convergence Reports shall examine the compatibility of national legislation with Articles 130 and 131 of the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, public finances, exchange rate stability and long term interest rates as well as some additional

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<sup>(4)</sup> QUEST is the global macroeconomic model that the Directorate General for Economic and Financial Affairs (DG ECFIN) uses for macroeconomic policy analysis and research, see [https://economy-finance.ec.europa.eu/economic-research-and-databases/economic-research/macro-economic-models/quest-macro-economic-model\\_en](https://economy-finance.ec.europa.eu/economic-research-and-databases/economic-research/macro-economic-models/quest-macro-economic-model_en). See the Staff Working Document on the RRF Mid-term evaluation for further information on QUEST's results regarding the macroeconomic impacts of the RRF.

<sup>(5)</sup> OJ L, 2024/1264, 30.4.2024; OJ L, 2024/1263, 30.4.2024; and OJ L, 2024/1265, 30.4.2024.

factors. The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 13 on the convergence criteria).

#### 1.2.1. Compatibility of legislation

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

- First, the independence of the national central bank and of the members of its decision-making bodies, as laid down in Article 130, must be assessed. This assessment covers all issues linked to a national central bank's institutional, financial independence and to the personal independence of the members of its decision-making bodies.
- Second, in accordance with Articles 123 and 124 of the Treaty, the compliance of the national legislation is verified against the prohibition of monetary financing and privileged access. The prohibition of monetary financing is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the central banks of Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or central banks of debt instruments. As regards the prohibition on privileged access as set out in Article 124, the central banks, as public authorities, may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations.
- Third, in accordance with Article 131, the integration of the national central bank into the ESCB has to be examined, in order to ensure that at the latest by the moment of euro adoption, the objectives of the national central bank are compatible with the objectives of the ESCB as formulated in Article 127 of the Treaty. The national provisions on the tasks of the national central bank are assessed against the relevant rules of the Treaty and the ESCB/ECB Statute.

#### 1.2.2. Price stability

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

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

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation <sup>(6)</sup> setting the legal basis for

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

the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which are used for assessing the fulfilment of the price stability criterion.

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



**Box 1.2: Assessment of price stability and the reference value**

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

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

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

As Article 140(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States, the Convergence Reports select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006, EU-27 for reports between 2007 and 2013, EU-28 for reports between 2014 and 2018 and EU-27 for the reports between 2020 and 2024.

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

Outliers were identified in the convergence reports of 2004, 2010, 2013, 2014, 2016 and 2022. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability. Its 12-month average inflation rate was 2.3 percentage points below that of the euro area (2.1%). In 2010, in an environment characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries faced episodes of negative inflation rates (the euro-area average inflation rate in March 2010 was only slightly positive, at 0.3%). In this context, Ireland was excluded from the best performers on the ground that its average inflation rate (-2.3% in March 2010) deviated by a very wide margin from that of the euro area, mainly due to the severe economic downturn in that country. In 2013, Greece was excluded from the best performers, as its inflation rate was 1.8 percentage points lower than the euro area average of 2.2%, mainly reflecting the severe adjustment needs and the exceptional situation of the Greek economy. In 2014, Greece, Bulgaria and Cyprus were identified as outliers. In April 2014, the 12-month average inflation rate of Greece, Bulgaria and Cyprus were respectively -1.2%, -0.8% and -0.4%, significantly deviating from the

*(Continued on the next page)*

*Box (continued)*

euro area average of 1.0%. In case of Greece and Cyprus, negative inflation mainly reflected the severe adjustment needs and exceptional situation of the economy. In case of Bulgaria, it was due to an unusually strong combination of disinflationary factors, inter alia, a good harvest, administrative energy price reductions and declining import prices. In 2016, it was warranted to identify Cyprus and Romania as outliers, as their inflation rates deviated by a wide margin from the euro area average. In April 2016, the 12-month average (negative) inflation rates of Cyprus and Romania were respectively 1.9 percentage points and 1.4 percentage points below the euro area inflation rate of 0.1%. In case of Cyprus, deeply negative inflation mainly reflected the adjustment needs and exceptional situation of the economy. In case of Romania, it was mainly due to large VAT rate reductions. In 2022, Malta and Portugal were identified outliers as their average inflation rates in April 2022 were 2.2 percentage points and 1.7 percentage points below the euro area average of 4.4%. In the case of Malta, the comparatively low average inflation rate reflected broadly stably energy prices due to government measures 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 Member States in 2021. In the case of Portugal, the comparatively very low average inflation rate reflected low energy inflation and the weaker cyclical position of the country compared with most of other EU Member States. In addition, the COVID-19 crisis had a prolonged negative impact on Portuguese activity and inflation. Table 1 lists the reference value in the convergence reports issued since 1998.

In May 2024, the three Member States with the lowest 12-month average inflation rates are: Denmark (1.1%), Finland (1.9%) and Belgium (1.9%). The next Member States with the lowest average inflation are the Netherlands (2.5%), Italy (2.6%) and Latvia (2.6%). It appears warranted to identify Denmark, Finland and Belgium as outliers, as their inflation rates a.) deviated by a wide margin from the euro-area average and b.) were driven by country-specific factors that limit their scope to act as meaningful benchmarks for other Member States. In past Convergence Reports those Member States that had an inflation rate of 1.5 percentage points or more below the euro area were generally considered as outliers. In May 2024, the 12-month average inflation rates of Denmark, Finland and Belgium were respectively 2.3, 1.6 and 1.5 percentage points below the euro area average of 3.4%.

In addition, the inflation performances of Denmark, Finland and Belgium were driven by country-specific factors. In the case of Denmark, the country-specific factors that drove in the relatively very low average inflation rate included a faster unwinding of the exceptional energy inflation shock than in the euro area that was mainly due to the fact that the most electricity contracts in Denmark have variable prices, which are adjusted either monthly or quarterly. This led to a much faster transmission of the drop in wholesale energy prices to retail prices in Denmark than the euro area average. A very low rate of inflation for food and non-energy industrial goods compared with the euro area also contributed to the low inflation rate in Denmark.

In the case of Finland, the relatively very low average inflation rate compared with the average inflation rate of the euro area as a whole reflected lower energy inflation and an adjustment by Statistics Finland to the price index of electricity because the rise in prices had been erroneously taken into account twice in the index <sup>(1)</sup>. The correction, which was introduced in August 2023, reduced the year-on-year HICP inflation rate by 0.7 percentage point in that month. It will continue to artificially reduce HICP inflation in Finland until July 2024. Furthermore, the 12-month average of HICP inflation excluding energy and food in Finland was significantly below the corresponding inflation rate for the euro area as a whole, reflecting a much weaker cyclical position and weaker wage growth than the euro area as a whole.

<sup>(1)</sup> Statistics Finland, Adjustment of the price index of electricity in the releases of the Consumer Price Index and the Harmonised Index of Consumer Prices for August 2023, August 2023. See <https://stat.fi/en/revisionrelease/dm92f0dg5s810avv7mlerjj>.

*(Continued on the next page)*

Box (continued)

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

Convergence Report adoption date	Cut-off month	Three best performers <sup>1) 2)</sup>	Reference value <sup>3)</sup>	Euro area average inflation rate <sup>4)</sup>
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, France, Luxembourg <sup>5)</sup>	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5
2010	March 2010	Portugal, Estonia, Belgium	1.0	0.3
2012	March 2012	Sweden, Ireland, Slovenia	3.1	2.8
2013	April 2013	Sweden, Latvia, Ireland	2.7	2.2
2014	April 2014	Latvia, Portugal, Ireland	1.7	1.0
2016	April 2016	Bulgaria, Slovenia, Spain	0.7	0.1
2018	March 2018	Cyprus, Ireland, Finland	1.9	1.4
2020	March 2020	Portugal, Cyprus, Italy	1.8	1.1
2022	April 2022	France, Finland, Greece	4.9	4.4
2024	May 2024	Netherlands, Italy, Latvia	4.1	3.4

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

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

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

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

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

Sources: Eurostat and European Commission calculations.

In the case of Belgium, the country-specific factors that drove the relatively very low average inflation rate include lower retail energy prices in 2023. After a rapid transmission of exceptionally high wholesale gas and electricity prices into retail prices in 2022, energy inflation fell sharply throughout 2023. A combination of factors weighed on energy inflation. Contract prices for gas and electricity are typically based on formulae that use the future gas and electricity prices. This led to a much faster transmission of the drop in wholesale energy prices to retail prices in Belgium than the euro area average. This effect was reinforced by (i) the HICP inflation being calculated on the basis of the prices of new contracts; and (ii) the new HICP weights for 2023 reflecting a strong increase in the size of the energy component, which amplified the effect of the very sizeable drop in energy prices on HICP inflation in 2023.

Accordingly, the reference value is currently 4.1%, based on the data of the Netherlands (2.5)%, Italy (2.6)% and Latvia (2.6)% over the 12-month period covering June 2022 – May 2024. Denmark, Finland and Belgium were identified as outliers, as their inflation rates deviated by a wide margin from the euro area average reflecting country-specific economic circumstances (see Box 1.2).

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

must be corrected via painful adjustment processes and can trigger negative spillover effects on other Member States.

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

From a forward-looking perspective, the report includes an assessment of medium-term prospects for price developments. The analysis of factors that have an impact on the inflation outlook – cyclical conditions, labour market developments and credit growth – is complemented by a reference to the most recent Commission inflation forecast. That forecast can subsequently be used to assess whether the Member State is likely to meet the reference value also in the months ahead <sup>(7)</sup>. Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

### 1.2.3. Public finances

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

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact (see Box 1.3 for further information on the excessive deficit procedure as strengthened by the 2024 reform of the Stability and Growth Pact). The details of the excessive deficit procedure are defined in Regulation 1467/97 as amended in 2024 which sets out the way in which government deficit and debt levels are assessed to determine whether an excessive deficit exists, under Article 126 of TFEU. The convergence assessment in the budgetary area is therefore judged by whether the Member State is subject to a Council decision under 126(6) on the existence of an excessive deficit <sup>(8)</sup>.

On 19 June 2024, the Commission adopted a report under Article 126(3) of the TFEU for twelve Member States, including for Czechia, Hungary and Poland. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled by Hungary and Poland. In the light of this assessment, and after considering the opinion of the Economic and Financial Committee as established under article 126(4) TFEU, the Commission will propose in July to open excessive deficit procedures, by proposing to the

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<sup>(7)</sup> Based on the Commission's Spring 2024 Economic Forecast, the inflation reference value is forecast to stand at 3.0% in December 2024.

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

Council to adopt a Decision under Article 126(6) establishing the existence of an excessive deficit.

Romania has been subject to an Excessive Deficit Procedure (EDP) since 2020, due to the planned non-compliance with the deficit criterion in 2019. Considering the deep contraction in economic activity linked to the COVID-19 pandemic, on 18 June 2021, the Council adopted a revised Recommendation to put an end to the excessive deficit situation by 2024, at the latest. On 19 June

**Box 1.3: Excessive Deficit Procedures under the new EU fiscal framework**

The new EU fiscal framework was adopted on 29 April 2024. The rules on the opening of a deficit-based Excessive Deficit Procedure (EDP) remain unchanged while the rules on the opening of a debt-based EDP are changed and clarified in the amended Council Regulation (EC) 1467/97.<sup>(1)</sup>

In order to simplify the EU fiscal framework and increase transparency, a single operational indicator anchored in debt sustainability will serve as a basis for setting the fiscal path and for carrying out annual fiscal surveillance. That single operational indicator will be based on nationally financed net primary expenditure, i.e. government expenditure net of interest expenditure, discretionary revenue measures, expenditure on Union programmes fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, as well as cyclical elements of unemployment benefit expenditure. One-offs and other temporary measures will also be excluded from the net expenditure indicator.

The EDP is specified in Article 126 of the Treaty on the Functioning of the European Union (TFEU). Protocol 12 of the Treaty gives further details on the excessive deficit procedure, including the reference values on deficit and debt. Council Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the EDP (the corrective arm of the Stability and Growth Pact) clarifies the implementation of the excessive deficit procedure. Together, these provisions determine the steps to be followed to reach a Council decision on the existence and correction of an excessive deficit.

The Commission will produce reports under Article 126(3) of TFEU on the basis of the following criteria:

- whether the ratio of the planned or actual government deficit to gross domestic product exceeds 3% of GDP, unless:
  - the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
  - or, alternatively, the excess over the reference value is exceptional and temporary and the ratio remains close to the reference value;
- when the ratio of the government debt to GDP exceeds 60% of GDP, the budgetary position is not close to balance<sup>(2)</sup> or in surplus and when the deviations recorded in the control account<sup>(3)</sup> of the Member State exceed the established annual or cumulative thresholds (0.3% and 0.6% of GDP respectively).

When assessing the existence of an excessive deficit in accordance with Article 126(3) TFEU, the Commission should take into account all relevant factors. Substantial public debt challenges in the Member State concerned should be considered a key aggravating factor. The increase of government investment in defence, where applicable, should be considered as a relevant factor when assessing the existence of an excessive deficit. The Commission shall give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and the Commission. In that context, particular consideration shall be given to financial contributions to fostering international solidarity and achieving the common priorities of the Union

<sup>(1)</sup> OJ L 2024/1264, 30.4.2024, [Council Regulation \(EU\) 2024/1264 of 29 April 2024 amending Regulation \(EC\) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure \(europa.eu\)](#). The consolidated version of Regulation No 1467/97 can be found at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A01997R1467-20240430>.

<sup>(2)</sup> The budgetary position shall be considered close to balance if the general government deficit does not exceed 0.5 % of GDP.

<sup>(3)</sup> The Commission will set up a control account for each Member State to keep track of annual and cumulative upward and downward deviations of the net expenditure observed from the net expenditure path as set by the Council pursuant to the new preventive arm Regulation (see footnote 5).

*(Continued on the next page)*



*Box (continued)*

referred to in the new preventive arm Regulation.<sup>(4)</sup> For deficit-based EDPs, the relevant factors can be considered for i) those Member States with debt below 60% and ii) those Member States with debt exceeding 60% of GDP and satisfying the double condition of the overarching principle, i.e. that the general government deficit remains close to the 3% of GDP reference value and its excess over the reference value is temporary.

In the next step of the procedure, the Economic and Financial Committee (EFC) shall formulate an opinion in accordance with Article 126(4) TFEU within two weeks of the adoption by the Commission of a report issued in accordance with Article 126(3) TFEU. Taking fully into account this opinion, the Commission, if it considers that an excessive deficit exists, shall address an opinion and a proposal to the Council in accordance with Article 126(5) and (6) TFEU and shall inform the European Parliament thereof. The Council shall then decide on the existence of an excessive deficit in accordance with Article 126(6) TFEU, as a rule within four months of the reporting dates established in Article 3(2) and (3) of Regulation (EC) No 479/2009. When it decides that an excessive deficit exists, the Council shall at the same time make recommendations to the Member State concerned in accordance with Article 126(7) TFEU.

In its recommendation, the Council shall request that the Member State implements a corrective net expenditure path which ensures that the general government deficit remains or is brought and maintained below the reference value within the deadline set in the recommendation. The corrective net expenditure path under the EDP would in principle be the one originally set by the Council under the preventive arm Regulation<sup>(5)</sup>, taking into account the need to ensure a minimum structural adjustment of 0.5 % of GDP in case of a breach of the deficit criterion or the need to correct the deviation from that path in case of a breach of the debt criterion. In case the original path is no longer feasible, due to objective circumstances, the Council should be able to set a different path under the EDP.

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<sup>(4)</sup> OJ L 1263, 30.4.2024, [Regulation \(EU\) 2024/1263 of the European Parliament and of the Council of 29 April 2024 on the effective coordination of economic policies and on multilateral budgetary surveillance and repealing Council Regulation \(EC\) No 1466/97 \(europa.eu\)](#).

<sup>(5)</sup> Under the preventive arm Regulation (see footnote 5), following the assessment of the national medium-term fiscal-structural plans by the Commission, the Council should adopt - on the basis of a recommendation from the Commission, a recommendation setting out the net expenditure path and, as appropriate, endorse the reforms and investments underpinning the possible extension of an adjustment period.

2024, the Commission adopted a recommendation for a Council Decision establishing that no effective action has been taken by Romania.

In the context of the European Semester, the country-specific recommendations for 2024 emphasised the need to ensure prudent fiscal policy, phase out the energy support measures and to preserve nationally-financed investment (see Box 1.4).

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

On 20 March 2020, the Commission issued a Communication where it considered that the conditions for activating the general escape clause of the Stability and Growth Pact (SGP) were fulfilled. The EU Finance Ministers endorsed the Commission's view on 23 March 2020. The general escape clause of the Stability and Growth Pact was deactivated at the end of 2023, as announced in the Commission Communication of 8 March 2023. <sup>(1)</sup>

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

No new Excessive Deficit Procedure (EDP) has been opened between the activation of the general escape clause and its subsequent deactivation. Romania is the only EU Member State under an EDP since spring 2020. The situation created by the COVID-19 crisis first and by Russia's invasion of Ukraine in February 2022 created exceptional uncertainty, including for designing a detailed path for fiscal policy.

The fiscal outlook has overall improved in 2022-23. After reaching a historically high level of around 92% in 2020, the EU aggregate debt-to-GDP ratio fell significantly, reaching 84.8% in 2022 and 83% at the end of 2023 thanks to the strong post-pandemic economic recovery and high inflation. Seemingly, the EU deficit fell steadily from 6.7% of GDP in 2020 to around 3.5% in 2022-2023, also thanks to the complete phase-out of pandemic-related temporary measures.

#### ***Fiscal developments in 2023 compared with Council's recommendations***

The Council provided fiscal guidance for 2023 via qualitative recommendations on 12 July 2022. The fiscal recommendations were differentiated on the basis of debt levels:

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

All Member States were recommended to stand ready to adjust current spending to the evolving situation and expand public investment for the green and digital transitions and for energy security taking into account the REPowerEU initiative, including by making use of the Recovery and Resilience Facility and other Union funds.

Romania, which is under an EDP, was recommended to pursue fiscal policies in line with the Council Recommendation of 18 June 2021 with a view to bringing an end to the situation of an excessive government deficit. The fiscal effort of Romania in 2023 was lower than recommended by the Council and the Commission is of the view that Romania did not take effective action in response to the June 2021 Council Recommendation under Article 126(7) TFEU.

The other countries examined in this report were considered low or medium-debt Member States.

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<sup>(1)</sup> COM(2023) 141 final, 8.3.2023.

*(Continued on the next page)*



*Box (continued)*

Based on the Commission 2024 spring forecast, the fiscal stance in 2023 was expansionary in Poland, driven by the increase in nationally financed investment and expenditure financed by RRF grants and other EU funds. By contrast, the contribution to the fiscal stance of net primary current expenditure was neutral in Poland - which is in line with the Council recommendation – driven by the reduction in energy support measures. The 2023 fiscal stance was instead contractionary in Hungary and Czechia and broadly neutral in Bulgaria and Sweden. These Member States also preserved or increased their nationally-financed investment in 2023, in line with the Council recommendations.

*Fiscal projections for in 2024 compared with Council's recommendations*

The fiscal recommendations for 2024 - adopted by the Council on 14 July 2023 - are fully consistent with the legislation in force at that time, but some aspects of the Commission's reform orientations have already been integrated to the possible extent. They are country-specific and formulated with a view to limiting the nominal increase in nationally-financed net expenditure for Member States not already at their medium-term budgetary objective (MTO). In all Member States, emergency energy support measures should be wound down as soon as possible in 2023 and 2024, and the related savings should be used to reduce the government deficit in Member States not already at their MTO. In addition, all Member States were recommended to continue preserve nationally financed public investment and ensure the effective absorption of grants under the Facility and of other Union funds, in particular to foster the green and digital transitions.

Among the Member States examined in this report, Sweden was expected to be at its MTO in 2023 and, based on the Commission 2024 spring forecast, it is projected to remain at its MTO also in 2024. Bulgaria and Czechia are projected to comply with the increase in net expenditure recommended by the Council on 14 July 2023. Poland is projected to record a higher-than-recommended increase in net expenditure. As for nationally financed investment, it is not expected to be preserved in 2024 in Bulgaria, Hungary and, to a lesser extent, Czechia. In Bulgaria and Hungary this decrease in nationally financed public investment risks being not in line with what was recommended by the Council. Finally, Hungary and Poland are both not expected to wind down energy support measures as soon as possible in 2023 and in 2024, as these measures are set to remain above 0.25% of GDP in 2024. This risks being not in line with what was recommended by the Council. Moreover, in Poland savings from those measures are not expected to be used for deficit reduction. This also risks being not in line with the Council recommendation.

*Fiscal guidance for 2025*

The new EU framework adopted on 29 April 2024 will guide fiscal policy in 2025, considering country-specific debt sustainability risks and whether the general government deficit exceeds the Treaty reference value of 3% of GDP. The fiscal recommendations for 2025 proposed by the Commission on 19 June 2024 consist of a procedural part that invites all Member States to a timely submission of medium-term fiscal-structural plans. The net expenditure path put forward in those plans should then be implemented in 2025 (and in the other years covered by the plans) if endorsed by the Council in autumn 2024. Moreover, for countries with adjustment needs, on 19 June 2024 the Commission proposed qualitative fiscal recommendations, which for the countries examined in this report are as follows:

Hungary: In line with the requirements of the reformed Stability and Growth Pact, limit the growth in net expenditure in 2025 to a rate consistent with putting the general government debt on a plausibly downward trajectory over the medium term and reducing the general government deficit towards the 3% of GDP Treaty reference value.

Poland: In line with the requirements of the reformed Stability and Growth Pact, limit the growth in net expenditure in 2025 to a rate consistent with reducing the general government deficit towards the 3% of GDP Treaty reference value and keeping the general government debt at a prudent level over the medium term.

*(Continued on the next page)*

*Box (continued)*

Bulgaria and Czechia: In line with the requirements of the reformed Stability and Growth Pact, limit the growth in net expenditure in 2025 to a rate consistent with maintaining the general government deficit below the 3% of GDP Treaty reference value and keeping the general government debt at a prudent level over the medium term.

Sweden does not have fiscal adjustment needs and thus the Commission has not proposed a qualitative part in the fiscal recommendation.

#### 1.2.4. Exchange rate stability

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

Article 3 of the Protocol on the convergence criteria stipulates: 'The criterion on participation in the exchange rate mechanism of the European Monetary System [...] shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period' <sup>(9)</sup>. Based on the Council Resolution on the establishment of the ERM II <sup>(10)</sup>, the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

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

The assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. Currently one of the Member States assessed in this Convergence Report, namely Bulgaria, participates in ERM II (see Box 1.5 for further information on ERM II participation). The relevant period for assessing exchange rate stability in this Technical Annex is 19 June 2022 to 18 June 2024.

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

<sup>(10)</sup> 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

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

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

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

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

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

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

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

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

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

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

*(Continued on the next page)*

*Box (continued)*

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

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

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

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

[https://ec.europa.eu/commission/presscorner/detail/en/IP\\_20\\_1321](https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1321)

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

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

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

[https://ec.europa.eu/commission/presscorner/detail/en/IP\\_20\\_1321](https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1321)

<sup>(8)</sup> See: [https://www.ecb.europa.eu/pub/pdf/annex/ecb.pr200710\\_annex-29156bba37.en.pdf](https://www.ecb.europa.eu/pub/pdf/annex/ecb.pr200710_annex-29156bba37.en.pdf)

<sup>(9)</sup> See: [https://www.ecb.europa.eu/pub/pdf/annex/ecb.pr200710\\_1\\_annex.en.pdf](https://www.ecb.europa.eu/pub/pdf/annex/ecb.pr200710_1_annex.en.pdf)

#### 1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires that 'the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism' is 'reflected in the long-term interest rate levels'. Article 4 of the Protocol on the convergence criteria further stipulates that 'the criterion on the convergence of interest rates [...] shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions' (see Box 1.6).

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

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

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

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

For sixteen Member States, the residual maturity of the benchmark bond is at least 10 years. For eleven Member States, the residual maturity of the benchmark bond is below 10 years, in particular for Bulgaria with the residual maturity slightly below 8 years. All yields are calculated on the basis of secondary market rates, where available. For Germany, Malta and Spain a basket of bonds is used, while a single benchmark bond is used in twenty-four Member States.

Data used in this Report can be found on Eurostat ("Maastricht criterion bond yields (mcb): EMU convergence criterion bond yields", code: te00097). The same series is also published by the ECB's Statistical Data Warehouse (code IRS.M.Country Code.LL40.Q.0000.Currency Code.NZ) and in a dedicated page in the ECB website with additional information:

[http://www.ecb.europa.eu/stats/financial\\_markets\\_and\\_interest\\_rates/long\\_term\\_interest\\_rates/html/index.en.html](http://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index.en.html).

For the assessment of the criterion on the convergence of interest rates, yields on benchmark long-term bonds have been taken, using an average rate over the latest 12 months. The reference value for May 2024 is calculated as the simple average of the average long-term interest rates in the Netherlands (2.8%), Italy (4.1%) and Latvia (3.7%) plus 2 percentage points, yielding a reference value of 5.5%.

### **Box 1.7: The Macroeconomic Imbalance Procedure (MIP)**

#### **Key elements of the MIP**

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

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

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

In a second step, the analysis carried out in the in-depth reviews (IDRs) for selected Member States following the AMR provides the basis for the identification of imbalances, and their severity, by the Commission. IDR analysis makes use of updated and country-specific information and analytical tools developed by the Commission services. In addition, when relevant, the IDRs include analysis of spillovers and exposures to from the Member State concerned and other Member States, and account is taken of vulnerabilities that carry cross-border relevance.

Both 'imbalances' and 'excessive imbalances' imply possible recommendations by the Council upon Commission proposal, which have so far been integrated in the single package of Country-Specific Recommendations (CSRs) under the European Semester. The identification of 'excessive imbalances' implies a stronger surveillance process, possibly leading to an Excessive Imbalance Procedure. The latter provides a framework underpinned by a corrective action plan designed by the concerned Member State, endorsed by the Commission and the Council and monitored by the Commission, and including the possibility of sanctions for euro area Member States in case of repeated non-compliance. Over recent years, the approach to CSRs, including MIP-relevant ones, was subject to some streamlining as economic policy coordination refocused first on the response to the COVID-19 pandemic crisis and subsequently on the preparation and implementation of the recovery and resilience plans to address the green and digital transition challenges for our economies and societies.

The revised EU economic governance framework, encompassing the MIP, is now being rolled out. A main objective is to have a more flexible and forward-looking MIP, including an enhanced preventive role for the MIP to be better able to deal with new risks to macroeconomic stability. Greater ownership by the Member States of their policies to address imbalances is another objective and a way to increase policy traction too. In particular, the medium-term fiscal-structural plans will also include the measures that Member States will take to address the MIP-relevant CSRs and tackle their imbalances or excessive imbalances, on the top of their fiscal policies. At the same time, enforcement is being stepped up as no implementation of those measures in the plans could lead to escalation of the procedure, including the opening of an Excessive Imbalance Procedure. Finally, a stronger EU and euro area dimension in

*(Continued on the next page)*



*Box (continued)*

the MIP is sought. All those objectives under the MIP remit will be pursued within the existing legal provisions.

#### **The 2024 Alert Mechanism Report (AMR) and In-Depth Reviews (IDR)**

In its latest AMR from November 2023, the Commission concluded that IDRs were warranted for 12 Member States, which mostly coincided with the ones that had been identified with imbalances or excessive imbalances in the previous annual MIP cycle <sup>(1)</sup>. Three of those Member States are covered in this Convergence Report (Hungary, Romania, and Sweden). On the basis of the most recent IDRs, in June 2024, the Commission concluded that Hungary and Sweden continue to experience imbalances while Romania is experiencing excessive imbalances after being identified with imbalances in 2023 <sup>(2)</sup>.

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<sup>(1)</sup> European Commission (2023), Alert Mechanism Report 2024, COM(2023) 902 final; and European Commission (2023), Alert Mechanism Report 2024, SWD(2023) 901 final.

<sup>(2)</sup> Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank '2024 European Semester – Spring Package', COM(2024) 600 final.

#### **1.2.6. Additional factors**

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

The assessment of additional factors gives an important indication of a Member State's ability to integrate into the euro area without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance <sup>(11)</sup>. Market integration is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Moreover, progress in financial integration is examined, together with the main characteristics, structures and trends of the financial sector. Given that Member States which adopt the euro also participate in the banking union, developments in national banking sectors are specifically looked at as well.

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

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

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<sup>(11)</sup> The external balance is defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account. It is the concept closest to the current account as defined when the Maastricht Treaty was drafted.

## 2. BULGARIA

### 2.1. LEGAL COMPATIBILITY

#### 2.1.1. Introduction

The legal basis for the Bulgarska Narodna Banka (the BNB – Bulgaria’s central bank), the Law on the Bulgarian National Bank (the BNB Law) of 1997, has been amended since the 2022 Convergence Report. The new version of the BNB Law was adopted by the 49th National Assembly on 1 February 2024 and published in the State Gazette no 13 of 13 February 2024. In accordance with paragraph 14 of its transitional and final provisions, it shall enter into force on the date specified in the Council Decision on the adoption of the euro by Bulgaria<sup>(12)</sup>. The entry into force would therefore be automatic and would not require further action from the Bulgarian authorities.

The analysis contained in this convergence report is therefore based on the latest version of the BNB Law, as adopted and published in the Bulgarian official journal, even though it is not yet in force. This latest version of the BNB Law has remedied the incompatibilities and imperfections highlighted in the Commission’s 2022 Convergence Report’s sections on central bank independence, prohibition of monetary financing and privileged access, as well as integration into the European System of Central Banks (ESCB). Notably, the new BNB Law clearly recalls the applicability and primacy of EU law over national law by stating that the ‘reproduction of directly applicable provisions of EU law is merely declaratory and has been introduced in order to ensure consistency and comprehensibility for the persons concerned’ (paragraph 2 of the Supplementary provisions). Overall, the amended legislation on the BNB can, once it enters into force, be considered compatible with the relevant provisions of EU law.

#### 2.1.2. Central bank independence

The previous version of the BNB Law contained a degree of ambiguity regarding the dismissal of the Governor of the BNB and could be understood in such a way that the Governor might be dismissed under conditions other than those mentioned in Article 14(2) of the ESCB/ECB Statute. The new BNB Law (Article 15) clearly refers to Article 14(2) of the ESCB/ECB Statute: ‘The National Assembly may dismiss the Governor prematurely in accordance with Article 14(2) of the Statute’) Reading it together with paragraph 2 of the Supplementary provisions, which recalls the applicability and primacy of EU law, it can only be interpreted in a way that does not allow any additional grounds of dismissal, other than those stated in Article 14(2). On this condition, the new provision can be considered compatible with EU law.

The new BNB Law (Article 15(3)) provides that the grounds for the early dismissal of a member of the Management Board, with the exception of the Governor, shall be established by a decision of the Management Board. A member of the Management Board whose dismissal is proposed shall cease to exercise their powers from the day of the Management Board’s decision. The Management Board’s decision is subject to appeal before the Supreme Administrative Court within 7 days. The Supreme Administrative Court gives its decision within 14 days of receipt of the appeal. This decision is final. Ensuring personal independence requires that national legislation should allow reasonable time for appealing a dismissal decision as well as for the judicial review to take place for appealing. The short time-limit for the appeal and the very constrained timeframe for the judicial procedure in Article 15(3) may be seen as a residual imperfection that Bulgaria should consider addressing.

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<sup>(12)</sup> [Decree No.26, 13.02.2024](#)



Article 14(2) (former Article 13(2)) of the new BNB Law provides that the Governor of the BNB shall swear an oath before the National Assembly. The content of the oath laid down in paragraph 1 of the same provision refers, inter alia, to abiding by the law and to assisting in the independent performance of the functions entrusted to the BNB and to maintaining any official, banking, professional, commercial or other legal secrecy (including after the Governor's have ceased). The imperfection identified in the previous convergence report was that the oath did not make a clear reference to central bank independence, as required by Article 130 TFEU. It was explained that the Governor of the BNB acts in a dual capacity, as a member of the relevant decision-making bodies of the ECB and of the BNB's decision-making bodies. The oath therefore needs to reflect this dual membership and role. Although, in the new version of the BNB Law, Article 14 still does not refer specifically to Article 130 TFEU, Article 2(1) of the BNB Law does expressly specify that the BNB is part of the ESCB. The Law should therefore be understood in the sense that the Governor of the BNB is also a member of decision-making bodies of the ECB. On this understanding, the provision can be considered compatible with EU law. The new provision on the BNB's independence from public bodies, Article 6 (the former Article 44(1)), has been improved by including a specific reference to Article 130 TFEU, as was suggested in the previous convergence report.

The Bulgarian Constitution has been amended in January 2024 in a matter that could indirectly impact the BNB's independence. The new Article 99(5) of the Bulgarian Constitution provides that, in a case where no agreement is reached on the formation of a government, the President, following consultations with the parliamentary groups and acting on a motion by the caretaker prime minister-designate, appoints a caretaker cabinet, and schedules new elections within 2 months. A caretaker prime minister is to be appointed from among the Chairperson of the National Assembly, the Governor or a Deputy Governor of the BNB, the President or a Vice-President of the Bulgarian National Audit Office, and the Ombudsman (or a deputy thereof).

The appointment as caretaker prime minister of the Governor or one of the Deputy Governors of the BNB could, in some situations, disrupt its effective and independent functioning. This is potentially a serious cause for concern. The appointment would only be for a limited period (until a regular government is formed), but the caretaker government could be reappointed for several successive periods as long as election results do not result in the formation of a government and new elections have to be scheduled. To avoid such potential disruption and its potential impact on the BNB's independence, one possible solution could be to amend the BNB Law to provide sufficient and effective safeguards for the BNB's independence as required by EU law. Firstly, any appointment of the Governor or a Deputy Governor of the BNB as a caretaker prime minister should be conditional on their explicit consent and they should be empowered to refuse such an appointment. Secondly, if such consent is expressed, the rules should prevent that person from holding both positions simultaneously, because this could lead to conflicts of interest and lack of independence. In this respect, the effective and independent functioning of the BNB must be preserved. This could be ensured through the person's resignation from their post at the BNB at the time of their appointment as caretaker prime minister.

### 2.1.3. Prohibition of monetary financing and privileged access

The current version of the BNB Law (Article 47) includes a statement that the BNB complies with the prohibition of monetary financing laid down in Article 123 TFEU. The provisions on extension of credit and purchase of public debt instruments (former Articles 45(1) - 45(3)), which were a cause for concern in the previous convergence report, have been repealed. Incompatibilities in the area of prohibition of monetary financing and privileged access have therefore been resolved.

#### 2.1.4. Integration into the ESCB

##### Objectives

Article 2(2) of the BNB Law provides that in accordance with Article 127(1) TFEU, and without prejudice to the primary objective of maintaining price stability, the BNB shall support general economic policies within the EU in order to contribute to the achievement of the objectives of the EU as set out in Article 3 TFEU. The BNB shall act in accordance with the principles of an open market economy with free competition, supporting the efficient allocation of resources and in accordance with the principles set out in Article 119 TFEU. Article 2(2) of the BNB Law is compatible with Article 127(1) TFEU.

Article 2(1) of the BNB Law, which reflects that the BNB's primary objective is to maintain price stability, has been amended to reflect the fact that the euro would replace the national currency. The wording 'through ensuring the stability of the national currency' has been deleted.

Other remaining incompatibilities and imperfections have been resolved. In the current version, the BNB Law includes a reference to the BNB being an integral part of the ESCB (Article 2) and mentions the relevant provisions of EU law.

##### Tasks

The incompatibilities and imperfections in the BNB Law linked to ESCB/ECB tasks have been solved.

#### 2.1.5. Assessment of compatibility

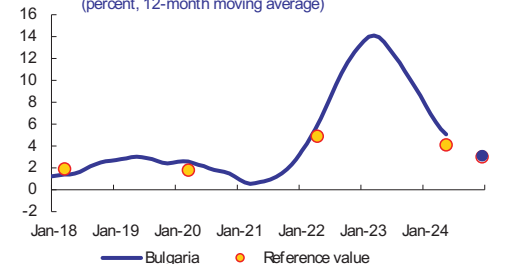
The Bulgarian authorities have taken measures to remedy the incompatibilities and imperfections that were identified in the 2022 Convergence Report. Subject to the conditions and interpretations set out above, the BNB Law can be considered compatible with the relevant provisions of EU law regarding central bank independence, the prohibition of monetary financing and privileged access, and integration into the ESCB at the time of euro adoption.

### 2.2. PRICE STABILITY

#### 2.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Bulgaria in 2022. The 12-month average inflation rate increased from 5.9% in April 2022 to a high of 14.1% in March 2023, but then decreased throughout the rest of 2023 and the first months of 2024. In May 2024, the reference value was 4.1%, calculated as the average of the 12-month average inflation rates in the Netherlands, Italy and Latvia plus 1.5 percentage points. The corresponding inflation rate in Bulgaria was 5.1% - 1.0 percentage point above the reference value. The 12-month average inflation rate is projected to remain slightly above the reference value in the coming months but the gap is projected to close by the end of 2024 or early 2025.

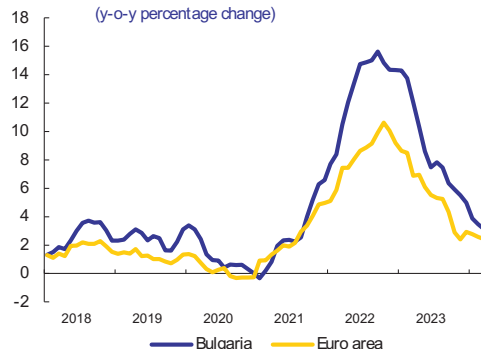
Graph 2.1: Bulgaria - Inflation criterion  
(percent, 12-month moving average)



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of Bulgaria in December 2024. The reference values for 2018, 2020 and 2022 refer to the reference values calculated in the previous convergence reports.

Source: Eurostat, Commission's Spring 2024 Economic Forecast.

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



Source: Eurostat.

## 2.2.2. Recent inflation developments

After early signs of a pick-up in 2021, the annual HICP inflation rate continued to accelerate in 2022 to reach 15.6% in September. It then stabilised at 14.3% between November 2022 and January 2023 before decelerating to 2.7% in May 2024. The direct contribution of energy prices to inflation gradually diminished from the last quarter of 2022 and turned negative as of April 2023. The contributions of the other HICP components to inflation continued to grow throughout 2022. In 2023, the deceleration in inflation was broad based, with an important contribution from food prices. Overall, inflation in Bulgaria has been substantially higher than in the euro area over the past 2 years. Over this period the average annual inflation rate in Bulgaria was 10.9%, exceeding that of the euro area by 4 percentage points.

Table 2.1:

Bulgaria - Components of inflation	(percentage change) <sup>1)</sup>							weights in total
	2018	2019	2020	2021	2022	2023	May-24	2023
HICP	2.6	2.5	1.2	2.8	13.0	8.6	5.1	1000
Non-energy industrial goods	-0.5	0.2	-0.1	0.7	7.1	8.5	5.2	285
Energy	6.4	1.4	-6.1	10.6	26.8	-1.3	-2.8	130
Unprocessed food	1.3	5.3	5.5	-0.3	20.0	15.5	9.0	55
Processed food	2.3	4.0	4.1	2.9	17.2	12.0	6.3	236
Services	4.3	3.2	2.3	2.0	8.2	9.4	6.8	295
HICP excl. energy, food, alcohol and tobacco	2.1	1.8	1.2	1.4	7.6	8.9	6.0	579
HICP at constant tax rates	2.4	2.4	1.5	3.2	13.3	8.7	4.9	1000
Administered prices HICP	2.2	2.6	1.7	2.4	6.2	6.9	5.8	164

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

Source: Eurostat, European Commission calculations.

HICP inflation excluding energy and food increased steadily throughout 2022, peaking at 11.1% in December 2022, and then came down to 3.0% in May 2024. Both non-energy industrial goods and services prices grew on an annual basis less strongly than overall HICP until March 2023. HICP inflation excluding energy and food afterwards exceeded headline inflation until March 2024, indicating its stronger persistence. The stronger than usual tourism season in the summer of 2023 also temporarily held back disinflation in the related core price components.

In the past 2 years, services inflation has been driven mainly by the transport, catering and accommodation sectors. Prices in these sectors have been strongly influenced by food and energy input prices, as well as by strong nominal growth in wages in 2022. Some wage moderation in these sectors contributed to the deceleration in services inflation after the first quarter of 2023. High inflation in non-energy industrial goods prices was broad-based throughout 2022, driven by high import prices and producer costs. Inflation in this product

group persisted during 2023 due to the lagged increase in the prices of pharmaceutical products that followed the indexation of the administratively determined price ceilings.

### 2.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and growth developments

Real GDP grew by 3.9% in 2022 and then slowed down to 1.8% in 2023. Household consumption growth declined markedly in the first half of 2022 with inflation weighing down on real income. However, it grew rapidly in the second half, supported by a sizeable increase in nominal wages that restored the purchasing power of labour income. In a context of a tight labour market and falling inflation, real wages continued to expand in 2023, further supporting consumption. Nevertheless, the growth rate of households' consumption expenditures slowed down, accompanied by a downward trend in confidence indicators in the trade and services sector. At the same time, household deposits increased by more than consumer credit in 2023, indicating a higher propensity to save. Investment in fixed assets rebounded in 2022 as construction firms caught up with the accumulated delays in starting and finishing construction projects during the COVID-19 crisis. In 2023, investment increased by 3.3% with an important contribution from public investment and purchases of new equipment. Goods exports grew particularly strongly in the first half of 2022, reflecting both higher prices and volumes of exported commodities. Goods exports then contracted in 2023, due to the deterioration of external demand, the strong negative base effect in 2022 and some one-off factors<sup>(13)</sup>. Services exports expanded robustly in 2022 and 2023, benefiting from the continued recovery in the tourism sector in the aftermath of the COVID-19 crisis and the further development of services outsourced to Bulgaria. The strong accumulation of inventories in 2021 and the first half of 2022 turned sharply negative in the second half of 2022 and this decline deepened in 2023. Imports grew strongly in 2022, driven by high domestic demand and the high import content of exports. In 2023, imports contracted sharply, following the decline in exports and inventories.

Economic growth is expected to increase marginally to 1.9% in 2024, before reaching 2.9% in 2025. Domestic demand is expected to be the main growth driver in both years. Short-term indicators suggest that exports continued to contract at the beginning of 2024. Beyond Q1-2024, exports are projected to rebound, driven by the recovery of external demand. Household consumption is expected to keep growing, albeit somewhat less strongly than in 2023 because employment is expected to remain largely constant and as saving rates gradually return to higher levels. Some indicators also point towards a slowdown in consumer spending growth at the start of 2024. These dynamics depend crucially on the expectation of a good labour market performance and the assumption that the pass-through of relatively high euro area interest rates to the domestic credit market remains incomplete.

Based on the Commission's Spring 2024 Economic Forecast, Bulgaria is expected to move from a broadly neutral fiscal stance<sup>(14)</sup> in 2023 to a slightly contractionary one in 2024 (0.3% of GDP) due to the impact of increased spending on pensions and wages, which is not fully compensated by (i) a drop in nationally financed investment; and (ii) a decrease in the fiscal impulse from EU-funded expenditure following the last year of implementation of the 2014-2020 programming period of the EU structural funds. The budgetary costs related to people fleeing Russia's full-scale invasion of Ukraine are estimated at 0.1% of GDP. The no-policy-change forecast for 2025 reverts to a supportive stance (1.4% of GDP) driven by

<sup>(13)</sup> Notably planned maintenance in the steel industry and the nuclear power plant and the ban on exports of petroleum products processed from Russian oil.

<sup>(14)</sup> The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding COVID-19-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

the impact of nationally financed investment and increasing expenditure financed by the Recovery and Resilience Fund and other EU grants.

The BNB pursues its primary objective of price stability through an exchange rate anchor in the context of a currency board framework with the lev pegged to the euro. The currency board framework serves as a key macroeconomic policy anchor. The monetary tightening in the euro area has affected the non-financial corporations segment of the Bulgarian banking sector, but the pass-through to the mortgage lending segment has been rather muted. Country-specific factors in the setting of interest rates, high domestic liquidity and competition in the sector explain the continued strong lending for house purchases. The deposit base continued to grow due to growing disposable income in a context of limited investment alternatives available to households. The ample liquidity in the banking sector provided cheap and abundant funding for credit expansion. Moreover, mortgage lending interest rates are predominantly linked to the domestic deposit interest rates, which has helped keep down the lending rates, against a backdrop of strong competition among leading banks.

Given the risks to the debt-servicing capacity of borrowers, and the quality of banks' assets, the BNB decided in September 2022 to raise the countercyclical capital buffer rate applicable to domestic credit exposures from 1.5% to 2.0% (effective from 1 October 2023). The BNB also reconfirmed the systemic risk buffer at 3% on 11 December 2023. Moreover, the BNB's Governing Council increased the minimum required reserves on the funds attracted from non-residents from 5% to 10% as from 1 June 2023. The minimum required reserves on the funds attracted from both residents and non-residents were increased from 10% to 12% as from 1 July 2023. The increased reserve requirements were motivated by high inflation, high consumer demand, dynamic credit activity, and slow and weak transmission from the monetary tightening in the euro area to the domestic financial market.

Table 2.2:

Bulgaria - Other inflation and cost indicators

(annual percentage change)

	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
<b>HICP inflation</b>								
Bulgaria	26	25	12	28	13.0	8.6	3.1	2.6
Euro area	18	12	0.3	2.6	8.4	5.4	2.5	2.1
<b>Private consumption deflator</b>								
Bulgaria	2.4	2.0	-0.6	6.0	16.2	6.9	3.0	2.7
Euro area	1.5	1.1	0.6	2.3	6.8	6.0	2.4	2.0
<b>Nominal compensation per employee</b>								
Bulgaria	9.7	6.9	7.2	11.3	14.2	13.3	10.4	9.4
Euro area	2.1	2.2	-0.4	4.2	4.5	5.1	4.2	3.1
<b>Labour productivity</b>								
Bulgaria	2.8	3.7	-1.7	7.5	4.3	0.9	2.4	2.8
Euro area	0.1	0.2	-4.7	4.4	1.1	-1.0	0.1	0.9
<b>Nominal unit labour costs</b>								
Bulgaria	6.7	3.1	9.0	3.6	9.5	12.3	7.9	6.4
Euro area	2.0	1.9	4.6	-0.2	3.3	6.2	4.1	2.2
<b>Imports of goods deflator</b>								
Bulgaria	2.2	-0.1	-6.0	16.2	23.4	-3.2	1.0	2.0
Euro area	2.6	-0.6	-3.8	9.7	21.6	-4.9	0.4	1.8

1) Commission's Spring 2024 Economic Forecast.

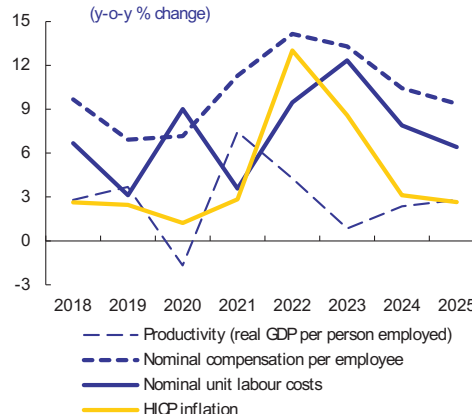
Source: Eurostat, Commission's Spring 2024 Economic Forecast.

## Wages and labour costs

The labour market remained tight in 2022 and 2023, with the unemployment rate fluctuating between 4% and 4.5%. In 2022, nominal wages continued to increase strongly (by 14.2%), reflecting both labour shortages and pressures from high inflation. The minimum wage was increased by 9.2% in April 2022 and then by 9.9% at the beginning of 2023, still below the accumulated inflation since the preceding update on 1 January 2021. In 2023, nominal wage growth moderated gradually to 13.3% as inflation pressures subsided and firms aimed to improve their competitive position given weakened external demand. The average monthly wage reached BGN 2012 (EUR 1,029) in 2023. As from 1 January 2024 the minimum wage was increased by 19.6%, to BGN 933 (EUR 477), following a new rule in the Labour Code aligned with the aims of Directive (EU) 2022/2041 on adequate minimum wages. According to the amendments to the Labour Code, the minimum wage in 2024 should be 50% of the average wage in the period July 2022 - June 2023. Aggregate labour productivity improved by 4.3% in 2022, driven by productivity gains in manufacturing. It then decelerated to 0.9% in 2023, reflecting more moderate output expansion and some employment gains. Overall, unit labour costs (ULC) increased by 9.5% in 2022 and 12.3% in 2023.

The aggregate ULC dynamics in 2022 and 2023 conceal important sectoral developments. Nominal ULCs in manufacturing declined in 2022, on the back of strong productivity gains and output growth. The tight labour market and high inflation caused wages in service sectors (e.g., trade, transport and hospitality) to increase strongly in 2022. At the same time labour productivity stagnated, giving rise to rapid growth in nominal ULCs. In 2023, the processes that determined the ULC dynamics in 2022 partially reversed. Wage growth in manufacturing first accelerated (possibly reflecting the strong productivity gains in 2022) and

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



Source: Eurostat, Commission's Spring 2024 Economic Forecast.



then decelerated as firms tried to gain competitiveness in export markets. Wages in key service sectors (e.g., trade, transport and hospitality) have been growing much more moderately since the end of 2022. Wage increases in the public sector were also an important factor in the strong aggregate wage dynamics in 2022 and 2023.

### External factors

Import prices are an important channel through which external price shocks affect the domestic price dynamics. The price hikes in imported energy and other materials in 2021 and 2022 led to a surge in production costs. The cost-push factor has been more pronounced than on average in the EU because the Bulgarian economy is around three times more energy intensive than the EU average and is also more resource/material intensive than the EU. External inflation has also been directly imported through consumer goods imports, which constituted 24% of total imports in 2023.

The lev's nominal effective exchange rate, which is determined by the price of the lev vis-à-vis the currencies of 36 major trade partners, appreciated by 3.4% in 2022 and 2% in 2023. The appreciations were strongly influenced by the depreciation of the Turkish lira against the euro. Türkiye is Bulgaria's most important trading partner outside the EU, accounting for 5.6% of total exports and 8.2% of total imports in 2023.

### Administered prices and taxes

The share of administered prices in the HICP basket is relatively high at around 17%, compared with 13% in the euro area. Regulated prices of electricity, heat and water follow a seasonal pattern because they are usually updated at the beginning of the year or in the summer months. Administered price inflation accelerated to 6.2% in 2022 and to 6.9% in 2023 on the back of increasing energy prices. Administered price inflation remained well below overall HICP in 2022 and 2023.

Changes in indirect taxes had a slight negative effect on inflation in 2022 and 2023. The most important measures introduced in 2022 were the reduction of VAT rates for natural gas and central heating from 20% to 9% and the exemption from excise duties for gas and electricity. These measures expired in mid-2023. Moreover, a temporary subsidy for car fuel of 0.25 leva per litre of fuel was introduced in mid-2022 and expired at the end of 2022. In 2023 and 2024, excise duty on cigars and cigarettes was increased cumulatively by almost 10% and with further similar increases are planned for 2025 and 2026. Annual HICP at constant tax rates was 0.3 of a percentage point and 0.1 of a percentage point above headline inflation in 2022 and 2023, respectively. Some of the support measures introduced in 2022 were still in place in 2023, which explains the persistence in the positive inflation differential between HICP at constant tax rates and headline HICP in 2023 through the carry-over effect from 2022. In the euro area, annual constant-tax HICP exceeded headline inflation by 0.5 of a percentage point in 2022 and then fell below it by 0.1 of a percentage point in 2023. The decision to reduce co-payments for certain medicines in late March 2024 has also brought down the administered prices since April 2024.

### Medium-term prospects

Looking forward, annual HICP inflation is expected to decrease markedly to 3.1% in 2024, and 2.6% in 2025. Import prices are set to exert downward pressure on the energy and non-energy industrial goods components in 2024. Services price inflation is also projected to decelerate, driven by second-round effects from lower input prices and a projected moderation in wage growth. Inflation in this category is nevertheless set to remain above overall HICP inflation, supported by nominal wage growth in the sector and the expiration of the reduced VAT measure for restaurant and catering services at the end of 2024.

Increased inflation in 2022 and 2023 has brought the consumer price level in Bulgaria closer to the euro area average. The level of consumer prices in Bulgaria nevertheless stood at

about 55% of the euro area average in 2022. This suggests that there is potential for price level convergence in the long term, as GDP per capita in terms of purchasing power standards (about 60% of the euro-area average in 2022) rises towards the euro area average.

Medium-term inflation prospects will depend on the containment of price expectations and wage-productivity developments, as well as on the functioning of product and services markets. These developments may be substantially affected by the cyclical position of the economy. The ambitious investment and reform agenda of the Bulgarian RRP aims at expanding the productive potential, including via the green transition and digital transformation. The implementation of the planned measures that target energy savings, reduction in fossil fuel consumption, diversification of energy supplies and more renewable energy would improve the economy's currently low energy efficiency, and its overall resilience and competitiveness.

### 2.3. PUBLIC FINANCES

#### 2.3.1. Recent fiscal developments

After 2 years at around 4% of GDP in 2020 and 2021 due to the pandemic-induced shock, the government deficit narrowed to 2.9% of GDP in 2022. It further decreased to 1.9% in 2023. The revenue-to-GDP ratio increased by 0.8 percentage point in 2022 to 38.5% of GDP before declining to 37.9% in 2023. The expenditure-to-GDP ratio fell from 41.4% in 2022 to 39.8% in 2023.

In 2022, the budget introduced a gradual increase in excise duty on tobacco and fees for the use of the national paid road network (toll taxes and e-vignette). The increasing prices of products and growing labour income also increased tax revenues. The expenditure measures in the 2022 budget included increases in the minimum wage and changes in pension policy parameters. Some key COVID-19 support measures continued to apply in 2022, including the provision of vaccines and medical products, pension top-ups and business support schemes. Further measures were introduced to support displaced persons from Ukraine. These included the provision of humanitarian aid and had a budgetary impact of 0.1% of GDP in 2022 and 0.4% in 2023 (based on Commission estimates). In addition, in 2022 Bulgaria implemented measures to mitigate the impact of high energy prices. These measures had a net budgetary impact of 1.3% of GDP. They were almost fully phased out in 2023.

In 2023, changes in income policy parameters such as minimum and maximum insurable income drove social contributions up even though the labour market was still tight. Revenues were further supported by the introduction of a 100% dividend on SOEs, with an estimated budget impact of 0.6% of GDP. In addition, the partial phasing-out in 2023 of the measures to moderate the impact of high energy prices helped to contain the deficit, while the remaining emergency energy measures were fully compensated by windfall revenues from the energy sector. The deficit also benefited from compensatory measures to increase revenue collection, including in the area of fiscal control of goods with high fiscal risk, with an estimated impact of 0.3% of GDP. Increases in wages and pensions that had been enacted in previous years started to have a budgetary impact estimated at almost 3% of GDP. However, the outturn deficit for 2023 was contained by a limited spending capacity in 2023, which caused a drop in intermediate consumption, as well as by the normalisation of energy prices, which contributed to a sharp decrease in subsidies (down by 46.7% from 2022, the equivalent of 2.2% of GDP).

In 2022, the debt-to-GDP ratio fell by 1.3 percentage points to 22.6% of GDP but rose back up to 23.1% in 2023. The debt-increasing impact of the primary deficit in 2022 was more than compensated by a large snowball effect, reflecting the stronger impact of inflation and real GDP growth on the debt ratio than the interest rate on government debt. Together with



a small negative stock-flow adjustment, this led to decrease in the debt ratio. In 2023, the primary deficit of 1.4% of GDP was fully compensated by real GDP growth and inflation, but the joint impact of interest expenditure and a positive stock-flow adjustment increased the debt ratio.

### 2.3.2. Medium-term prospects

The 2024 budget targets a general government deficit of 2.9% of GDP in 2024. According to the Commission's Spring 2024 Economic Forecast, which is based on a no-policy-change assumption, the general government deficit is expected to be 2.8% of GDP in 2024.

Supported by favourable labour market developments, changes in income policy such as increased minimum and maximum insurable income are expected to translate into higher social security contributions. A positive impact is again expected from a package of measures to increase the collection of VAT and corporate taxes, and the introduction of a domestic top-up tax in accordance with Council Directive (EU) 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise groups and large domestic groups in the Union<sup>(15)</sup>. Projected increases in imports in 2024 will further increase revenues from indirect taxation. However, overall tax revenue increases are set to slow in line with the economic outlook and lowered inflation.

The growth in expenditure is set to outpace revenue growth. The budgetary impact of pension expenditure and measures to increase the minimum wage and the guaranteed minimum income in line with the poverty line are only partly compensated by the full phasing out of the energy-related measures (0.8% of GDP in 2023), with pension measures alone driving an increase of more than 1% of GDP. Compensation of employees and social transfers are therefore expected to increase the most. Public investment is expected to decrease, due in part to the full implementation of the 2014-2020 EU funds programming period in 2023 and also due to a slowdown in national public investment.

On 30 April 2024, Bulgaria submitted its 2024 Convergence Programme. In line with the outturn, the headline deficit in the Programme stands at 1.9% in 2023 and is projected to be 3% of GDP in 2024 and 2025. The government deficit projected by the Commission is slightly lower but broadly in line with the planned deficit in the Convergence Programme, at 2.8% vs 3% in 2024. This is also due to different assumptions on the evolution of gross fixed capital formation.

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<sup>(15)</sup> OJ L 328, 22.12.2022, p. 1–58.

Table 2.3:

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

Outturn and forecast <sup>1)</sup>	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
General government balance	1.7	2.1	-3.8	-3.9	-2.9	-1.9	-2.8	-2.9
- Total revenue	38.7	38.5	37.7	37.7	38.5	37.9	37.2	38.6
- Total expenditure	37.0	36.3	41.5	41.6	41.4	39.8	39.9	41.6
of which:								
- Interest expenditure	0.7	0.6	0.5	0.5	0.4	0.4	0.5	0.5
p.m.: Tax burden	29.7	30.4	30.5	30.8	31.1	30.1	30.2	31.1
Primary balance	2.4	2.7	-3.3	-3.5	-2.5	-1.4	-2.3	-2.4
Fiscal stance <sup>2)</sup>					-1.0	0.0	0.3	-1.4
Recommended growth in net nationally financed primary expenditure (%)							4.6	-
Growth in net nationally financed primary expenditure (%)							6.2	-
Government gross debt	22.1	20.0	24.6	23.9	22.6	23.1	24.8	24.6
p.m: Real GDP growth (%)	2.7	4.0	-4.0	7.7	3.9	1.8	1.9	2.9

1) Commission's Spring 2024 Economic Forecast.

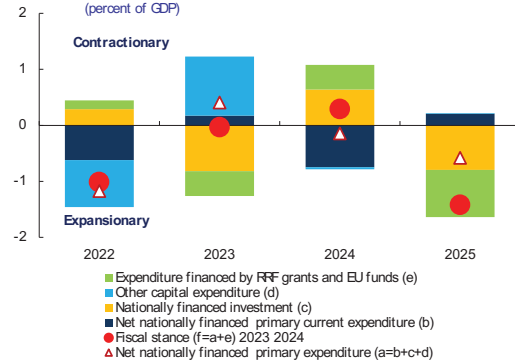
2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

Based on the Commission's estimates, the fiscal stance is projected to be slightly contractionary at 0.3% of GDP in 2024, following a broadly neutral fiscal stance of 0.0% of GDP in 2023. The mildly contractionary fiscal stance in 2024 is primarily being driven by nationally financed investment and by EU-financed expenditure, which are contributing 0.6% and 0.4% of GDP respectively. The contribution of net nationally financed primary current expenditure is expansionary (0.07% of GDP) because current expenditure is set to grow above medium-term potential growth. This is despite the contraction driven by the full phasing-out of measures to moderate the impact of high energy prices. Expenditure financed by grants from the RRF and other EU funds also has a slightly contractionary contribution of 0.4% of GDP. The general government debt-to-GDP ratio is forecast to increase to 24.8% in 2024. Declining inflation, paired with the slow picking-up of economic growth, has a negative impact on the size of the snowball effect. This is therefore not large enough to offset the impact of the primary balance, which is expected to increase the debt-to-GDP ratio by 1.8 percentage points.

On 14 July 2023, the Council recommended that Bulgaria ensures a prudent fiscal policy, in particular by limiting the nominal increase in nationally financed net primary expenditure in 2024 to not more than 4.6%. According to the Commission's Spring 2024 Economic Forecast, Bulgaria's net nationally financed primary expenditure is projected to increase by 6.2% in 2024, which is above the recommended maximum growth rate (although base effects apply). This excess spending over the recommended maximum growth rate in net nationally financed primary expenditure corresponds to 0.6% of GDP in 2024. However, net expenditure in 2023 was lower than expected at the time of the recommendation (by 3.3% of GDP). Therefore, because the recommendation for 2024 was

Graph 2.4: Bulgaria - Fiscal stance and its components (percent of GDP)



Source: Commission's Spring 2024 Economic Forecast.

formulated as a growth rate, the assessment of compliance also needs to take into account the base effect from 2023. Had net expenditure in 2023 been the same as expected at the time of the recommendation, the resulting growth rate of net expenditure in 2024 would have been below the recommended growth rate by 2.7% of GDP. Moreover, the Council recommended that Bulgaria takes action to wind down the emergency energy support measures in force, using the related savings to reduce the government deficit as soon as possible in 2023 and 2024. The Council further specified that, if renewed energy price increases necessitate new or continued support measures, Bulgaria should ensure that these measures are targeted at protecting vulnerable households and firms, are fiscally affordable and preserve incentives for energy savings.

According to the Commission's Spring 2024 Economic Forecast, the net budgetary cost of energy support measures is projected to be 0.0% of GDP in 2023, 2024 and 2025.

The Council also recommended that Bulgaria preserves nationally financed public investment and ensures the effective absorption of RRF grants and other EU funds, in particular to foster the green and digital transitions. According to the Commission's Spring 2024 Economic Forecast, nationally financed public investment is projected to decrease from 2.7% of GDP in 2023 to 2.1% of GDP in 2024 and is therefore not expected to be preserved. This is also due to the timing of the programming periods of the EU structural funds and the related nationally financed contributions. Investments in 2024 (during the new programming period) are not expected to be fully replaced by investments which occurred in 2023 (during the previous programming period). This will lead to a decline in investment expenditure and in the nationally co-financed part of the investment expenditure. These risks not being in line with what was recommended by the Council. In turn, public expenditure financed from revenues from EU funds, including grants from the RRF, is expected to decrease to 0.8% of GDP in 2024 (from 1.2% of GDP in 2023). This decrease will be driven by the end of the 2014-2020 programming period of EU structural funds, for which funds were available until 2023.

In 2025, the fiscal stance is projected to be expansionary at 1.4% of GDP, with a positive impact on economic growth of (i) 0.8% of GDP coming from nationally financed investment and (ii) 0.8% of GDP from expenditure financed by grants from the RRF. The general government deficit is projected to remain at 2.9% of GDP in 2025, including the impact of the delivery of military equipment with a total temporary cost close to 0.8% of GDP, which contributes to a steep increase in gross fixed capital formation. With revenues from taxes slowly picking up from 2024 and a broadly constant growth in social security contributions, projected increases in pensions and wages still outweigh the higher revenues, supported by a favourable labour market.

The general government debt-to-GDP ratio is forecast to slightly decrease to 24.6% in 2025, mainly reflecting a stable projected primary deficit, a moderate debt-reducing contribution from the snowball effect, and an increased debt-reducing contribution from the stock-flow adjustment. Stable interest rates, paired with declining inflation and the picking-up in economic growth, is forecast to result in a snowball effect in 2025 of -0.8% of GDP, which will only partly counter the debt-increasing effect of the primary deficit of 2.4% of GDP. However, a relatively high debt-reducing stock-flow adjustment, reflecting higher expected RRF cash inflows during the year, is expected to contribute to a moderate decrease in the debt-to-GDP ratio by 0.2 percentage point in 2025 compared with 2024.

Debt sustainability risks appear medium over the medium term. Government debt is projected to increase from around 25% in 2024 to around 41% of GDP in 2034. This projection assumes that the structural primary deficit (excluding changes in the cost of ageing) will remain constant at the level projected for 2024 of 2.3% of GDP <sup>(16)</sup>.

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<sup>(16)</sup> For further details on the methodology, see European Commission (2024), Debt Sustainability Monitor 2023, Institutional Paper 271, March 2024.

The sensitivity to possible macro-fiscal shocks contributes to this assessment. In particular, if the interest-growth rate differential were to be 1 percentage point higher than the baseline, then the projected debt ratio in 2034 would be around 3 percentage points higher than in the baseline (i.e. still well below 60% of GDP). The stochastic projections point to a large degree of uncertainty.

Several factors are mitigating risks, including the low share of short-term government debt and Bulgaria's favourable positive net international investment position. Risk-increasing factors include (i) the substantial share of public debt denominated in foreign currencies, although this is mitigated by the operation of the currency board; (ii) the significant share of public debt held by non-residents; (iii) and some contingent liability risks stemming from the banking sector.

The key elements of a robust fiscal framework are in place in Bulgaria, but some difficulties in implementation remain, partly due to shortcomings in public investment management. Bulgaria has a complex system of national fiscal rules in place, as indicated in the Convergence Report 2022. Several rules target the same budget aggregates but the fact that they are expressed according to different accounting standards (accrual and cash-based) may create conflicting messages. Moreover, the capacity of the Ministry of Finance to monitor, plan, forecast and report on the general government budget in both accrual and cash terms remains a challenge, especially with respect to the management and planning of government finances. The Ministry does not always have as much information or access to detailed data as would be desirable for budgetary planning. In particular, information is lacking on the operations of entities outside the central administration and occasionally even of some other ministries. The Ministry of Finance also has weaknesses in producing projections on an accrual basis (e.g., under the European System of National and Regional Accounts (ESA)). The Fiscal Council of Bulgaria has a narrow mandate that is focused on monitoring fiscal rules and assessing macroeconomic and budgetary forecasts. Its policy dialogue with the Bulgarian government and parliament is also quite limited. The amended Budgetary Framework Directive (2011/85/EU), which is part of the Economic Governance Review and was adopted on 29 April 2024, will affect some aspects of the Bulgarian fiscal framework and particularly the tasks of the Fiscal Council. The amended Directive extends the independence safeguards for independent fiscal institutions to all EU Member States and assigns some tasks to these institutions. Concerning public investment management, Bulgaria displays scope for improvement on key dimensions such as (i) aligning investment decisions with their long-term strategic goals; (ii) vertical (between levels of government) and horizontal (across sectors) coordination; (iii) the application of consistent project selection criteria and methodologies; (iv) limiting the under-execution of capital expenditure; and (v) the carry-over of unspent funds.

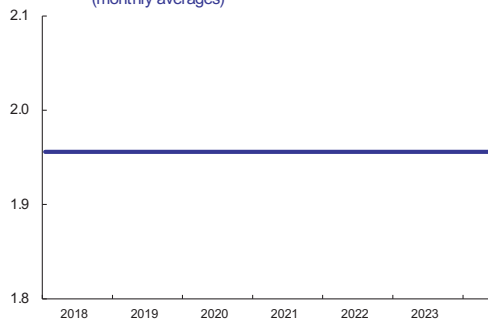
#### 2.4. EXCHANGE RATE STABILITY

The Bulgarian lev joined the Exchange Rate Mechanism II (ERM II) on 10 July 2020. The Bulgarian National Bank (BNB) entered in parallel into a 'close cooperation' agreement with the ECB. After joining, Bulgaria committed to pursue a set of policy measures (known as post-entry commitments) to ensure that its participation in the mechanism is sustainable and achieves a high degree of economic convergence before the adoption of the euro. The measures cover four policy areas: (i) the non-banking financial sector; (ii) the insolvency framework; (iii) the anti-money laundering framework; (iv) and governance of state-owned enterprises.

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

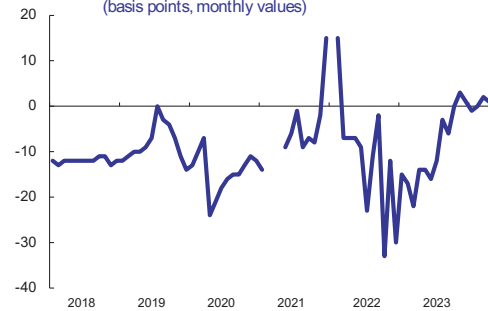
Bulgaria's international reserves increased from around EUR 35 billion at the beginning of 2022 to around EUR 38 billion at the end of 2022 and then to around EUR 42 billion by the end of 2023. Government securities issued on international financial markets accounted for most of the inflows in 2022 and 2023. Positive contributions were made by EU funds transfers in 2022 and reserve currency transactions in 2023. International reserves remained stable between 2022 and 2023 at around 45% of GDP.

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



Source: ECB.

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



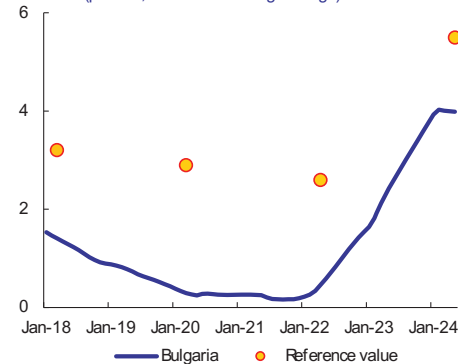
Source: Eurostat and National Bank of Bulgaria.

The BNB does not set monetary policy interest rates. The euro area's monetary policy affects domestic interest rates directly through the operation of Bulgaria's currency board framework. The BNB discontinued the production of short-term reference rates (e.g. SOFIBOR) from 1 July 2018. The BNB now instead publishes a base interest rate (BIR) based on the LEONIA Plus (LEv OverNight Interest Average Plus) index, which is a reference rate of concluded and effected overnight deposit transactions in Bulgarian lev on the interbank market in Bulgaria. The BIR stood at -0.6% in April 2022, which was close to an all-time low. It increased in the second half of 2022 and 2023, reaching a peak of 3.9% in October 2023 and remains relatively stable at that level thereafter. The BIR's increase in the second half of 2022 was slower than that of the 1-month Euribor rate, resulting in a widening of the interest rate differential between the BIR and the 1-month Euribor to -30 basis points by December 2022. As the BIR rose throughout 2023, the interest differential narrowed. Since October 2023, and until April 2024, there has been no or a minimal interest rate differential.

## 2.5. LONG-TERM INTEREST RATES

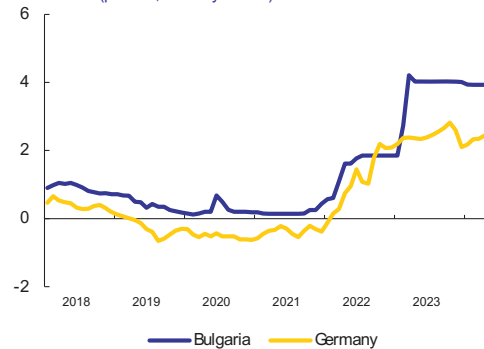
Long-term interest rates used for the convergence examination reflect the secondary market yield on a single benchmark Bulgarian government bond with a residual maturity of around 8 years.

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



Source: European Commission.

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



Source: Eurostat.

The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value in the 2022 convergence assessment of Bulgaria. The average interest rate has since increased substantially. It increased from 0.5% in April 2022 to 1.5% at the end of 2022 and then to 3.75% at the end of 2023. In May 2024, the reference value, calculated as the average of long-term interest rates in the Netherlands, Italy and Latvia plus 2 percentage points, was 5.5%. In that month, the 12-month moving average of the yield on the Bulgarian benchmark bond was 4.0%, i.e. 1.5 percentage points below the reference value.

From a low rate at the beginning of 2022, the Bulgarian long-term interest rate has shown a trend of stepwise increases. It increased in the first 3 months of 2022 before remaining within a narrow band of 1.6-1.9%, from April 2022 to January 2023. It then increased again substantially in February and March 2023. However, throughout the rest of 2023, the interest rate remained in a very narrow band of 4.0-4.2%. The higher long-term interest rate reflects the very high inflation that Bulgaria has experienced in the last 2 years and the tightening of monetary policy in the euro area. The stepwise increases resulted from the changes in the single benchmark bond used at any point in time for this assessment and the fact that the bond is infrequently traded on the secondary market. Financial developments are therefore not seen in the yields until the bond is either traded or replaced by a new benchmark bond. The German long-term interest rate also increased, but more gradually than the Bulgarian long-term interest rate. The difference between the Bulgarian and German long-term interest rates remained within a range of -0.4-0.9% from the beginning of 2022 to February 2023 before increasing to a range of 1.2-1.9% between March 2023 and May 2024. The increase in the spread reflects political uncertainty in Bulgaria and the effect this could have on the government budget.

## 2.6. ADDITIONAL FACTORS

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

In November 2023, the Commission published its 13th Alert Mechanism Report (AMR 2024) under the Macroeconomic Imbalance Procedure. This concluded that it was not necessary to carry out further in-depth analysis on Bulgaria in the context of the Macroeconomic Imbalance Procedure. In the past, vulnerabilities in the financial sector were coupled with high indebtedness and non-performing loans in the corporate sector. However, continued policy action and a favourable macroeconomic environment reduced risks and



vulnerabilities before the onset of the COVID-19 crisis. Developments related to cost competitiveness, dynamic household borrowing, and strong house-price growth require close monitoring, although associated macroeconomic risks appear to be limited. In particular, house prices remain a concern, despite some moderation. They have been growing more slowly than income since 2013 but are estimated to be overvalued by some 8%. Nominal house-price growth increased to 13.8% in 2022, reflecting also a sharp increase in construction costs in the first quarter of the year that were linked to higher construction material prices due to Russia's full-scale invasion of Ukraine. Prices nevertheless fell in real terms. The rise in house prices has moderated since the second half of 2022 and the number of transactions of house sales has declined.

Bulgaria's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, by reforming in the energy sector; investing in sustainable transport and green transition; promoting deployment of 5G networks; reforming the legal framework to promote entrepreneurship and e-governance; improving the quality and inclusiveness of education; and reforming the minimum income. In addition to the EUR 5.7 billion of RRF funding, cohesion policy provides Bulgaria with EUR 10.7 billion for the 2021-2027 period.

Bulgaria has submitted two payment requests, corresponding to 84 milestones and targets in the plan and resulting in an overall disbursement of EUR 1.37 billion on 16 December 2022.

While some reforms (in the areas of anti-money laundering, education) and investments, (e.g., energy efficiency, renewable energy, smart industry, healthcare) have already started, the implementation of the Bulgarian RRP faces significant delays and substantial challenges to complete all the measures of the plan by August 2026. Bulgaria has yet to implement key business environment reforms under the RRP, including in the areas of rule of law, anti-corruption, governance of state-owned enterprises and public procurement. The RRP includes major reforms for the decarbonisation of the energy sector, but delays create significant risks to their implementation.

Cohesion policy funding helps tackle Bulgaria's growth and competitiveness challenges and aims to reduce the country's territorial and social disparities. In the current 2021-2027 programming period, financing aims to further support Bulgaria's competitiveness, green transition and social cohesion, improve the living and working conditions of Bulgaria's people, and promote regional and social convergence.

Bulgaria's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, to boost its competitiveness and stimulate sustainable growth and reduce the country's territorial and social disparities. The RRF funding provides Bulgaria with EUR 5.7 billion in grants over the 2021-2026 period. Bulgaria has submitted two payment requests resulting in an overall disbursement of EUR 1.37 billion on 16 December 2022.

While some reforms (in the areas of anti-money laundering, education, etc.) and investments, (e.g., energy efficiency, renewable energy, smart industry, healthcare) have already started, the implementation of the Bulgarian RRP faces significant delays. Bulgaria has yet to implement major reforms and investments for the decarbonisation of the energy sector, as well as key business environment reforms under the RRP, including in the areas of rule of law, anti-corruption, governance of state-owned enterprises and public procurement.

In addition, cohesion policy provides Bulgaria with EUR 10.7 billion for the 2021-2027 period. Cohesion policy financing aims particularly to further support Bulgaria's competitiveness, green transition, including energy independence, the just transition and climate change resilience, as well as upward social convergence, including by addressing labour shortages, further developing educational systems and skills and making them more

inclusive for disadvantaged groups. Bulgaria has made progress in implementing cohesion policy but challenges remain.

### 2.6.1. Developments in the balance of payments

Bulgaria's external balance (i.e. the combined current and capital accounts) improved to -0.5% and 1.3% of GDP in 2022 and 2023 respectively. Net services exports improved throughout the last 2 years, benefiting from the recovery in tourism to pre-pandemic levels and the development of other services, including those outsourced to Bulgaria (e.g., IT and business services). The trade balance deteriorated in 2022 as buoyant exports and domestic demand (including the building-up of import-intensive inventories) drove up imports. The terms of trade improved in 2022 but then deteriorated in 2023. In 2022, the export deflator increased by 26% and the import deflator grew by 23.4%. The surge in energy prices weighed on the trade balance but its effect on the terms of trade was offset by export price increases in other products and materials. In 2023, the trade balance improved, as imports declined more steeply than exports. The capital account and secondary income balance remained positive and improved in 2022 and 2023. The primary income deficit shrank slightly to 3.2% of GDP in 2022 but then widened to 5% of GDP in 2023, driven by the decline and the subsequent rise in foreign direct investment (FDI) income.

Table 2.4:

Bulgaria - Balance of payments		(percentage of GDP)				
	2018	2019	2020	2021	2022	2023
Current account	0.9	1.9	0.0	-1.7	-1.4	-0.3
of which: Balance of trade in goods	-4.8	-4.7	-3.2	-4.1	-5.9	-3.9
Balance of trade in services	7.4	8.0	5.1	5.9	6.1	7.1
Primary income balance	-4.8	-4.2	-3.5	-4.7	-3.2	-5.0
Secondary income balance	3.2	2.9	1.6	1.2	1.6	1.5
Capital account	1.1	1.4	1.4	0.7	0.9	1.6
External balance <sup>1)</sup>	2.0	3.3	1.5	-1.0	-0.5	1.3
Financial account	5.6	3.9	3.4	3.8	4.1	1.2
of which: Direct investment	-1.3	-2.0	-4.5	-1.8	-2.4	-3.3
Portfolio investment	2.8	2.6	1.2	3.2	1.2	1.3
Other investment <sup>2)</sup>	1.7	4.2	-2.7	-2.8	0.7	-0.4
Change in reserves	2.4	-0.9	9.4	5.1	4.7	3.5
Financial account without reserves	3.1	4.8	-6.0	-1.3	-0.5	-2.3
Errors and omissions	3.5	0.6	1.9	4.9	4.6	-0.1
Gross capital formation	21.2	21.0	20.3	21.1	23.4	18.8
Gross saving	22.2	22.8	20.4	19.3	22.0	18.5
Net international investment position	-37.0	-30.2	-25.6	-18.6	-12.9	-7.6

1) The combined current and capital account.

2) Including financial derivatives.

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

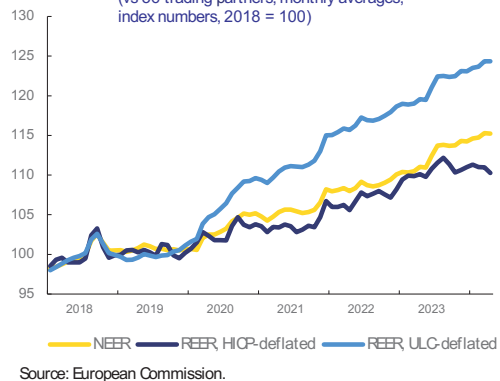
The financial account, net of official reserves, improved to -0.5% of GDP in 2022 but then deteriorated to -2.3% of GDP in 2023. FDI, notably in the form of reinvested earnings, made the largest negative contribution to the financial account balance both in 2022 (2.4% of GDP) and 2023 (3.3% of GDP). Net investments in debt securities abroad contributed 1.2% of GDP in 2022 and 1.3% of GDP in 2023 to the financial account. The balance of other investments had a limited impact on the financial account balance, with gross inflows and outflows of currency and deposits roughly offsetting each other. The BNB's reserve assets increased by 4.7% of GDP in 2022 and by 3.5% of GDP in 2023. Given that external and financial accounts almost balanced each other out in 2022, the accumulation of reserves by the BNB resulted in large net errors and omissions. In 2023, the BNB accumulated further assets mostly due to the sizeable improvement in the external balance.



The negative net international investment position continued to shrink as a share of GDP in 2022-2023, also due to the rapid nominal GDP growth during the period. Net external liabilities stood at 7.6% in 2023 and consisted mostly of FDI equity, which has been relatively stable since the crisis of 2009.

In 2022-2023, measures of competitiveness exhibited different dynamics depending on the set of trading partners considered. The real effective exchange rate deflated by the HICP appreciated with respect to the euro area on account of Bulgaria's higher domestic inflation rate. However, when considering an enlarged set of 36 countries, the real effective exchange rate appreciated by less in 2022 and 2023, suggesting higher relative prices in the trading partners outside the euro area. By contrast, the real effective exchange rate deflated by unit labour costs (ULC) accelerated, as domestic wage growth outstripped the wage dynamics abroad.

Graph 2.9: Bulgaria - Effective exchange rates  
(vs 36 trading partners; monthly averages;  
index numbers, 2018 = 100)



The strong export performance in 2022 suggests that the exporters were able to exploit market opportunities following Russia's full-scale invasion of Ukraine, and more generally, the persistence of global supply bottlenecks. At the same time, exporting firms were able to pass on higher input costs (including energy costs), to foreign buyers due to the global hikes in international prices. With the deterioration of external demand in 2023, exporters sharply reduced inventory accumulation and cut purchases from abroad. Wage growth also gradually decelerated throughout 2023, possibly reflecting firms' efforts to secure competitiveness gains against the backdrop of deteriorated foreign demand.

The Commission's Spring 2024 Economic Forecast projects that the current account balance will slightly improve in 2024 to +0.3% of GDP, on account of lower net primary income and current transfers, and then worsen due to imports expanding faster than exports.

### 2.6.2. Market integration

The economy is well-integrated with the euro area through trade and investment linkages. After a period of decline between 2018 and 2020, the ratio of trade openness (see Table 2.5 for a definition) rebounded to close to 70.9% in 2022, which was a new peak. It decreased to 61.4% in 2023. Bulgaria therefore remains a relatively open economy. Trade with the euro area was around 27% of total trade in 2023. France, Germany, Italy and Greece were the main trading partners. Outside the euro area, Bulgaria's main trading partners were Romania and Türkiye.

Table 2.5:

**Bulgaria - Market integration**

	2018	2019	2020	2021	2022	2023
Trade openness <sup>1)</sup> (%)	66.5	64.2	56.8	62.0	70.9	61.4
Trade with EA in goods & services <sup>2)+3)</sup> (%)	30.5	28.7	25.6	27.9	30.4	27.2
IMD World Competitiveness Ranking <sup>4)</sup>	48	48	48	53	53	57
Internal Market Transposition Deficit <sup>5)</sup> (%)	0.7	0.6	1.6	2.2	1.8	1.7
Real house price index <sup>6)</sup>	113.8	118.3	124.4	127.5	124.9	128.3

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

2) (Imports + Exports of goods with EA-20 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-20 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) International Institute for Management Development (IMD).

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

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

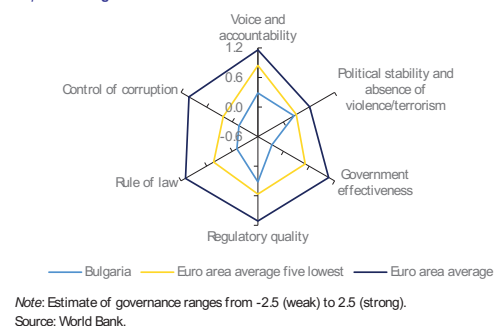
Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

Net FDI inflows increased but remained relatively low at 2.4% of GDP in 2022 and 3.1% of GDP in 2023. The stock of inward FDI declined to 63% of GDP in 2022 and 58% in 2023. This decline is due to the high nominal GDP growth. In 2023, 22% of the overall inward FDI stock was directed to industry (excluding construction), 21% to real estate and 14% to the trade sector.

The business environment does not generally support investment and institutional quality remains a challenge. According to the World Bank's 2022 Worldwide Governance Indicators, Bulgaria ranks lower in accountability, government effectiveness, the rule of law and control of corruption than the average of the five euro area Member States with the lowest scores <sup>(17)</sup>. In addition, the first pillar (Institutions) remains among the least performing areas in the Global Competitiveness Index. The Bulgarian RRP includes several measures to improve the business environment: an ambitious reform of the judiciary; an anti-corruption reform including whistle-blowing regulation; the overhaul of public procurement practices; the liberalisation of the electricity market, and the strengthening the frameworks for insolvency, anti-money laundering and the governance of state-owned enterprises. The last three are also part of the post-entry commitments for when Bulgaria entered the ERM II. The implementation of many of these reforms is experiencing delays.

In the course of 2023 and the first half of 2024 Bulgaria has taken action to improve the framework for preventing and fighting money laundering, its predicate offences and the financing of terrorism by amending the Law on Measures Against Money Laundering and updating the national risk assessment of money laundering and terrorist financing, and by issuing sectoral risk assessments relating to the non-profit organisations' sector and virtual assets. Steps are also being taken to enhance the functioning of the beneficial ownership registers in Bulgaria; reinforce the analytical capacity of the Financial Intelligence Unit to make better use of suspicious transaction reports and develop financial intelligence; improve cooperation with investigative and prosecutorial authorities regarding the usefulness of the financial intelligence; and strengthen the capacity of Bulgaria's anti-money laundering and countering the financing of terrorism (AML/CFT) supervisory authorities to take action where obliged entities fail to comply with their obligations stemming from the

Graph 2.10: Bulgaria - World Bank's 2022 Worldwide Governance Indicators



<sup>(17)</sup> A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage point lower (higher) than that of the average of this group of five euro area Member States.

AML/CFT regime. Bulgaria underwent an assessment of the effectiveness of its framework for fighting money laundering and countering the financing of terrorism against international standards developed by the Financial Action Task Force. The assessment has resulted in an action plan with recommendations to be addressed.

Labour and skills shortages remain a significant challenge and risk worsening, considering the negative demographic trends. This in turn combined with the high inactivity rates for Roma, persons with disability and those not in education, employment or training poses challenges for economic growth and social outcomes.

Bulgaria scores low on to digital skills. Only 35.5% of Bulgaria's population has basic digital skills, which is among the lowest rates in the EU. Bulgaria scores very low on the digitalisation of businesses. One key challenge is the adoption of digital technology in enterprises (mainly small and medium sized enterprises), where the percentage is one of the lowest in the EU. One of the priorities of Bulgaria's RRP is to improve digital skills with significant investment to adapt the skill set of the workforce. Moreover, the RRP includes measures such as a voucher scheme for the digitalisation of small and medium sized enterprises and is complemented by targeted Cohesion Policy investments.

Public and private R&D investments remain amongst the lowest in the EU. R&D intensity stood at 0.77% in 2022, has remained at the same level since 2020 and is still well below the EU average. Limited academia-business linkages remain a serious obstacle to the commercialisation of research results and limits technology transfer and innovation activities.

Challenges also remain in ensuring quality and inclusive education. A high share of low achievement combined with few top performers in the Programme for International Student Assessment reflects challenges to improving the quality and equity of education. Socio-economic background has a major impact on students' performance. To tackle some of these challenges, the Bulgarian RRP is supporting the ongoing creation of STEM learning centres, which is ongoing. Tertiary educational attainment also remains low. In 2022, 33.8% of Bulgarians aged 25-34 had a tertiary degree, significantly below the EU average (42.0%). The rate has not improved much in recent years.

Regional disparities in GDP per capita remain very high in Bulgaria. At the beginning of the current decade, regional disparities remained at the same level as in the previous one. They can be seen in terms of GDP and labour productivity, demographics, education and training, employment, infrastructure, competitiveness, and research and innovation performance. Addressing territorial disparities is one of the high-level objectives laid down in the Bulgaria's 2021-2027 Partnership Agreement.

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

	BG		EA		Ratio to GDP (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Financial corporations (total)	179	168	689	715	174	190
Central bank	45	45	53	68	46	52
Monetary financial institutions	97	90	266	290	87	93
Other financial intermediaries	17	15	181	163	16	18
Non-MMF investment funds <sup>1)</sup>	1	2	101	113	4	5
Insurance co. and Pension Funds	18	17	87	81	21	22
	BG		EA		Share of total (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Central bank	25	27	8	10	27	27
Monetary financial institutions	54	54	39	40	50	49
Other financial intermediaries	10	9	26	23	9	10
Non-MMF investment funds	1	1	15	16	2	3
Insurance co. and Pension Funds	10	10	13	11	12	11

1) MMF stands for money market funds.

Source: Eurostat.

The Bulgaria's financial sector is smaller and less developed than the euro area's. Assets managed by the financial sector amounted to 168% of GDP in 2022, which was much less than in the euro area (715% of GDP) but similar to the average of the five euro area Member States with the smallest financial sectors. While it has grown in the euro area, the size of the financial sector as a share of GDP has shrunk in Bulgaria since 2018, as the development of the financial sector has been outstripped by growth in GDP. Banking dominates the Bulgarian financial sector, making up 54% of the financial sector's assets in 2022. The BNB is the second largest holder of financial assets with a share of 27% in 2022, more than all non-banking financial intermediaries taken together. These shares are larger than in the euro area, reflecting a relative underdevelopment of non-bank financial intermediaries and investment funds, similar to that of the five euro area Member States with the smallest financial sectors. At the same time, the relative share of the insurance and pension-fund sector in Bulgaria is similar to that in the euro area.

As part of the commitments that Bulgaria made unilaterally upon entering the ERM II in July 2020, the authorities have been implementing several measures to ensure the sustainability of the Bulgarian non-banking financial sector. These include the adequacy of the level of technical provisions; compliance with the applicable requirements for assets and liabilities valuation; the effectiveness of the system of governance; and the proper handling and settlement of claims in the Bulgarian Green Card system. Bulgaria has also adopted legislative changes to the Insurance Code to improve the claims handling process.

Table 2.7:

**Bulgaria - Financing of the economy<sup>1)</sup>**

	BG		EA		Ratio to GDP (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Liabilities (total)	370	352	706	696	316	304
Loans	120	94	228	219	109	103
Non-financial co. debt securities	3	2	12	12	3	2
Financial co. debt securities	1	1	66	58	3	4
Government debt securities	19	17	78	71	47	42
Listed shares	11	9	60	63	12	10
Unlisted shares	73	69	176	184	54	53
Other equity	84	96	53	54	56	58
Trade credits and advances	60	63	34	35	31	32

	BG		EA		Share of total (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Loans	32	27	32	32	34	33
Non-financial co. debt securities	1	1	2	2	1	1
Financial co. debt securities	0	0	9	8	1	1
Government debt securities	5	5	11	10	15	14
Listed shares	3	3	9	9	3	3
Unlisted shares	20	20	25	26	19	19
Other equity	23	27	7	8	17	18
Trade credits and advances	16	18	5	5	10	11

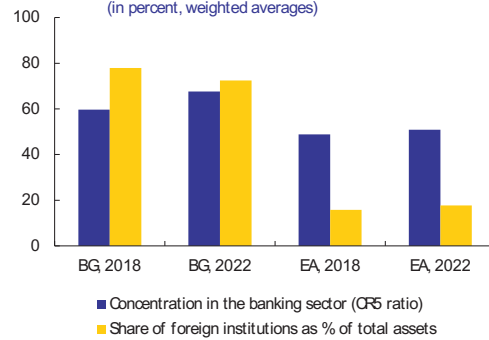
1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total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

Source: Eurostat.

As to the financing of the economy, outstanding liabilities are much lower than in the euro area (352% of GDP in 2022 vs 696% of GDP in the euro area) but similar to those of the euro area Member States with the lowest financing needs. As in the euro area, loans are the dominant source of funding. However, Bulgaria has less developed bond and equity markets than the euro area and market financing (debt securities and listed shares) is relatively underdeveloped. Equity and private-sector-debt markets represented 3% of liabilities in 2022 (and only 12% of GDP altogether), compared with 19% of liabilities in the euro area (where private-sector debt and listed stocks amounted to 70% and 63% of GDP respectively). Bulgaria is still broadly similar to the five euro area Member States with the smallest financial needs, except for the size of its bond market. The size of its bond market mostly reflects the low level of public debt in the country. Trade credits and advances play a bigger role in the financing of the economy in Bulgaria than in the euro area, even when compared with the five euro area Member States with the lowest financing needs.

Bulgaria's banking sector is well integrated into the euro area's financial sector, in particular through a high level of foreign ownership in the banking system. The ratio of foreign-owned institutions to total bank assets was 72% in 2022, which is a decrease from 78% in 2018. Bank concentration (as measured by the market share of the five largest credit institutions in total assets) has increased significantly since 2018, and reached almost 68% in 2022. This is 17 percentage points above the euro area average in 2022. In parallel with the inclusion of the Bulgarian lev in the ERM II, the BNB entered into a close cooperation agreement with the ECB, effectively joining the Banking Union.

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



Source: ECB, Structural financial indicators.



## 3. CZECHIA

### 3.1. LEGAL COMPATIBILITY

#### 3.1.1. Introduction

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

Following the Commission's 2022 Convergence Report, the ČNB Law was amended <sup>(18)</sup>. However, since there have been no amendments as regards the incompatibilities highlighted in the Commission's 2022 Convergence Report, the comments made in the latter report remain relevant and are repeated in this year's assessment.

#### 3.1.2. Central bank independence

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

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

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

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

Pursuant to Article 11(1) of the ČNB Law, the Minister of Finance or another nominated member of the Government may attend the meetings of the Bank Board in an advisory capacity and may submit motions for discussion. Article 11(2) entitles the Governor of the ČNB, or a Vice-Governor nominated by him, to attend the meetings of the Government in an advisory capacity. With regard to Article 11(1) of the ČNB Law, although a dialogue between a central bank and third parties is not prohibited as such, it should be ensured that this dialogue is constructed in such a way that the Government should not be in a position to

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<sup>(18)</sup> The amendments stem from the Act. No. 277/2019 Coll., Act No. 417/2021 Coll., Act No. 129/2022 Coll. and Act No. 462/2023 Coll.



influence or to appear to be able to influence the central bank when the latter is to adopt decisions for which its independence is protected by Union law. The active participation of the Minister, even without voting rights, in discussions where monetary policy is set would structurally give to the Government the opportunity to influence the central bank when taking its key decisions, or to appear to be able to do so, casting doubts on the central bank's independence. Therefore, Article 11(1) of the ČNB Law is incompatible with Article 130 TFEU.

### 3.1.3. Prohibition of monetary financing and privileged access

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

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

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

### 3.1.4. Integration into the ESCB

#### Objectives

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

#### Tasks

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

- definition of monetary policy and monetary functions, operations and instruments of the ECB/ESCB (Articles 2(2)(a), 5(1) and 23 to 26, 28, 29, 32, 33 of the ČNB Law);
- conduct of exchange rate operations and the definition of exchange rate policy (Articles 35 and 36 of the ČNB Law);
- holding and management of foreign reserves (Articles 35(c), 36 and 47a of the ČNB Law);
- non-recognition of the competences of the ECB and of the Council on the banknotes and coins (Article 2(2)(b), Articles 12 to 22 of the ČNB Law);
- ECB's right to impose sanctions (Article 46a of the ČNB Law);
- the possibility for Parliament to demand amendments to the report of the ČNB on monetary policy developments and to determine the content/scope of the extraordinary report in view of the absence of a specification regarding the non-forward-looking nature of the reports (Article 3 of the ČNB Law).
- There are also some imperfections regarding the following issues:
- the partial absence of reference to the role of the ECB and of the EU in the collection of statistics (Article 41);
- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2.2 c), 38 and 38a of the ČNB Law);
- non-recognition of the role of the ECB and of the Council in the appointment of the external audit of the ČNB (Article 48(2) of the ČNB Law);
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 48 of the ČNB Law);
- non-recognition of the role of the ECB in the field of international cooperation (Article 2(3) of the ČNB Law).

#### 3.1.5. Assessment of compatibility

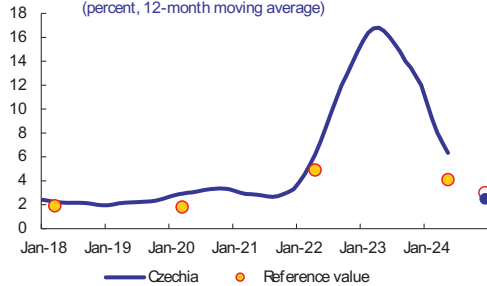
As regards the independence of the central bank, the prohibition of monetary financing and the integration of the central bank into the ESCB at the time of euro adoption, the ČNB Law is not fully compatible with the requirements of Article 131 TFEU for the reasons set out above. The above-mentioned incompatibilities and imperfections should be remedied.

### 3.2. PRICE STABILITY

#### 3.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Czechia in 2022. From 6.2% in April 2022, the 12-month average inflation rate increased steadily to 16.8% by April 2023.

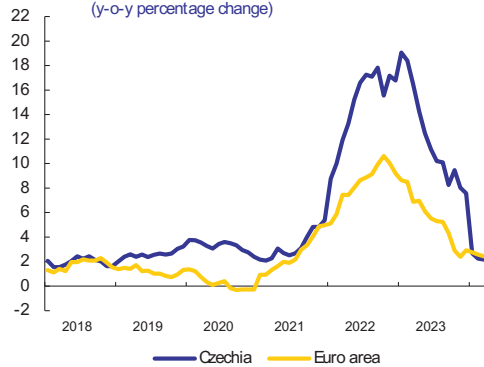
Graph 3.1: Czechia - Inflation criterion  
(percent, 12-month moving average)



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of Czechia in December 2024. The reference values for 2018, 2020 and 2022 refer to the reference values calculated in the previous convergence reports.

Source: Eurostat, Commission's Spring 2024 Economic Forecast.

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



Source: Eurostat.

Table 3.1:

Czechia - Components of inflation

	(percentage change) <sup>1)</sup>							weights in total
	2018	2019	2020	2021	2022	2023	May-24	2023
HICP	2.0	2.6	3.3	3.3	14.8	12.0	6.3	1000
Non-energy industrial goods	0.6	0.5	2.6	4.3	12.3	7.2	3.3	260
Energy	3.2	4.8	-1.5	1.7	31.5	25.5	14.2	130
Unprocessed food	2.3	1.4	8.4	-1.3	14.5	11.3	-1.1	55
Processed food	1.7	2.7	5.0	4.3	13.3	10.1	3.8	246
Services	2.6	3.4	3.6	3.1	11.8	11.1	8.4	309
HICP excl. energy, food, alcohol and tobacco	1.8	2.2	3.1	3.6	12.0	9.3	6.1	569
HICP at constant tax rates	1.9	2.6	3.2	3.4	14.3	12.0	6.1	1000
Administered prices HICP	1.5	3.7	3.6	0.8	11.9	26.5	18.6	134

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

Source: Eurostat, European Commission calculations.

It then decreased to 12.0% by the end of 2023. In May 2024, the reference value was 4.1%, calculated as the average of the 12-month average inflation rates in the Netherlands, Italy and Latvia plus 1.5 percentage points. The corresponding inflation rate in Czechia was 6.3%, i.e. 2.2 percentage points above the reference value. The 12-month average inflation rate is projected to be below the reference value in the coming months.

### 3.2.2. Recent inflation developments

HICP inflation in Czechia started accelerating in the end of 2021 and continued growing fast throughout 2022 averaging 14.8% that year. A peak value of 19.1% was reached in January 2023, followed by a gradual decrease throughout the year. The high inflation rate in 2022 and beginning of 2023 was primarily the result of the growth in energy and food prices (41.9% and 19.6% annual growth respectively in January 2023), triggered by Russia's full-scale invasion of Ukraine and supply bottlenecks. Government measures to mitigate the impact of high energy prices (including energy price caps, support to consumers to pay electricity bills, reductions in excises or reduction in the electricity tariff component that covers the Renewable Energy Sources support), were effective in limiting a potentially even higher growth in inflation at the end of 2022 and beginning of 2023. As energy and food prices stabilized in the second half of 2023, the pace of growth of the HICP index slowed down significantly and HICP inflation decelerated throughout 2023. Annual inflation reached 2.8% in May 2024, in spite of the annual repricing of administered prices in January (growth of 5.6% m-o-m).

As the food and energy prices were important drivers of the surge in inflation, HICP inflation excluding energy and food, alcohol and tobacco was lower than headline inflation in 2022 (12.0%) and 2023 (9.3%). Still, other components of inflation have not been spared of spill-over effects from energy and commodity price. Price increases of services and non-energy

industrial goods were more pronounced than in other countries in the region, reflecting some of these spill-over effects but also supply-side bottlenecks or raw materials shortages. Despite declining in real terms, unit labour costs increased in nominal terms in 2022 and 2023 by an average of 6.5% per year, adding to inflation pressures. Gross operating surplus of corporations also increased significantly during that period, reaching 30.5% of GDP in 2023, compared to 28.3% of GDP in 2021. In line with headline inflation, HICP inflation excluding energy and food also slowed down significantly in the first 5 months of 2024, reaching 4.1% in May 2024.

### 3.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and growth developments

In the context of high inflation and uncertainty, the Czech economy registered a sluggish performance in 2022-2023, with GDP growth at 2.4% in 2022 (almost entirely driven by the carry-over effects from 2021) and at -0.4% in 2023. Household consumption decreased in both years as the high inflation (especially high energy and food prices) dampened the purchasing power of consumers. Uncertainty about the future of inflation prompted lower income households to build-up precautionary savings at the detriment of current consumption, while for higher income households, the opportunity cost to consume also increased due to the increase in interest rates. The tightening of financing conditions by the ČNB to maintain inflation under control also led to a contraction in residential construction, though this was offset by an increase in non-residential construction and equipment investments supported by the still high savings of companies and by the increased EU funds absorption. Thus, gross fixed capital formation grew over the period.

Export activity slowed down in 2022-2023 due to a depressed external demand from the main trading partners. At the same time, growth in real imports was also low, as import prices, especially energy prices, surged. Thus, overall, net exports still contributed positively to growth in the two years.

According to the Commission's Spring 2024 Economic Forecast, real GDP is expected to increase by 1.2% in 2024 and 2.8% in 2025 and reach the pre-pandemic output level during the third quarter of 2024. While consumer confidence was still below the long-term average in the beginning of 2024, a gradual recovery is visible. As a significant decline in inflation is forecasted for 2024, real wages and households' real purchasing power are also expected to start growing again, driving up private consumption which will be a main contributor to GDP growth. Investments should also contribute to economic growth in 2024 and 2025 as the easing of financing conditions helps restart the cycle in residential construction while public investments should benefit from the use of EU funds and an acceleration of RRP deployment. While exports are expected to recover gradually in 2024 and 2025 due to a slow growth in demand from the main trading partners, imports are forecast to accelerate more due to increasing domestic demand. Thus, net exports are expected to contribute negatively to GDP in 2025 and risks remain from the uncertain international trade outlook.

*Table 3.2:*  
**Czechia - Other inflation and cost indicators**

(annual percentage change)

	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
<b>HICP inflation</b>								
Czechia	2.0	2.6	3.3	3.3	14.8	12.0	2.5	2.2
Euro area	1.8	1.2	0.3	2.6	8.4	5.4	2.5	2.1
<b>Private consumption deflator</b>								
Czechia	2.5	2.8	2.9	2.9	15.0	9.3	3.0	2.4
Euro area	1.5	1.1	0.6	2.3	6.8	6.0	2.4	2.0
<b>Nominal compensation per employee</b>								
Czechia	8.1	7.2	3.1	5.0	6.0	7.0	7.3	6.9
Euro area	2.1	2.2	-0.4	4.2	4.5	5.1	4.2	3.1
<b>Labour productivity</b>								
Czechia	1.9	2.8	-3.9	3.2	0.8	-1.1	1.0	2.7
Euro area	0.1	0.2	-4.7	4.4	1.1	-1.0	0.1	0.9
<b>Nominal unit labour costs</b>								
Czechia	6.1	4.3	7.3	1.8	5.1	8.2	6.3	4.1
Euro area	2.0	1.9	4.6	-0.2	3.3	6.2	4.1	2.2
<b>Imports of goods deflator</b>								
Czechia	-0.6	0.6	-0.8	4.9	14.2	-4.0	3.9	3.3
Euro area	2.6	-0.6	-3.8	9.7	21.6	-4.9	0.4	1.8

1) Commission's Spring 2024 Economic Forecast.  
Source: Eurostat, Commission's Spring 2024 Economic Forecast.

The overall fiscal stance turned from broadly neutral in 2022 to slightly contractionary in 2023 <sup>(19)</sup>, as the expansionary effect of measures taken to mitigate the effect of the energy crisis were offset by the introduction of windfall taxes and by the positive impact of high inflation on the tax base. The fiscal stance is expected to be more contractionary in 2024 as the government introduced a consolidation package envisaging higher taxes and a decrease in subsidies, including the phase-out of energy measures. The overall fiscal stance is thus likely to contribute to the decline in inflation in 2024. Government consumption contributed positively to real GDP growth. It grew by 0.3% in 2022 and 3.5% in 2023 but the pace of growth is expected to slow down relative to 2023, to 1.8% in 2024 and 2.2% in 2025. Public investment reached a peak, as a percentage of GDP, in 2023 with the help of EU funds (as the end of the previous programming period overlapped with the start of the new one and with the RRF), but it is likely to be less dynamic in 2024 and 2025.

The Czech National Bank conducts monetary policy within an inflation targeting framework. The use of the exchange rate as an additional monetary policy instrument was discontinued in April 2017. To fight inflationary pressures, the ČNB continued to tighten its policy in 2022, hiking its main policy rate (the 2-week repo rate) by 75 basis points in May 2022 and by 125 basis points in June to 7.00%.

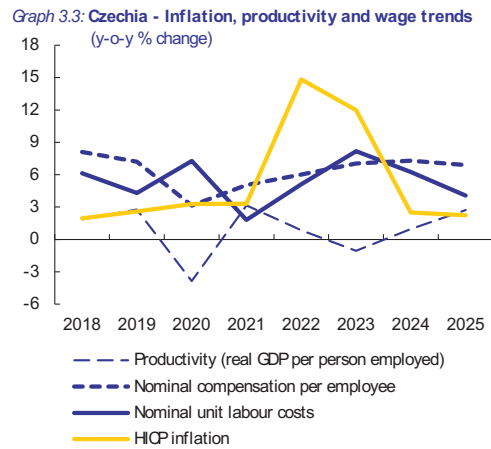
The rate was kept at this level until December 2023. Due to the easing of domestic inflation pressures since April 2023, the ČNB Board lowered its policy rates by 25 basis points in December 2023, by 50 basis points in February 2024, by 50 basis points in March 2024, and by 50 basis points in May 2024 to 5.25%. From early March to October 2022, the ČNB intervened in the exchange rate market to stabilise the Czech koruna in the aftermath of Russia's full-scale invasion of Ukraine <sup>(20)</sup>.

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

<sup>(20)</sup> For details, see Section 3.4 on exchange rate stability.

### Wages and labour costs

Despite economic growth being depressed in 2022 and 2023, the labour market remained tight, and the unemployment rate reached the lowest level among EU countries in 2022 at 2.2% before increasing slightly to 2.6% in 2023. The significant inflow of people fleeing the war in Ukraine, which stood at one of the highest levels in the EU (in per capita terms), did not alleviate much of the labour market pressures. Shortages of workers persisted during the period especially at higher skill levels and added also to the pressures on nominal wages stemming from inflation. Compensation per employee thus increased at rates of 6-7% per year in 2022-2023. Still, due to the high inflation, real wage growth was negative over the period. The minimum wage also increased significantly, from 15200 Czech korunas in 2021 to 18900 Czech korunas in 2024.



Labour productivity increased only modestly in 2022 and declined in 2023. This allowed significant increases in nominal unit labour costs by 5.1% in 2022 and 8.2% in 2023. Still, the increase in unit labour costs was below the high rate of domestic inflation (as measured by the GDP deflator) during this period. Thus, compensation of employees decreased as percentage of nominal GDP, while gross operating surplus increased. In terms of sectorial decomposition, the fastest increase in unit labour costs was observed in construction and other non-tradable segments, due to a significant extent to the productivity decline in these sectors as a result of the growth slowdown.

### External factors

As a country with a high degree of trade openness especially in goods trade, Czech domestic price formation is influenced by developments in import prices. The imports of goods deflator increased by 14.2% in 2022 before declining by 4.0% in 2023. The fluctuation followed the developments in international commodity prices (energy and food), which represent a significant explanatory factor of fluctuations in import deflators. The increase in the import deflator (cumulated 2022-2023) was however below that of other EU Member States. This is most likely due to the strengthening of the Czech koruna during the period, a comparatively lower degree of energy dependency on energy imports of the Czech economy and the longer-term nature of gas contracts. Nevertheless, energy inflation accounted for a large part of the inflation shock in 2022-2023 and this was reflected both in the import deflator but also in the gross operating surplus of energy companies for the part of energy that was locally produced. In terms of effects stemming from the exchange rate, the nominal effective exchange rate (measured against the main 36 trading partners) appreciated significantly over 2022 and the first half of 2023. The trend reversed afterwards and the announcement by the ČNB in August 2023 that it ended its intervention regime fuelled further the Czech koruna depreciation.

### Administered prices and taxes

The share of administered prices in the HICP basket reached 13.4% in 2023, the same level as the EU average. The higher growth in 2022 and 2023 in administered prices, compared to the headline HICP, is explained by the fact that electricity and heating have the highest weight in the basket of administered prices and were among the items with the highest price growth in the period. Electricity and heating administered prices were lifted by the price of



energy in the wholesale market, although the effect was mitigated by the measures taken by the government to limit the price increases. Among these measures, the largest were price caps on electricity and gas applicable through-out 2023, a support to households covering part of the electricity bills (the so-called 'saving tariff') in 2022-4Q, support for the electricity distributors to maintain lower network fees, and support for heating plants or a reduction in the support for renewables paid by end users. The expiry of the support measures on 1 January 2024 led to a jump in administered prices by 5.6% and to a 1.8% m-o-m increase in the HICP that month. However, as most of the repricing was done in January, no major further hikes are expected during the remainder of the year.

In terms of taxation, the largest impact on inflation came from changes in excises for fuel and alcohol and the change in the VAT regime. As part of the measures to mitigate the effects of energy prices, the government reduced the excises for gasoline and diesel by 1.5 Czech koruna per litre (about 3.5% of the end price at that time) as from April 2022. The gasoline and diesel excises reverted to their previous levels in October 2022 and December 2023 respectively. Excises for alcoholic beverages were increased in 2022, 2023 and 2024, and further increases are planned. Additional tax changes that could impact inflation in 2024 include the increase in the Corporate Income Tax in January 2024 from 19% to 21%, which could be passed through into consumer prices for some products or services. A series of changes in VAT rates from January 2024 (from 15% to 12% for food and medicine, and an increase from 10% to 12% for transport, water and sewage, accommodation, and catering) had an impact on the corresponding HICP items but the overall impact on headline inflation was muted.

#### Medium-term prospects

According to the Commission's Spring 2024 Economic Forecast, annual HICP inflation is projected to average 2.5% in 2024 and 2.2% in 2025. The significant projected decrease compared with 2022 and 2023 is attributed to declining wholesale prices of energy and food, a high based effect and only modest recovery in internal demand. The biggest upward inflation impact in 2024 is likely to be limited to the change in administered prices after the expiry of the energy measures in January 2024. Energy and food prices have been on a decline over the past 12 months on wholesale markets, thus their corresponding HICP items are forecast to have a lower contribution to inflation.

Further upside pressures come from the growth in salaries which are likely to outpace inflation for the first time in two years in 2024. Services inflation is thus forecast to be the component with the highest growth in 2024 and 2025, as it is also the component that is the most sensitive to salaries. According to the Commission's Spring 2024 Economic Forecast, wage growth is likely to continue with 7.3% in 2024 and 6.9% in 2025. The labour market remains extremely tight, Czechia reporting a very low unemployment rate in 2023 (2.6% vs 6.1% in EU) and high general employment rates (81.7% vs 75.3% in EU), thus adding further pressures to salaries in the private sector. Conversely, a consolidation package introduced by the government is likely to keep wages growth lower in the public sector and generate a contractionary fiscal stance (also due to measures like cuts in subsidies and increased taxation) thus further contributing to maintaining inflation under control. Considering a gradual recovery in economic activity and consequently in productivity, the growth in nominal unit labour costs should be limited at 6.3% in 2024 and 4.1% in 2025. Additionally, the increase in salaries could be partly absorbed by companies' profits which have been above average levels for the past 2 years. Unit profits are thus expected to grow slower after the high growth levels achieved in 2022-2023 and contribute less to inflation.

The long-term convergence of prices towards the EU levels also plays a role in determining the inflation levels in the coming years. The level of consumer prices in Czechia was about 80% of the euro area average in 2022, suggesting that there is still potential for further price level convergence in the long term. Since 2012, Czechia has steadily converged to the euro

area average in GDP per capita in PPS, to about 88% in 2023 (the COVID-19 pandemic brought about a small decrease from the 89% reached in 2020).

Upside risks remain to the inflation outlook. An eventual rebound in energy or food prices could put additional pressure on inflation considering that the consumer basket in Czechia has a comparatively higher weight for these goods and considering that the Czech economy is one of the most energy intensive in the EU. An increase in wage growth beyond the baseline scenario could also further increase core inflation. However, for the moment, the risks of significant second-round effects of wage increases – a wage-price spiral – appear to be contained.

### 3.3. PUBLIC FINANCES

#### 3.3.1. Recent fiscal developments

After the withdrawal of the COVID-19 related programmes and the introduction of energy support measures, Czechia reported a deficit of the general government budget of 3.2% in 2022 and 3.7% in 2023. Government revenues were boosted by high inflation, with the revenue-to-GDP ratio growing by 0.3 percentage point from 41.4% in 2021 to 41.7% in 2023. The expenditure-to-GDP ratio dropped from 46.5% in 2021 to 45.4% in 2023, driven by high nominal GDP growth. In 2022, temporary COVID-related measures were withdrawn. In 2023, among the largest temporary measures were price caps on energy prices. While these schemes were instrumental in helping households and the industry to face raising energy prices, they were largely untargeted. In addition, expenditure increased due to the automatic, albeit reduced, indexation of pensions on inflation, and measures to support the inflow of people fleeing from Ukraine. These came on top of permanent fiscal measures taking effect from 2021, notably the decrease in personal income tax by about 1.8% of GDP per year.

On 19 June 2024, the Commission adopted a report under Article 126(3) of the TFEU. The report assessed the budgetary situation of Czechia, as its government deficit in 2023 exceeded the Treaty reference value of 3% of GDP. The report concluded that the deficit criterion of the Stability and Growth Pact is fulfilled by Czechia, taking into account the relevant factors brought forward by Czechia. While its general government deficit in 2023 exceeded and was not close to the Treaty reference value of 3% of GDP, and the excess over the Treaty reference value is not considered to be exceptional, Czechia took consolidation measures in 2024 that should translate into a year-on-year reduction in the deficit to well below 3% of GDP in 2024. The Commission concluded that it would not propose the opening of the excessive deficit procedure.

The 2023 general government deficit of 3.7% of GDP, higher than 3.2% in 2022, was slightly worse than the estimate of 3.5% in the 2023 Convergence Programme. This is explained by lower revenue items like corporate income tax (linked to lower growth of the macroeconomic base, gross operating surplus) or lower property income as well as some expenditure items like public investment or subsidies growing slightly more than expected.

Public debt is still low compared to the EU average despite its high pace of growth in 2020-2022. The government debt-to-GDP ratio rose from 42.0% in 2021, to 44.0% in 2023, driven by the negative headline balance, only partly offset by nominal GDP growth.

#### 3.3.2. Medium-term prospects

The 2024 budget approved by the Czech parliament in December 2023 envisages a central government deficit of 3.2% of GDP and aimed to continue correcting the high deficit registered in the previous years. The budget maintained the tax cuts taking effect from 2021 (e.g., the cut in the personal income tax) and focused instead on withdrawing measures to mitigate the impact of high energy prices, including the elimination of the cap on energy prices, coupled with a reduction of government subsidies to renewable sources of energy.



Table 3.3:

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

<b>Outturn and forecast <sup>1)</sup></b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024<sup>1)</sup></b>	<b>2025<sup>1)</sup></b>
General government balance	0.9	0.3	-5.8	-5.1	-3.2	-3.7	-2.4	-1.9
- Total revenue	41.5	41.3	41.5	41.4	41.4	41.7	42.3	42.2
- Total expenditure	40.6	41.1	47.2	46.5	44.6	45.4	44.6	44.1
of which:								
- Interest expenditure	0.7	0.7	0.8	0.8	1.1	1.3	1.4	1.5
p.m.: Tax burden	36.0	35.9	36.0	36.0	35.4	35.7	36.8	36.7
Primary balance	1.6	1.0	-5.0	-4.4	-2.0	-2.3	-1.0	-0.4
Fiscal stance <sup>2)</sup>					-0.2	0.9	2.3	0.0
Recommended growth in net nationally financed primary expenditure (%)							6.0	-
Growth in net nationally financed primary expenditure (%)							-1.1	-
Government gross debt	32.1	30.0	37.7	42.0	44.2	44.0	45.2	45.5
p.m.: Real GDP growth (%)	3.2	3.0	-5.5	3.6	2.4	-0.3	1.2	2.8

1) Commission's Spring 2024 Economic Forecast.

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

Source: European Commission.

Raising the corporate income tax rate from 19% to 21% and increasing some social security contributions will help increase related revenue. However, the budget saw increasing defence expenditure (to 2% of GDP) in line with international commitments. In addition, due to high inflation in previous years, pensions were set to continue increasing, thus continuing to add pressure on expenditure.

The 2024 Convergence Programme was approved by the government on 24 April 2024. The Program expects the general headline deficit at 2.3% in 2024 and at 2.1% in 2025. The consolidation path is mostly based, in 2024, on the withdrawal of measures to mitigate the impact of high energy prices, additional expenditure and revenue measures introduced in the consolidation package, and, over 2025 – 2027, on the forecast of an economic recovery.

In 2024, based on Commission estimates, the fiscal stance <sup>(21)</sup> is projected to be contractionary, at 2.3% of GDP, following a contractionary fiscal stance of 0.9% of GDP in 2023. The strong contractionary fiscal stance in 2024 is primarily driven by net nationally financed primary current expenditure (2.1% of GDP).

<sup>(21)</sup> For a definition of the fiscal stance used in this report, see footnote in Section 3.2.3. on underlying factors and sustainability of inflation.

On 14 July 2023, the Council recommended that Czechia ensures a prudent fiscal policy, in particular by limiting the nominal increase in nationally financed net primary expenditure in 2024 to not more than 6%. According to the Commission's Spring 2024 Economic Forecast, Czechia's net nationally financed primary expenditure is projected to decrease by 1.1% in 2024, which is well below the recommended maximum growth rate.

In addition, the Council recommended that Czechia takes action to wind down the emergency energy support measures in force, using the related savings to reduce the government deficit, as soon as possible in 2023 and 2024. The Council further specified that, should renewed energy price increases necessitate new or continued support measures, Czechia should ensure that these were targeted at protecting vulnerable households and firms, fiscally affordable, and preserve incentives for energy savings.

According to the Commission's Spring 2024 Economic Forecast, the net budgetary cost of energy support measures is projected at 1.1% of GDP in 2023, 0.2% in 2024, and 0% in 2025. If the related savings were used to reduce the government deficit, as recommended by the Council, these projections would imply a fiscal adjustment of 1.1% of GDP in 2024, whereas net nationally financed primary expenditure provides a contractionary contribution to the fiscal stance of 2.1% of GDP in that year. Therefore, the related savings from the winding down of energy measures are projected to be fully used to reduce the government deficit.

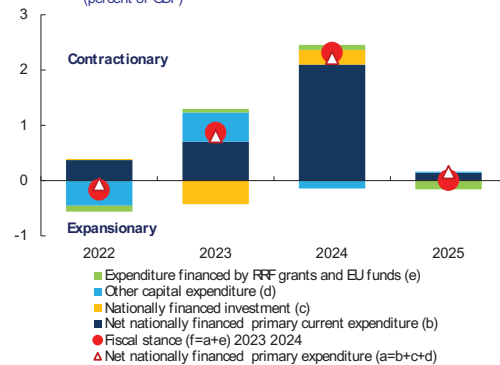
In addition, the Council also recommended that Czechia preserves nationally financed public investment and ensures the effective absorption of Recovery and Resilience Facility grants and other EU funds, in particular to foster the green and digital transitions. According to the Commission's Spring 2024 Economic Forecast, nationally financed public investment is projected to decrease in 2024 and, therefore, it is not expected to be preserved. The general government deficit is projected to decrease gradually to 1.9% of GDP in 2025, reflecting accelerating GDP growth. In turn, the general government debt is projected to stabilise at 45.5% of GDP in 2025, driven by the negative headline balance being offset by nominal GDP growth. The general government investment is projected to settle at 4.9% of GDP in 2025.

Further details can be found in the Commission's recommendation for a Council recommendation on the 2024 Convergence Programme for Czechia.

The government debt-to-GDP ratio is forecast by the Commission to increase to 45.2% in 2024 and to 45.5% in 2025, which is more than 1 percentage point higher than in 2022, driven by the negative headline balance and being only partly offset by the nominal GDP growth.

Debt sustainability risks appear medium over the medium term. Government debt is projected to slightly increase from around 45% of GDP in 2024 to around 48% of GDP in 2034. This projection assumes that the structural primary deficit is reduced from 1.6% in 2023 to 0.1% of GDP in 2024 and remains at that level (excluding changes in the cost of ageing) over the projection period <sup>(22)</sup>.

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



Source: Commission's Spring 2024 Economic Forecast.

<sup>(22)</sup> For details on the methodology see European Commission (2024), Debt Sustainability Monitor 2023, Institutional Paper 271, March 2024.

The sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the projected improvement in the structural primary balance in 2024 were to occur, the projected debt ratio in 2034 would be 8 percentage points of GDP higher than in the baseline.

Finally, several additional risk factors need to be considered in the assessment. On one hand, risk-increasing factors are related to the recent increase of interest rates and the significant share of short-term debt. On the other hand, risk-mitigating factors include the stability of debt maturity in recent years, relatively stable financing sources (with a diversified and large investor base), and the currency denomination of debt.

The Czech national fiscal framework performs well but its robustness continues to be tested. The general government debt rule and structural balance rule have been complied with in 2022. However, in its report on compliance in 2022 <sup>(23)</sup>, the Czech Fiscal Council underlined that, despite the positive assessment, the medium-term plan did not underpin the setting of expenditure framework for the State budget and State funds. Some practices, such as including in the forecast measures that are not adopted or credibly announced, using State entities outside the regular budgets, changing the parameters underpinning the fiscal rule (i.e., the double amendment of the Act 23/2017 on Budgetary Responsibility Rules), tend to weaken the fiscal framework. The Committee on Budgetary Forecasts, tasked with assessing the macroeconomic and budgetary forecasts, confirmed the realism of the forecasts in all its 2023 assessments. Local governments' finances are assessed by the Czech Fiscal Council as healthy with an overall positive contribution to the budget balance. However, about 10% of local municipalities failed to comply with the local governments' debt rule to keep debt below 60% of the average local revenues of the last 4 years. 10 municipalities could not implement the correction of 5% of the deviation but, despite that, the Finance Ministry did not suspend tax transfers towards these municipalities. The authorities should clarify how to interpret the provisions of Act 23/2017 on Budgetary Responsibility Rules on the correction of deviations from the debt rule for local municipalities, in law or methodological documents. The amended Budgetary Framework Directive (2011/85/EU) may affect some aspects of the Czech fiscal framework. Among other requirements, the amended Directive extends the independence safeguards for independent fiscal institutions to all EU Member States and assigns some tasks to these institutions.

#### 3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990s, the ČNB has been operating an explicit inflation targeting framework combined with a floating exchange rate regime, that allows for foreign exchange market interventions by the central bank <sup>(24)</sup>. The ČNB is legally allowed to conduct foreign exchange interventions to influence the Czech koruna exchange rate and moderate excessive exchange rate volatility in exceptional situations (e.g., in 2022).

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<sup>(23)</sup> <https://rozpocetvarada.cz/en/publications/report-on-compliance-with-the-rules-of-budgetary-responsibility-for-2022/>.

<sup>(24)</sup> Since 2010, the inflation target has been set at 2% with a tolerance band of +/- 1%.

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



Source: ECB.

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



Source: Czech national Bank, Eurostat and Thomson Reuters.

The ČNB terminated its exchange rate commitment in April 2017. Following a period of relative stability in 2018-2019, the Czech koruna has experienced significant volatility since the COVID-19 pandemic. It depreciated significantly in 2020, due to an economic downturn that was more pronounced than expected. This was then followed by a moderate appreciation trend up to early 2022. In 2022, pressure for depreciation following Russia's full-scale invasion of Ukraine triggered stabilising interventions by the ČNB on the foreign exchange market between May and October 2022. In October 2022, the Czech koruna was trading against the euro at around 24.5. It then slightly appreciated until April 2023 but started to depreciate again on account of market expectations of a decline in interest rates. By May 2024, it had reached levels very close to those of 2022 and not far from pre-pandemic levels.

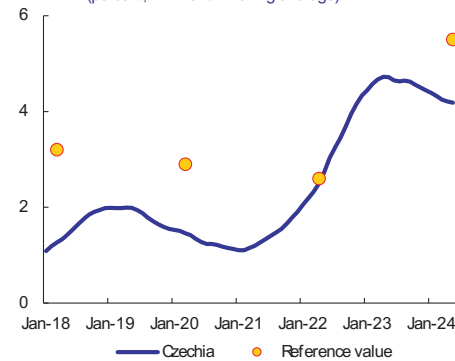
The 3-month interest rate differential vis-à-vis the euro area reached a peak by mid-2022 before returning to close to pre-pandemic levels by the end of 2023. The strong tightening cycle by the ČNB from August 2021 till June 2022 led to a steady and large rise in the Czech 3-month PRIBOR and, accordingly, in the spread vis-à-vis the euro area, which surpassed 720 basis points in July 2022. Subsequently, the ČNB kept its main policy rate (the 2-week repo rate) unchanged (till December 2023), while the ECB continued its monetary policy tightening cycle initiated in July 2022, pushing the 3-month EURIBOR rate up. This allowed the three-month interest rate spread to decrease steadily from its peak, to reach 300 basis points by the end of 2023. As the ČNB Board lowered its policy rates three times in first five months of 2024 the three-month interest rate spread fell below the 140 basis points in May.

International reserves held by the ČNB decreased from EUR 153 billion at the end of 2021 (64% of GDP) to about EUR 134 billion (44% of GDP) at the end of 2023. The reserves increased in the first months of 2024 and stood at around EUR 136 billion in May 2024. The level of reserve assets was mainly influenced by foreign exchange intervention sales by the ČNB's in 2022. Since October 2022, the ČNB has not intervened in the foreign exchange market to affect the Czech koruna rate.

### 3.5. LONG-TERM INTEREST RATES

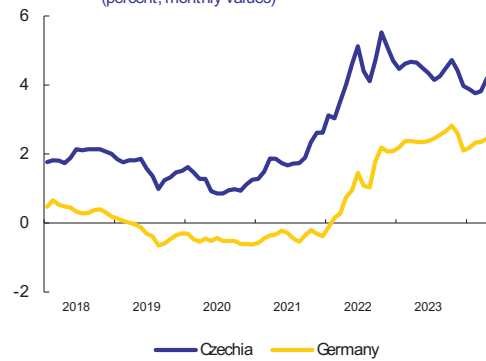
Long-term interest rates in Czechia used for the convergence examination reflect secondary market yields on a basket of government bonds with an average residual maturity of close to, but below, 10 years.

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



Source: European Commission.

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



Source: Eurostat.

The Czech 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was slightly below the reference value at the time of the last convergence assessment in 2022. It then followed a gradual upward trend up to April 2023 (4.7%) and started to decline thereafter, reaching 4.4% by the end of 2023. In April 2024, the reference value, given by the average of long-term interest rates in the Netherlands, Italy and Latvia plus 2 percentage points, stood at 5.5%. In that month, the 12-month moving average of the yield on the Czech benchmark bond stood at 4.2%, i.e. 1.3 percentage points below the reference value.

The long-term interest rate of Czechia increased rapidly in 2022, reaching a peak of 5.5% in October that year. The upward movement followed the ČNB's sharp monetary tightening, a rapid increase in inflation and increased economic uncertainty due to Russia's full-scale invasion of Ukraine. The stabilisation of the policy rate in the second half of 2022 and its decline in December 2023, contributed to the fall in the long-term interest rate towards 4.0% at the end of 2023. The long-term interest rate was 4.2% in May 2024. The German long-term benchmark bond rate also increased in 2022, although by a lesser extent, allowing the long-term interest rate spread to climb to 370 basis points in June 2022. Subsequently the spread started to narrow as the ČNB kept key interest rates unchanged and the ECB continued its monetary tightening. By mid-2023 the spread had narrowed to about 180 basis points, close to its pre-pandemic level. It subsequently fell further on the back of a rapid monetary easing by the ČNB, reaching about 164 basis points by May 2024.

### 3.6. ADDITIONAL FACTORS

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

In November 2023, the Commission published its 13th Alert Mechanism Report (AMR 2024) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.7), which highlighted issues relating to price competitiveness and pressures in the housing market in Czechia. However, since overall risks remained limited, the report concluded that no In-Depth Review (IDR) was warranted for the country. Concerns in terms of price competitiveness are related to nominal unit labour costs (ULC), which have increased significantly in 2022 and 2023 as productivity was dampened by the slow economic activity while wages continued growing, albeit at a pace below inflation. A slowdown in ULC growth is expected in 2024 and 2025 as economic activity recovers. While the current account was significantly negative in 2022, external sustainability concerns are receding as the trade balance became again positive in

2023. House prices grew faster than incomes over the past decade and are estimated to have reached an overvaluation of some 30-40% in Q4-2022 <sup>(25)</sup>. However, since Q4-2022, house prices have been falling in nominal terms although at a moderate rate. A structural supply constraint remains which could continue to put upside pressures on house prices.

Czechia's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, to boost its competitiveness and stimulate sustainable growth and reduce the country's territorial and social disparities. The RRF funding provides Czechia with EUR 8.4 billion in grants and EUR 818 million in loans over the 2021-2026 period.

Czechia has submitted two payment requests resulting in an overall disbursement of EUR 2.69 billion on 2 April 2024.

While the implementation of some reforms (digital public administration, anti-corruption framework, long-term care, permitting of renewable energy sources) and investments (green transition, the digital transition of public services and business, education, healthcare, social services) has already started, some potential delays are emerging. To deliver on the commitments of the plan by August 2026, it is essential for Czechia to address emerging delays while strengthening absorption capacity. The absorption capacity is constrained by limitations of administrative capacity at some of the implementing bodies and is particularly visible in areas that require more expertise, such as the digital and green transition.

In addition to the RRF funding, cohesion policy provides Czechia with EUR 21.1 billion for the 2021-2027 period. Cohesion policy financing aims particularly to further support Czechia's competitiveness, by facilitating the adaptation to the digital era and to the green transition, including energy efficiency, renewable energy and just transition and by helping workers and businesses to adapt to change.

#### 3.6.1. Developments in the balance of payments

According to balance of payments data, Czechia's external balance (i.e., the combined current and capital account) turned strongly negative in 2022, reaching -4.2% of GDP before becoming again positive at 1.6% of GDP in 2023. Developments in the external balance were mainly driven by the changes in the current account, and in particular by the changes in the balance of trade in goods. Exports increased in 2022 and 2023 due to an increase in export prices (the export deflator increased by 8.9% in 2022 and decreased by 0.8% in 2023) but also in volumes (7.2% in 2022 and 2.8% in 2023). The automotive industry, one of the main engines of growth, recovered gradually after the drop suffered during the COVID-19 pandemic, when it was negatively affected by the shortages in the semiconductors supply. Imports also increased during the period, driven especially by the high price of commodity imports (e.g., energy, food). However, in volume terms, imports had a more muted growth during the period (6.3% in 2022 and -0.7% in 2023), possibly due to savings in imports of energy products but also as local companies started unwinding high accumulated inventories. Import prices registered a significant volatility in the period, accounting for a significant part of the changes in the entire trade balance. Thus, high energy and commodity prices led to an increase of the import deflator by 13.1% in 2022, followed by a subsequent decline of 3.4% in 2023, as wholesale commodity prices started declining.

The services balance was positive in both years, although the values of services exported and imported are significantly lower than those of goods. The main drivers of the services balance were telecom and IT services (as compared to transport in previous years) though their contribution declined slightly in 2023. The primary income balance registered a slight dip in 2022 (-5.4% of GDP from -5.1% in 2021 and -4.2% in 2020) as the profitability of

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<sup>(25)</sup> For details on the methodology, see European Commission (2023), 'In-Depth Review 2023 - Czechia', Institutional Paper 208, May 2023.



Table 3.4:

Czechia - Balance of payments		(percentage of GDP)				
	2018	2019	2020	2021	2022	2023
Current account	0.4	0.3	2.0	-2.8	-4.9	0.4
of which: Balance of trade in goods	3.7	4.1	4.9	1.1	-0.3	4.0
Balance of trade in services	2.2	1.8	1.8	1.7	1.4	1.3
Primary income balance	-4.8	-5.0	-4.2	-5.1	-5.4	-4.3
Secondary income balance	-0.7	-0.6	-0.5	-0.5	-0.6	-0.5
Capital account	0.2	0.4	1.2	1.7	0.7	1.2
External balance <sup>1)</sup>	0.7	0.8	3.2	-1.1	-4.2	1.6
Financial account	1.1	0.1	2.9	-0.7	-4.3	2.0
of which: Direct investment	-0.9	-2.4	-2.6	-0.5	-1.2	-0.2
Portfolio investment	0.6	-1.8	-2.4	1.2	4.9	1.2
Other investment <sup>2)</sup>	0.6	2.4	7.0	-6.3	-3.5	0.5
Change in reserves	0.9	1.9	0.8	4.8	-4.5	0.5
Financial account without reserves	0.2	-1.8	2.0	-5.5	0.2	1.5
Errors and omissions	0.4	-0.6	-0.3	0.4	-0.1	0.4
Gross capital formation	27.2	27.6	26.2	30.2	32.2	28.9
Gross saving	26.6	26.7	26.8	27.9	27.6	30.3
Net international investment position	-24.4	-19.8	-16.3	-14.5	-18.7	-13.2

1) The combined current and capital account.

2) Including financial derivatives.

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

foreign-owned enterprises increased and higher outflows were paid in the form of dividends (with the banking system, in particular, paying delayed dividends from the pandemic years).

The capital account was also depressed in 2022 (0.7% of GDP compared to 1.7% in 2021) as high growth in the utilisation of funds from the EU budget was offset by higher net payments for emission allowances (ETS). The situation reversed in 2023 to 1.2% of GDP.

External balance developments were mirrored by the financial account (-4.3% of GDP in 2022 and 2.0% of GDP in 2023). The drop in the financial account balance in 2022 was driven to a large extent by a fall in the reserves of the ČNB, which intervened in the foreign exchange markets. The effect on the financial account was significant (4.5% of GDP), partly reversing the substantial reserves accumulation of 2021. Additional effects on the financial account came from the lower investments of residents abroad and by local companies increasing the financing in EUR-denominated loans. The net international investment position (NIIP) worsened in 2022 to -18.7% of GDP, due to a faster accumulation of liabilities relative to assets. The NIIP position improved to -13.2% of GDP in 2023 as net external lending improved and nominal GDP growth remained positive, as the growth in the GDP deflator outweighed the decline in real GDP.

The long-term upward trend in Czechia's export market share slowed down since 2018. The export market share in volumes even declined during the pandemic years, but started showing some rebound in 2022-2023. Several measures are signalling losses in cost competitiveness compared to trading partners. Nominal unit labour costs increased markedly in 2022 and 2023 as weak economic activity dampened productivity while labour costs continued to grow even though at a slower pace than inflation. Cost competitiveness was also influenced negatively by the movements in the nominal effective exchange rate

Graph 3.9: Czechia - Effective exchange rates



Table 3.5:

Czechia - Market integration

	2018	2019	2020	2021	2022	2023
Trade openness <sup>1)</sup> (%)	89.0	86.0	83.1	87.3	93.4	85.1
Trade with EA in goods & services <sup>2)+3)</sup> (%)	54.7	52.7	50.7	53.6	56.8	51.6
IMD World Competitiveness Ranking <sup>4)</sup>	29	33	33	34	26	18
Internal Market Transposition Deficit <sup>5)</sup> (%)	0.7	0.8	1.5	2.4	1.4	0.9
Real house price index <sup>6)</sup>	123.4	131.0	138.1	160.7	163.3	147.0

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

2)  $(\text{Imports} + \text{Exports of goods with EA-20} / (2 \times \text{GDP at current market prices})) \times 100$  (Foreign Trade Statistics).

3) Trade in services with EA-20 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) International Institute for Management Development (IMD).

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

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

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

(NEER), as the Czech koruna strengthened from 2020 until the first quarter of 2023, supported also by the ČNB interventions. The koruna reversed the trend and started to depreciate in April 2023 as the ČNB stopped interventions and the official announcement of the central bank ending its intervention regime in August 2023 fuelled a further depreciation. Due to comparatively higher inflation in Czechia in 2022 and 2023, the real effective exchange rates based on HICP and core inflation appreciated even more than implied by the evolution of the NEER during the period. As inflation has declined significantly since the beginning of 2024, a reversal of the trend is expected.

According to the Commission's Spring 2024 Economic Forecast, the external balance (based on national accounts data) is expected to contribute only slightly to real GDP growth in 2024 and 2025 as the positive effect of lower imports growth is expected to fade away on the back of a recovery of internal demand and the growth in exports is hindered by the still depressed global trade. Still, the balance of trade is expected to increase in nominal terms due to favourable terms of trade.

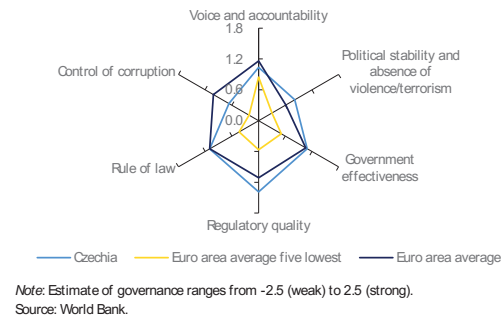
### 3.6.2. Market integration

The Czech economy is highly integrated with the euro area through trade and investment linkages. The trade openness (see Table 3.5 for a definition) of Czechia decreased in 2023 although it remained close to its long term average at around 85% of GDP. The share of trade with euro area countries stood at around 52% of GDP in 2023 (57% in 2022). In 2023, Czechia's main trading partners within the euro area were Germany, Slovakia and the Netherlands, while the main trade partners outside the euro area were Poland and China.



FDI inflows registered a small increase in 2022 to 3.2% of GDP, before dropping to 2.4% of GDP in 2023 <sup>(26)</sup>. However, the largest part of the FDI inflows was represented by reinvested earnings while new capital participations remained low. Nevertheless, the stock of FDIs as percentage of GDP reached 76% in 2023. Austria, Belgium, Germany, France, the Netherlands and Luxembourg are the biggest investor partners providing more than half of the stock of FDIs at the end of 2021. Financial services, manufacturing, real estate and trade are the main target sectors for FDI inflows. The geographical proximity to EU core markets, a relatively good infrastructure and a highly educated labour force have supported the attractiveness of the country for foreign investors. According to a ČNB report, Czechia provided the highest return on foreign investments in 2022 among the Visegrad group of countries (Poland, Czech Republic, Slovakia, and Hungary).

Graph 3.10: Czechia - World Bank's 2022 Worldwide Governance Indicators



Despite price competitiveness concerns persisting on the back of high growth in unit labour costs, in the IMD's World Competitiveness Index, Czechia's position improved over the past two years, moving up from 34th rank in 2021 to 18th in 2023. The improvements, according to the IMD's World Competitiveness Index are especially in terms of government efficiency, business efficiency as well as infrastructure while the economic performance has seen a deterioration during the period. According to the World Bank's 2022 Worldwide Governance Indicators, Czechia ranks higher than the average of the five euro area Member States with the lowest scores, in particular in relation to indicators that measure regulatory quality, political stability and absence of violence, the rule of law, control of corruption and government effectiveness <sup>(27)</sup>. According to the 2023 Single Market Scoreboard, Czechia's transposition deficit of EU Directives was at 1.4%, down from 2.4% in 2022. This is approaching the EU average (0.9%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

<sup>(26)</sup> See the database on foreign direct investment statistics of the Czech National Bank.

<sup>(27)</sup> A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage point lower (higher) than that of this group of five euro area Member States.

Table 3.6:

**Czechia - Allocation of assets by financial sub-sector**

	CZ		EA		Ratio to GDP (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Financial corporations (total)	248	236	689	715	174	190
Central bank	59	47	53	68	46	52
Monetary financial institutions	131	128	266	290	87	93
Other financial intermediaries	32	33	181	163	16	18
Non-MMF investment funds <sup>1)</sup>	8	11	101	113	4	5
Insurance co. and Pension Funds	18	16	87	81	21	22
	CZ		EA		Share of total (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Central bank	24	20	8	10	27	27
Monetary financial institutions	53	54	39	40	50	49
Other financial intermediaries	13	14	26	23	9	10
Non-MMF investment funds	3	5	15	16	2	3
Insurance co. and Pension Funds	7	7	13	11	12	11

1) MMF stands for money market funds.

Source: Eurostat.

Efforts are being made to address any pending corruption issues in Czechia, including by the reforms from the Recovery and Resilience Plan. Legal and institutional frameworks to address corruption are broadly in place, while the Government has prioritised some anti-corruption measures. According to Transparency International, Czechia still lags below the EU average in terms of corruption although some improvements are taking place. The country ranks 41st among 180 countries evaluated worldwide (up from 49th in 2021). Reforms like whistleblowing, a lobbying reform, or a set of measures to strengthen the legislative framework in the areas of courts, judges, prosecutors and bailiffs are part of the Recovery and Resilience Plan and some have already been approved but further efforts are needed.

The Czech Republic has notified a complete transposition of the 5th Anti-Money Laundering Directive. The Commission has assessed the transposition as complete and in conformity.

The Czech Republic has taken steps to improve its anti-money laundering and countering the financing of terrorism (AML/CFT) framework. The Register on Beneficial Owners and the Central Register of Bank Accounts were established to improve transparency of beneficial owners and to provide quicker access to bank account information. The Czech authorities have achieved a substantial level of effectiveness in international cooperation; confiscation of proceeds and instrumentalities of crime; and FT investigations and prosecutions. On the other hand, the Czech Republic has achieved moderate results in the other areas covered by the Financial Action Task Force (FATF) standards.

Table 3.7:

**Czechia - Financing of the economy<sup>1)</sup>**

	<b>CZ</b>		<b>EA</b>		<b>Ratio to GDP (%)</b>	
					<b>EA 5 smallest</b>	
	<b>2018</b>	<b>2022</b>	<b>2018</b>	<b>2022</b>	<b>2018</b>	<b>2022</b>
Liabilities (total)	333	335	706	696	316	304
Loans	100	93	228	219	109	103
Non-financial co. debt securities	7	4	12	12	3	2
Financial co. debt securities	16	16	66	58	3	4
Government debt securities	31	35	78	71	47	42
Listed shares	11	10	60	63	12	10
Unlisted shares	71	71	176	184	54	53
Other equity	60	65	53	54	56	58
Trade credits and advances	39	43	34	35	31	32

	<b>CZ</b>		<b>EA</b>		<b>Share of total (%)</b>	
					<b>EA 5 smallest</b>	
	<b>2018</b>	<b>2022</b>	<b>2018</b>	<b>2022</b>	<b>2018</b>	<b>2022</b>
Loans	30	28	32	32	34	33
Non-financial co. debt securities	2	1	2	2	1	1
Financial co. debt securities	5	5	9	8	1	1
Government debt securities	9	10	11	10	15	14
Listed shares	3	3	9	9	3	3
Unlisted shares	21	21	25	26	19	19
Other equity	18	19	7	8	17	18
Trade credits and advances	12	13	5	5	10	11

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

Source: Eurostat.

The Czech labour market continued to remain significantly tight in 2022 and 2023. The unemployment rate decreased further in 2022 and reached the lowest level in EU, before a slight increase to 2.6% in 2023. The employment rate of those aged between 20 and 64 increased constantly over the past years and reached 81.7% in 2023, which was seven percentage points above the EU average. Labour shortages and skill mismatches are pervasive and hamper Czechia's growth potential. Cross-border migration flows have increased significantly in 2022 and 2023 as Czechia was one of the countries with the highest number of people displaced from Ukraine per capita in the EU. However, the integration and impact on the labour market remained low, with 80% of Ukrainian born workers performing low-qualified jobs.

The financial sector in Czechia continues to be smaller and somewhat less developed than in the euro area. Assets managed by the financial sector amounted to 236% of GDP in 2022. This is much less than in the euro area (715% of GDP) but higher than in the five euro area Member States with the smallest financial sectors. While it has grown in the euro area, the size of the financial sector has decreased by about 12 percentage points since 2018 in Czechia. Banks dominate the Czech financial sector and made up around 54% of the financial sector's assets in 2022. The central bank is the second largest holder of financial assets with a share of 20% in 2022 (double that of the euro area average). The rest of financial intermediaries constituted about one quarter of the financial sector holdings in 2022, which is about half of the share observed for the euro area. This lower share is similar

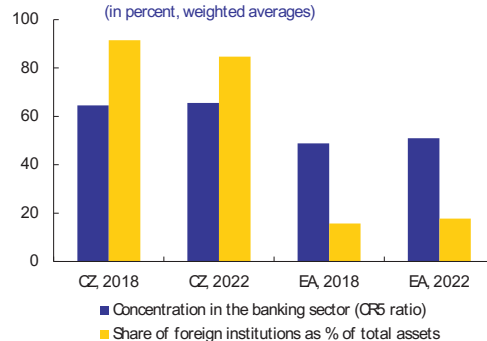
to that of the five euro area Member States with the smallest financial sector and reflects the relative underdevelopment of non-bank financial intermediaries and investment funds.

As to the financing of the economy, outstanding liabilities are much lower than in the euro area (225% of GDP vs. 696% of GDP in the euro area) but comparable to that of the euro area Member States with the lowest financing needs. Like in the euro area, loans are the dominant source of funding. However, Czechia has less developed bond and equity markets than the euro area, and market financing (especially debt securities and listed shares) is relatively underdeveloped. Equity and private sector debt markets represented 9% of liabilities in 2022 (and 30% of GDP altogether), compared to 19% of liabilities in the euro area (where private sector debt and listed stocks amounted to 70% and 63% of GDP respectively). Czechia is still comparable to the five euro area Member States with the smallest national financing needs and it has a higher share of private debt securities in the financing of the economy than these Member States.

Unlisted shares and other equity made up 40% of total liabilities in 2022, which is higher than in the euro area (34%). Trade credits and advances play a bigger role in the financing of the economy in Czechia than in the euro area. Relative to GDP, the bond market is smaller in Czechia than in the euro area, which reflects the lower level of public debt in Czechia.

The Czech financial sector is highly integrated into the euro area's financial sector. This integration is noticeable in the ownership linkages of the banking system. Foreign institutions held more than 80% of the banking sector's assets via their local branches and subsidiaries in 2022. Concentration in the banking sector, as measured by the market share of the largest five credit institutions in total assets, edged up from 64% in 2020 to 66% in 2022 and thus continued to exceed the euro area average of 51% by 15 percentage points.

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



Source: ECB, Structural financial indicators.



## 4. HUNGARY

### 4.1. LEGAL COMPATIBILITY

#### 4.1.1. Introduction

The main rules governing the Magyar Nemzeti Bank (MNB – Hungarian national bank, hereafter MNB) are laid down in Article 41 of the Hungarian Fundamental Law and Act CXXXIX 2013 on the MNB (hereafter: MNB Act). The amendments passed with regard to MNB law<sup>(28)</sup> did not solve the incompatibilities and imperfections mentioned in the Commission's 2022 Convergence Report. Therefore, the issues raised in the Commission's 2022 Convergence Report remain relevant and are repeated in this year's assessment.

#### 4.1.2. Central bank independence

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

Further to this principle, the MNB should be fully insulated from all financial obligations resulting from any HFSA activities. Contractual relationships in the period prior to 1 October 2013 including, amongst others, all employment relations between any new MNB staff member and the former HFSA can be continued only with the proviso that the continuation does not impinge on the MNB's independence and its power to fully carry out its duties under the Treaties. Against this background, Article 176 and 183 of the MNB Act should be aligned to the principle of central bank independence as enshrined in Article 130 of the TFEU.

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

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<sup>(28)</sup> The assessment of the compatibility of the MNB Law takes into consideration the version of the law communicated by the Hungarian authorities on February 2024.

Article 153(6) of the MNB Act provides for the possibility for members of the Monetary Council (including the Governor) and MNB employees to take on roles in the management, boards of trustees or supervisory boards of foundations and business associations under majority ownership of the MNB established by the MNB under Article 162(2) of the MNB Act without being subject to the conflict of interest rules provided for in Article 152(1) to (5) of the MNB Act, including any formal disclosure requirement. Hence, for those activities the MNB officials involved, including the Governor, are fully shielded from any scrutiny. Moreover, Article 153(6) of the MNB Act also provides for an explicit exemption to the rule of Article 156(1) of the MNB Act, which determines that members of the Monetary Council (including the Governor) may only perform other activities, which are compatible with their central bank decision-making duties. Hence, under national law such members may undertake activities in the MNB's foundations and business associations that are incompatible with their central bank decision-making duties. The provision conflicts with Article 162(2) of the MNB Act, which provides that the MNB may only establish foundations and business associations in line with its tasks and primary objective of ensuring price stability. Moreover, central bank decision-making duties must always be performed in compliance with Article 130 TFEU. The exemption therefore seems to imply that the latter principles of primary Union law may be disregarded by members of the Monetary Council when acting in the context of the foundations and business associations under MNB ownership. Therefore, this incompatibility needs to be removed.

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

Moreover, Article 157 of the MNB Act provides for an obligation for members of the Monetary Council, including the Governor and the Deputy Governors, to file asset declarations in the same manner as Members of Parliament, pursuant to the provisions of Article 90 of the Act XXXVI of 2012 on the National Assembly. According to Article 157(1) of the MNB Act and Article 90(2) of the Act XXXVI of 2012, the obligation to submit an asset declaration extends to close family members (spouse, domestic partner, and children). Pursuant to Article 90(3) of the Act XXXVI of 2012, members of the Monetary Council who fail to submit an asset declaration will not be allowed to exercise their functions and will receive no remuneration until they comply with the obligation. This provision allows for the temporary removal from office of, inter alia, the Governor, a removal that seems to follow automatically if the failure to submit an asset declaration as required by the above provisions is established by the Parliament. To fully preserve the requirement of central bank independence, a two-step approach could be considered: first, to officially notify the members of the Monetary Council, including the Governor and the Deputy Governors, of the failure of submission and its possible legal consequences to allow for its correction within a set, short and reasonable timeframe; second, to impose proportionate sanctions, which could include dismissal or temporary removal from office if the failure to submit an asset declaration constitutes serious misconduct within the meaning of Article 14.2 of the ESCB/ECB Statute. In any case, the law should clarify that the sanctions for the breach of the obligation to file asset declarations do not constitute extra grounds for dismissal (including temporary removal from office) of the members of the Monetary Council, including the Governor and the Deputy Governors, in addition to those contained in Article 14.2 of the ESCB/ECB Statute.

The Commission notes the provisions on restoration of capital of Article 166(3) of the MNB Act, which aim to safeguard the financial independence of the central bank. This implies that MNB should always be sufficiently capitalised in order to avoid any situations which may



negatively impact the central bank's ability to perform its ESCB-related tasks but also its national tasks.

#### 4.1.3. Prohibition of monetary financing and privileged access

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

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

Article 177(6) of the MNB Act provides for state compensation to the MNB of all expenses resulting from obligations, which exceed the assets the MNB has taken over from the HFSA. The law does not contain any provisions on the procedure and deadlines on how the state shall reimburse the MNB of the expenses. Therefore, the reimbursement under Article 177(6) of the MNB Act is not accompanied by measures that would fully insulate the bank from all financial obligations resulting from any activities and contractual relationships of the HFSA originating from prior to the transfer of tasks. In case of a substantial time gap between the costs arising to the MNB and the reimbursement by the state pursuant to Article 177(6) of the MNB Act, the reimbursement would result in an ex-post financing scheme. Should the expenses incurred at the MNB exceed the value of assets taken over from the HFSA, such a scenario would constitute a breach of the prohibition of monetary financing laid down in Article 123 TFEU. In order to comply with the prohibition of monetary financing, Articles 176 and 183 of the MNB Act should be amended in order to insulate the MNB by appropriate means from all financial obligations resulting from the HFSA's prior activities or legal relationships and obligations including those deriving from the automatic further employment of HFSA staff by the MNB.

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

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



monetary financing enshrined in Article 123 TFEU may be disregarded by members of the Monetary Council (including the Governor) when acting in the context of the foundations and business associations under MNB ownership. This incompatibility needs to be removed.

#### 4.1.4. Integration into the ESCB

##### Objectives

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

##### Tasks

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

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

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

- non-accurate reflection of the principle of central bank independence in the MNB Act (Article 1(2) and (3) of the MNB Act);
- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 1(2), 4(5) and (12), 9, 27-28, and 159(2), 171 (2) of the MNB Act);
- non-recognition of the role of the ECB and of the EU in the collection of statistics (Article 1(2), 30(1) and 171(1) of the MNB Act);
- non-recognition of the role of the ECB in the field of international cooperation (Article 135(5) of the MNB Act));
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 12(4)(b) and Law C of 2000/95 (IX.21.) in conjunction with Government Decree 221/2000 (XII.19.));
- non-recognition of the role of the ECB and the Council in the appointment of external auditors (Articles 6(1) (b), 15 and 144 of the MNB Act).

#### 4.1.5. Assessment of compatibility

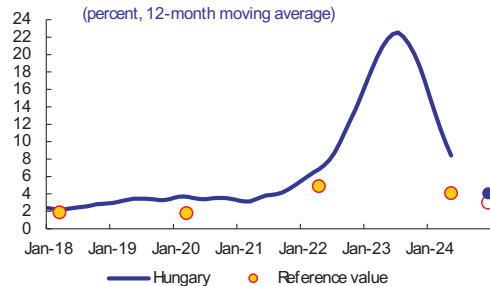
As regards the independence of the MNB, the prohibition of monetary financing and the integration of the MNB into the ESCB at the time of euro adoption, existing Hungarian legislation is not fully compatible with the Treaties and the ESCB/ECB Statute pursuant to Article 131 TFEU for the reasons set out above. The Hungarian authorities should remedy the above-mentioned incompatibilities and imperfections.

## 4.2. PRICE STABILITY

### 4.2.1. Respect of the reference value

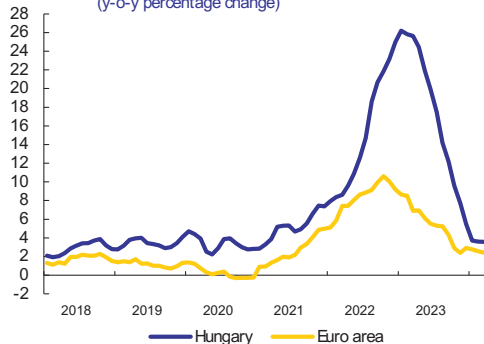
The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since the convergence assessment of Hungary in 2022. In May 2024, the reference value was 4.1%, calculated as the average of the 12-month average inflation rates in the Netherlands, Italy and Latvia, plus 1.5 percentage points. The corresponding inflation rate in Hungary was 8.4%, i.e. 4.3 percentage points above the reference value. The 12-month average inflation rate is projected to remain above the reference value in the coming months.

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



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of Hungary in December 2024. The reference values for 2018, 2020 and 2022 refer to the reference values calculated in the previous convergence reports.  
Source: Eurostat, Interim Spring 2024 Economic Forecast.

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



Source: Eurostat.

### 4.2.2. Recent inflation developments

Over the last two years, HICP inflation first increased substantially peaking at 26.2% in January 2023 before easing steadily to 3.9% in May 2024. Average annual HICP inflation rose to 15.3% in 2022 and 17.0% in 2023, and was significantly above that of the euro area in both years. This inflation differential was due to the higher HICP weight of energy and food in Hungary, a more positive output gap in Hungary in 2022 driven by expansionary policies, and significant currency depreciation in 2022. The inflation differential vis-à-vis the euro area narrowed until early 2022, then widened substantially until early 2023, and has narrowed again since then, mainly driven by energy price inflation that was influenced by measures aimed at reducing the effect of the inflation shock on households purchasing power.

Table 4.1:

Hungary - Components of inflation

	(percentage change) <sup>1)</sup>							weights in total
	2018	2019	2020	2021	2022	2023	May-24	2023
HICP	2.9	3.4	3.4	5.2	15.3	17.0	8.4	1000
Non-energy industrial goods	0.4	1.1	1.2	3.2	11.3	10.8	5.6	242
Energy	4.8	0.5	-3.2	12.4	18.7	18.2	3.5	133
Unprocessed food	6.4	7.0	12.9	2.1	24.1	18.9	6.1	51
Processed food	4.1	5.7	5.9	6.6	21.7	22.0	7.8	238
Services	2.4	4.0	3.8	3.8	10.2	16.3	12.7	336
HICP excl. energy, food, alcohol and tobacco	1.6	2.9	2.8	3.5	10.7	14.0	9.7	578
HICP at constant tax rates	3.4	3.2	3.3	4.7	15.3	16.2	7.8	1000
Administered prices HICP	0.3	1.0	0.3	0.9	11.8	11.3	3.2	144

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

Source: Eurostat, European Commission calculations.

Energy price inflation reached double digits in both 2022 and 2023. The pass-through of energy commodity price increases to HICP was delayed by temporary price caps and regulated prices. A price cap on motor fuel was in force between November 2021 and December 2022. Regulated residential energy prices also remained unchanged until July 2022. In August 2022, a two-tier price system was introduced for gas and electricity, with a higher price level for additional consumption beyond a certain threshold. As a result of these policy measures, energy inflation peaked later in Hungary than in the euro area. Even after the introduction of the two-tier price system, the price level of residential gas and electricity remained among the lowest in the EU, and the losses of utility companies were reimbursed from the budget, partly from temporary windfall profit taxes levied on certain sectors. At the same time, non-household consumers experienced some of the highest energy price increases in the EU in 2022-23, fuelling producer price inflation. Energy inflation fell from 18.2% in 2023 to 3.5% in May 2024, driven by base effects and methodological effects that reduced the measured price level of residential energy even though regulated gas, electricity and heat energy prices have not changed since August 2022.

Food price inflation was high in 2022-23, reflecting the severe droughts of 2022, production cost increases, and indirect tax hikes. The price index of agricultural inputs rose by a cumulative 48.1% in 2022-23, which was the largest increase in the EU, driven particularly by higher energy and fertiliser prices. Tax measures increasing food prices included a windfall profit tax on retail firms, higher excise duties on alcohol and tobacco, and a higher public health product tax since July 2022, as well as higher packaging costs due to the Extended Producer Responsibility scheme since July 2023. Other government measures aimed to contain food inflation. A temporary price cap on some basic food items was in effect between 1 February 2022 and 31 July 2023. From August 2023 until 30 June 2024, retail companies are required to keep certain products on sale in 20 predefined product categories. Food price inflation decreased in early 2024, mainly driven by lower agricultural commodity prices.

HICP inflation excluding energy and food rose sharply to 17.4% in April 2023, reflecting rising production costs, and strong demand up to mid-2022. The inflation of non-energy industrial goods was raised by the higher costs of labour and energy, as well as currency depreciation. Services inflation was boosted by strong demand, high wage growth and energy costs. In 2023 consumer demand cooled but services inflation was fuelled further by the automatic indexation of certain products, such as telecommunication and financial services, and sector-specific tax hikes, for example in air travel and telecommunication. HICP inflation excluding energy and food decreased gradually since April 2023 to 5.9% in May 2024, due to falling consumer demand and a partial reversal of the currency depreciation in 2022.

### 4.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and growth developments

Table 4.2:

Hungary - Other inflation and cost indicators

(annual percentage change)

	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
<b>HICP inflation</b>								
Hungary	2.9	3.4	3.4	5.2	15.3	17.0	4.1	3.7
Euro area	1.8	1.2	0.3	2.6	8.4	5.4	2.5	2.1
<b>Private consumption deflator</b>								
Hungary	3.3	4.6	3.4	6.3	15.2	15.3	4.1	3.7
Euro area	1.5	1.1	0.6	2.3	6.8	6.0	2.4	2.0
<b>Nominal compensation per employee</b>								
Hungary	6.4	7.0	3.1	8.2	17.0	14.0	11.7	7.7
Euro area	2.1	2.2	-0.4	4.2	4.5	5.1	4.2	3.1
<b>Labour productivity</b>								
Hungary	3.0	3.7	-3.3	5.8	3.0	-1.1	2.3	2.8
Euro area	0.1	0.2	-4.7	4.4	1.1	-1.0	0.1	0.9
<b>Nominal unit labour costs</b>								
Hungary	3.3	3.1	6.6	2.3	13.7	15.2	9.2	4.8
Euro area	2.0	1.9	4.6	-0.2	3.3	6.2	4.1	2.2
<b>Imports of goods deflator</b>								
Hungary	4.0	1.2	2.7	11.8	31.8	-6.5	3.8	2.0
Euro area	2.6	-0.6	-3.8	9.7	21.6	-4.9	0.4	1.8

1) Commission's Spring 2024 Economic Forecast.

Source: Eurostat, Commission's Spring 2024 Economic Forecast.

Hungary's economy grew by 4.6% in 2022, boosted by expansionary policy measures that raised households' income and temporarily shielded them from the impact of rising energy prices and interest rates. From the second half of 2022, some of these policies were reversed, notably residential energy prices were raised in August 2022 and the motor fuel price cap was lifted in December 2022. The resulting spike in inflation held back consumption, while low capacity utilisation, rising interest rates and fiscal consolidation efforts set back investment. Exports also faced headwinds from weak demand from trade partners. Consequently, the economy contracted by 0.9% in 2023. According to the Commission's Spring 2024 Economic Forecast, GDP growth is projected to recover gradually in 2024-2025, as inflation and interest rates decrease.

Hungary's fiscal stance was expansionary in 2022 at -1.2 of GDP, driven largely by the measures in response to high energy prices<sup>(29)</sup><sup>(30)</sup>. In 2023, the fiscal stance was strongly contractionary, at 4.7% of GDP, partly reflecting the phasing out of earlier, temporary stimulus measures. According to the Commission's Spring 2024 Economic Forecast, which is based on a no policy change assumption, the fiscal stance is projected to be contractionary at 1.0% of GDP in 2024, reflecting primarily the contractionary contributions of net nationally financed primary current expenditure (1.0% of GDP), which is partly offset by the expansionary contribution of the expenditure financed by RRF grants and EU funds (-0.9% of GDP). The no policy change forecast for 2025 shows an expansionary stance at -0.4% of GDP.

<sup>(29)</sup> The fiscal stance is measured as the change in general government primary expenditure, net of the incremental budgetary impact of discretionary revenue measures, excluding one-off and cyclical unemployment expenditure, but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term (10-year) average potential GDP growth rate, expressed as a ratio to nominal GDP.

<sup>(30)</sup> The income tax refund for families (equal to 1.2% of GDP) was recorded in 2021 in accrual terms, but was paid out in early 2022, thus underestimating the extent of fiscal expansion in 2022.

Monetary policy, conducted within an inflation targeting framework <sup>(31)</sup>, was tightened further in 2022 as inflation was rising fast. The MNB increased its base rate by 1060 basis points from 2.4% to 13% throughout 2022. The gap between the base rate and interest rate on the one-week deposit was closed in June 2022 <sup>(32)</sup>. The tightening was supported further by measures reducing excess liquidity in the banking system. This included increases in the mandatory reserve ratio and launching central bank discount bill auctions and a longer-term deposit instrument. As a result, there was a reallocation of excess liquidity from the one-week deposit facility to the new instruments. Amid financial market turbulence and currency depreciation in October 2022, the central bank increased the overnight collateralised lending rate from 15.5% to 25% while leaving the base rate unchanged. It also introduced a one-day foreign exchange (FX) swap instrument and overnight quick deposit tenders on a daily basis. The interest rate on the overnight deposit tender was set at 18%, and it effectively became the key policy rate. The measures represented a further monetary tightening on the interbank market and the swap market.

As financial markets stabilised in 2023, the MNB started reducing the overnight lending rate reducing the gap vis-à-vis the base rate to 100 basis points by September 2023. Inflation also started falling quickly in 2023, which allowed the central bank to start cutting the base rate from October 2023. The MNB also started reducing the interest rate on the overnight deposit tender and closed the gap between this and the base rate by September 2023. Since 1 October 2023 the base rate is also applicable to credit institutions' excess reserves held at MNB <sup>(33)</sup>. This change made the base rate a much more potent tool, allowing the phase-out of the overnight deposit tenders. By May 2024, the base rate was reduced by 575 basis points to 7.25% from the peak of 13%.

The central bank continued to hold FX swap tenders regularly throughout 2022-2023 to provide euro liquidity and manage potential tensions in the foreign exchange swap market. These auctions aimed to ensure the effectiveness of the central bank's monetary policy and contributed to maintaining price stability. The MNB started using one-day maturity swaps within quarters in July in addition to the existing end-of-quarter measures. These actions, along with other liquidity management tools, successfully maintained swap market stability.

#### Wages and labour costs

Employment continued to grow in 2022-2023, and the employment rate in the 20-64 age group rose to a historically high 80.7% in 2023, while the unemployment rate remained at around 4%. Employment continued to increase even as output was contracting in 2023, as companies preferred to hoard labour in a tight labour market. Nonetheless, the number of vacancies decreased from previous high levels. The projected economic recovery is set to restore labour demand and keep unemployment low.

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<sup>(31)</sup> The Hungarian central bank set a target inflation of 3% with a symmetric tolerance band of  $\pm 1$  percentage point.

<sup>(32)</sup> The main policy instrument used by MNB is the interest rate on the mandatory reserves deposited at the central bank by credit institutions. But since this instrument is small in volume, monetary conditions were rather influenced by the one-week deposit rate until the closure of the gap in interest rates.

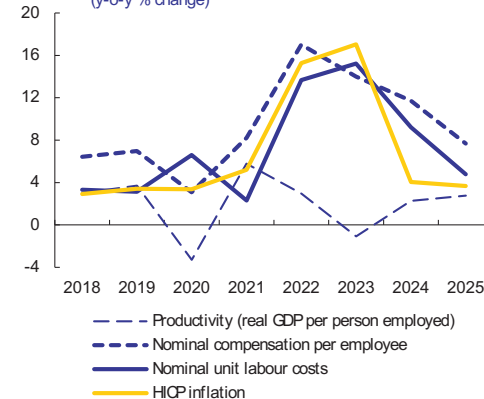
<sup>(33)</sup> These are reserves in excess of the mandatory reserves, which is different from the one-week deposit mentioned earlier.

Labour cost growth picked up compared to earlier years, reflecting the tight labour market, high inflation, and sizeable minimum wage hikes. In 2022-23, the minimum wage rose by 59.3%, well above the 31.9% increase in the consumer price level. Wage growth is projected to remain strong in 2024 against a backdrop of the continuing tightness of the labour market, also bolstered by the recent 15% minimum wage hike in December 2023. Once the impact of this measure fades, lower inflation could result in slower nominal wage growth.

Labour productivity growth, measured in terms of GDP per worker, slowed down in 2022, then declined in 2023 as real GDP contracted.

Productivity growth is set to pick up in 2024-25 as the economy recovers from the recession, but to remain subdued, also reflecting structural barriers such as weak product market competition, skills shortages and low digitalisation. Strong wage growth and weaker productivity dynamics led to a spike in unit labour cost, which grew by 13.7% in 2022 and by 15.2% in 2023. As wage growth is projected to slow down while productivity is set to recover, ULC growth could ease in 2024-25.

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



Source: Eurostat, Commission's Spring 2024 Economic Forecast.

#### External factors

Due to the high degree of openness of the Hungarian economy, developments in import prices play an important role in domestic price formation. Import prices contributed significantly to inflation in 2022-23, both due to the pass-through of currency depreciation, and the rise of global commodity prices. The forint's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated by 7.7% in 2022, followed by an appreciation of 3.6% in 2023. The nominal exchange rate reached its weakest level at the end of 2022, in the period when many companies were preparing business plans for 2023. Therefore, the depreciation in 2022 could have had an oversized effect on inflation in 2023<sup>(34)</sup>.

#### Administered prices and taxes

The share of administered prices in the Hungarian HICP basket (14.4% in 2023) is close to the euro area average. Administered prices increased by 11.8% in 2022 and 11.3% in 2023, reflecting the introduction of the two-tier energy price scheme for households, and the impact of high overall inflation, for example through the automatic indexation of road tolls. However, the prices of certain major items, such as district heating or water supply, did not change despite rising supply costs, and the utility companies providing these services required increasing subsidies from the budget to cover losses. Administered prices contributed to headline inflation by 1.7 and 1.6 percentage points in 2022 and 2023 respectively.

Changes in indirect taxation increased headline inflation by 0.8 percentage points in 2023, mainly due to rising excise duties on alcohol and tobacco. Further indirect tax measures (notably the sector-specific taxes on retail, telecommunication and airlines) could have had a significant impact on inflation in both 2022 and 2023, however these are not captured by the difference between headline inflation and HICP at constant tax rates.

<sup>(34)</sup> Recent research by the Hungarian central bank also points to the strengthening of exchange rate pass-through, see: Balatoni A. – Soós G. (2023): Változó világ, változó hatások – Az árfolyam makrogazdasági hatásai. Magyar Nemzeti Bank.



The excise duty on motor fuel fell below the EU minimum rate (which is set in euros) due to currency depreciation. In response, the duty was increased in January 2024.

#### Medium-term prospects

According to the Commission's Spring 2024 Economic Forecast, inflation is forecast to decrease in 2024 to 4.1% and 2025 to 3.7%, once the pass-through of commodity price increases to consumer prices is completed. However, high labour cost growth and the expected recovery of consumption are set to slow down disinflation in the coming quarters.

There are upside risks to the inflation outlook. The current level of administered utility prices continues to create losses in the largely state-owned utility sector. If wholesale energy prices increase again, the pressure to raise consumer prices could also increase significantly. The potential continuation of the expansionary economic policies, tight labour market and high inflation expectations are further sources of inflationary risk.

The price level of household final consumption in Hungary stood at about 64% of the euro area average in 2022, with the relative price gap significantly larger for services than for goods. Price convergence appears to have stalled since 2019 among industrial goods and services but continued for food. The low aggregate price level suggests that there is potential for price level convergence in the long term, as GDP per capita in PPS (73% of the euro area average in 2023) increases towards the euro area average.

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

### 4.3. PUBLIC FINANCES

#### 4.3.1. Recent fiscal developments

The general government deficit remained high over the 2022-2023 period, increasing from 6.2% in 2022 to 6.7% in 2023.

Revenues as a share of GDP were below the pre-pandemic levels at 42.7% in 2022 and 42.4% in 2023. While personal income tax revenue grew robustly on the back of rapidly growing nominal wages, the growth in social security contributions was hampered by the tax cuts implemented in 2022. The VAT revenue and excise duties fell as a share of GDP in 2023, in the context of weak consumption. The introduction of windfall profit and sectoral taxes over 2022-2024, levied on companies in the energy, financial and retail sectors, has temporarily mitigated a steeper decline in the tax-to-GDP ratio.

The expenditure-to-GDP ratio remained significantly above the pre-pandemic levels at 48.9% in 2022 and 49.1% in 2023, due to elevated discretionary spending, and the impact of high inflation and high energy prices. The elevated expenditure levels in 2022 and 2023 were driven in particular by a significant increase in interest burden in the context of high inflation and high nominal interest rates (from 2.8% of GDP in 2022 to 4.7% in 2023), and the introduction of measures adopted to mitigate the economic and social impact of the increase in energy prices, in particular the subsidies to utility companies for the losses incurred due to caps on residential energy prices and support schemes for energy-intensive companies. The fiscal impact of measures adopted to mitigate the economic and social impact of the increase in energy prices, net of the revenue from taxes on windfall profits of energy suppliers, was estimated at 1.0% of GDP in 2022 and 1.6% in 2023. The Commission assessed that these measures were not targeted at the most vulnerable households or firms, and most of them did not fully preserve the price signal to reduce energy demand and increase energy efficiency.

The 2023 budgetary outturn was well above the 3.9% GDP deficit target set in the 2023 Convergence Programme essentially due to weaker-than expected growth, persistently high

expenditure and the stronger-than-expected impact of high interest rates on public finances. The real GDP growth of -0.9% was well below 1.5% expected in the Convergence Programme. Overall, the large budget slippage in 2023 was driven mostly by: (i) the underperformance of tax revenue, in particular VAT, (ii) persistently high expenditure, including higher spending on interest expenditure due to high nominal interest rates and high coupon payments on inflation-indexed retail bonds, (iii) and higher-than-expected pension expenditure due to inflation indexation.

The Commission report under Article 126(3) concludes that, after considering the opinion of the Economic and Financial Committee, the Commission intends to propose to open an excessive deficit procedure for Hungary, by proposing to the Council to adopt a Decision under Article 126(6) establishing the existence of an excessive deficit. On 19 June 2024, the Commission adopted a report under Article 126(3) of the TFEU. The report assessed the budgetary situation of Hungary, as its government deficit in 2023 exceeded the Treaty reference value of 3% of GDP. The report concluded that the general government deficit in 2023 exceeded and was not close to the Treaty reference value of 3% of GDP. The excess over the Treaty reference value was not considered to be exceptional and was not expected to be temporary.

The government debt-to-GDP ratio ebbed to 74.1% in 2022 and to 73.5% at the end of 2023, mainly due to favourable nominal GDP dynamics. However, the strong debt-decreasing impact of high inflation was offset by the large budget deficit and borrowing by a state-owned development bank to finance subsidised lending schemes.

#### 4.3.2. Medium-term prospects

The 2024 budget was adopted by the Hungarian Parliament on 7 July 2023. It targeted a headline deficit of 2.9% of GDP and included emergency reserves of 0.3% of GDP to cover potential slippages based on risk scenarios.

Table 4.3:

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

Outturn and forecast <sup>1)</sup>	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
General government balance	-2.1	-2.0	-7.6	-7.2	-6.2	-6.7	-5.4	-4.5
- Total revenue	44.0	44.0	43.8	41.2	42.7	42.4	42.9	42.4
- Total expenditure	46.1	46.1	51.4	48.4	48.9	49.1	48.3	46.9
of which:								
- Interest expenditure	2.3	2.2	2.3	2.3	2.8	4.7	4.9	4.1
p.m.: Tax burden	36.9	36.4	36.0	33.9	35.2	35.1	35.7	35.0
Primary balance	0.3	0.2	-5.2	-4.9	-3.4	-2.0	-0.5	-0.4
Fiscal stance <sup>2)</sup>					-1.2	4.7	1.0	-0.4
Recommended growth in net nationally financed primary expenditure (%)							4.4	-
Growth in net nationally financed primary expenditure (%)							3.6	-
Government gross debt	69.1	65.3	79.3	76.7	74.1	73.5	74.3	73.8
p.m.: Real GDP growth (%)	5.4	4.9	-4.5	7.1	4.6	-0.9	2.4	3.5

1) Commission's Spring 2024 Economic Forecast.

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

Source: European Commission.

As in 2023, the budget included the Utility Bill Protection Fund (with the allocation of 1.7% of GDP down from 3.3% in 2023), primarily aimed at providing subsidies to utility companies for the losses incurred due to caps on residential energy prices and compensating central

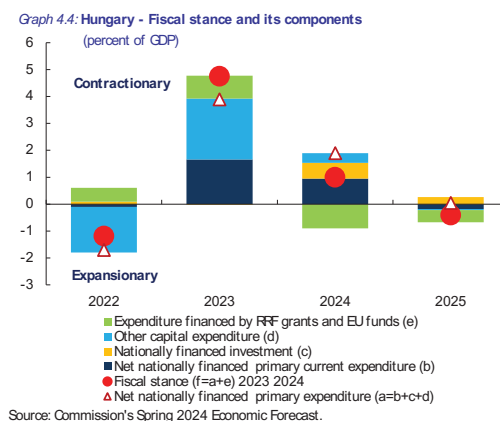


budgetary organisations for rising energy costs. The cost of energy measures was partly financed with proceeds from the windfall profit and sectoral taxes, which were extended to fiscal year of 2024. The 2024 budget law also included an increase in the allocation for the National Defence Fund with the objective to increase expenditure on defence to above 2 per cent of GDP in order to meet military obligations under international treaties.

On 30 April 2024, Hungary submitted its 2024 Convergence Programme. In light of the significant slippage of the 2023 budget deficit compared to official plans, the 2024 deficit target was revised up to 4.5%. The Programme projects the headline deficit to decline further to 3.7% in 2025.

Based on the Commission's Spring 2024 Economic Forecast, the deficit is projected to decrease to 5.4% of GDP in 2024 and 4.5% in 2025, above the official target set out in the 2024 Convergence Programme, based on a no-policy change assumption and reflecting, robust growth in tax revenue, lower projected subsidies to utility companies and a decrease in public investments. The general government debt is projected to remain at 73.8% of GDP in 2025, driven by high headline deficit that almost fully offsets the positive impact of high nominal GDP growth.

Based on the Commission's estimates, the fiscal stance is projected to be contractionary at 1.0% of GDP in 2024, following a contractionary fiscal stance of 4.7% of GDP in 2023<sup>(35)</sup>. The fiscal stance in 2024 reflects primarily the contractionary contributions of nationally-financed investments 0.6% of GDP and nationally-financed primary current expenditure 1.0% of GDP, which are partly offset by the expansionary contribution of expenditure financed by RRF grants and EU funds (-0.9% of GDP). Under the no policy-change forecast, the fiscal stance is projected to be expansionary at -0.4% of GDP in 2025, driven primarily by the expansionary contribution of the expenditure financed by RRF grants and EU funds -0.5% of GDP.



On 14 July 2023, the Council recommended that Hungary ensures a prudent fiscal policy, in particular by limiting the nominal increase in nationally financed net primary expenditure in 2024 to not more than 4.4%. According to the Commission's 2024 Spring Economic Forecast, Hungary's net nationally financed primary expenditure is projected to increase by 3.6% in 2024, which is below the recommended maximum growth rate. However, current estimates of net expenditure in 2023 are higher than expected at the time of the recommendation (by 1.8% of GDP). Therefore, as the recommendation for 2024 was formulated as a growth rate, the assessment of compliance also needs to take into account the base effect from 2023. If net expenditure in 2023 had been the same as expected at the time of the recommendation, the resulting growth rate of net expenditure in 2024 would be above the recommended growth rate by 1.5% of GDP.

Moreover, the Council recommended that Hungary takes action to wind down the emergency energy support measures in force, using the related savings to reduce the government deficit, as soon as possible in 2023 and 2024. The Council further specified that, should renewed energy price increases necessitate new or continued support measures, Hungary should ensure that these are targeted toward vulnerable households and firms, fiscally affordable, and preserve incentives for energy savings. According to the Commission's 2024 Spring Economic Forecast, the net budgetary cost of energy support

<sup>(35)</sup> For a definition of the fiscal stance used in this report, see footnote in Section 4.2.3. on underlying factors and sustainability of inflation.

measures is projected at 1.6% of GDP in 2023, 0.9% in 2024, and 0.4% in 2025. The energy support measures are not projected to be wound down as soon as possible in 2023 and 2024. If the related savings were used to reduce the government deficit, as recommended by the Council, these projections would imply a fiscal adjustment of 0.6% of GDP in 2024, whereas net nationally financed primary expenditure provides a contractionary contribution to the fiscal stance of 0.9% of GDP in that year. Therefore, the related savings from the winding down of energy measures are not projected to be fully used to reduce the government deficit.

In addition, the Council also recommended that Hungary preserve nationally financed public investment and ensure the effective absorption of Recovery and Resilience Facility grants and other EU funds, in particular to foster the green and digital transitions. According to the Commission's 2024 Spring Economic Forecast, nationally financed public investment is projected to decrease to 4.0% of GDP in 2024 (from 4.6% of GDP in 2023) and, therefore, it is not expected to be preserved. This is due to the cuts and postponements in nationally financed investment projects implemented by the government in response to rising fiscal pressures related to high inflation and energy prices. The decrease in investment is not in line with what was recommended by the Council. Further details can be found in the Commission's recommendation for a Council recommendation on the 2024 Convergence Programme for Hungary.

Debt sustainability risks appear medium over the medium run. Government debt is projected to slightly increase from around 74% in 2024 to around 78% of GDP in 2034. This projection assumes that the structural primary balance improves from a deficit of 1.3% of GDP in 2023 to a neutral position in 2024 and remains at that level (excluding changes in the cost of ageing) over the projection period <sup>(36)</sup>.

The sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, in case of permanently lower structural primary balance (if the improvement in the structural primary balance forecast for 2024 was halved), the projected debt ratio in 2034 would be only around 7 percentage points of GDP higher than in the baseline.

Some factors mitigate risks, including the high share of domestically held government debt. Risk-increasing factors include the significant shares of short-term government debt and government debt held in foreign currency. Some contingent liability risks stemming from the banking sector, as well as Hungary's negative net international investment position, pose additional fiscal risks.

Hungary's fiscal framework has gradually become more compliant with EU legal requirements, but it has not fostered transparency and a prudent fiscal stance. The country's medium-term budgetary framework could be more binding on the national budgets, as every May and December new figures can be presented for all years covered under the medium-term plans and plans in annual budgets can deviate from those in the medium-term plans. Additionally, the impact of the Fiscal Council of Hungary on the country's fiscal policy could be further developed. This could for example be done by involving the fiscal institution in the evaluation of the macroeconomic forecast and assessing the consistency of the national fiscal framework. The remit of the Fiscal Council of Hungary will be affected by the amended Budgetary Framework Directive (2011/85/EU), part of the soon-to-be adopted Economic Governance Review. The amended Directive extends the independence safeguards for independent fiscal institutions to all EU Member States and assigns some tasks to these institutions.

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<sup>(36)</sup> For details on the methodology, see European Commission (2024), Debt Sustainability Monitor 2023, Institutional Paper 271, March 2024.

#### 4.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. The MNB operates its monetary policy in an inflation targeting regime with the inflation target set at 3 percent with a tolerance band of +/-1 percentage point. Since 26 February 2008, the exchange rate band was abolished and a floating exchange rate regime was adopted that, however, allows foreign exchange interventions by the MNB.

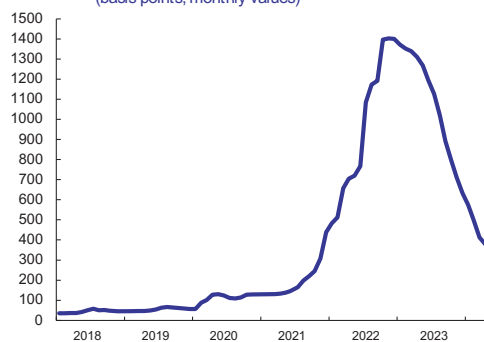
In 2022, the HUF/EUR exchange rate was on a steep depreciation path that started at the end of February following Russia's full-scale invasion of Ukraine. Starting from a level of around 355, the forint fell to a low of 430 HUF/EUR in October 2022. The depreciation of the forint reflected general uncertainty related to the war, a deteriorating current account balance due to high energy prices, inflation rising much faster in Hungary than in the euro area and concerns about the future EU fund receipts for Hungary. Following the monetary policy measures of October 2022, the forint started appreciating, a reversal which was later supported further by favourable developments regarding Hungary's receipt of EU funds. Inflation also started falling rapidly further contributing to the improvement of the risk assessment of the HUF/EUR exchange rate. The HUF/EUR appreciated to around 370 by May 2023. Since mid-2023 the forint was on depreciating path again while the central bank continued its monetary policy easing. In May, it traded against the euro on average at about 387 HUF/EUR.

Graph 4.5: Hungary - HUF/EUR exchange rate  
(monthly averages)



Source: ECB.

Graph 4.6: Hungary - 3-M BUBOR spread to 3-M Euribor  
(basis points, monthly values)



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

International reserves of the central bank that had already reached EUR 38.4 billion end-2021 rose to 38.7 billion by the end of 2022. Reserves increased more sharply in 2023 and reached EUR 41.4 billion by end 2023, which was around 21% of GDP. Reserves were increased by the issuance of foreign currency denominated government bonds and by inflows of EU funds, while debt servicing, foreign exchange expenditures of the Treasury, the change in the central bank's forint liquidity providing FX swap holdings, and valuation effects of central bank assets mitigated the increase. International reserves increased to EUR 47.7 billion in May 2024.

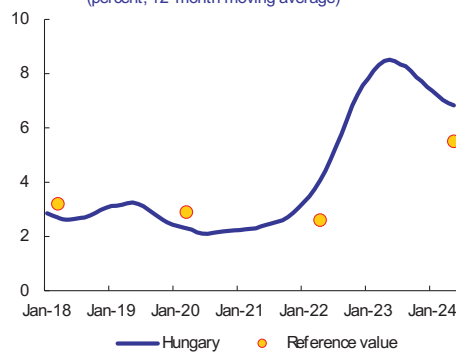
Short-term interest rate differentials measured by the 3-month interbank interest rate spread vis-à-vis the euro area increased sharply and peaked at 1400 basis points at the end of 2022. The increase reflected monetary tightening in view of rapidly rising inflation. Throughout 2023, the interest rate differential fell substantially reaching a level of around 570 basis points by end 2023, as inflation fell and monetary easing started in Hungary while the ECB was tightening its monetary policy. The spread stood at around 343 basis points in May 2024.

#### 4.5. LONG-TERM INTEREST RATES

The long-term interest rate in Hungary used for the convergence assessment reflects the secondary market yields on a single benchmark bond with a residual maturity of about 10 years.

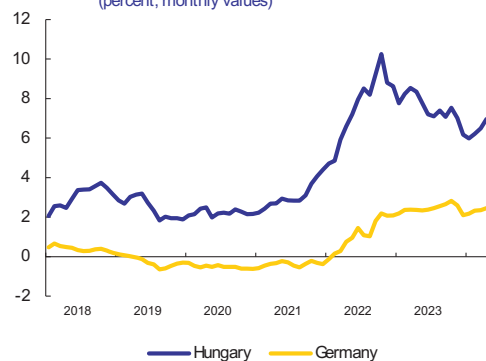
The Hungarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the time of the 2022 convergence assessment of Hungary. It increased from the 4.4% of May 2022 to reach 8.5% in June 2023 and then started to decrease. In May 2024, the latest month for which data are available, the reference value, given by the average of long-term interest rates in the Netherlands, Italy, and Latvia, plus 2 percentage points, stood at 5.5%. In that month, the 12-month moving average of the yield on the Hungarian benchmark bond stood at 6.8%, i.e. 1.3 percentage points above the reference value.

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



Source: European Commission.

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



Source: Eurostat.

The long-term interest in Hungary rose steeply in 2022 reflecting rapidly rising inflation, monetary policy tightening and heightened risk aversion due to Russia's full-scale invasion of Ukraine. It peaked at 10.2% in October 2022 but then started declining on the back of falling inflation and monetary easing. In May 2024, the long-term interest rate of Hungary was 6.8%.

The long-term interest rate spread vis-à-vis the German benchmark bond widened substantially in 2022 and peaked at around 800 basis points in October, reflecting markedly higher inflation and central bank policy rates in Hungary as well as higher sovereign risk in a context of emerging macroeconomic imbalances, as evidenced by a widening of credit default swaps spreads. As inflation started falling steeply, the Hungarian central bank started easing at the end of 2022, while German short-term rates edged upwards and then declined in 2023. The long-term interest rate spread narrowed to around 427 basis point by May 2024.

#### 4.6. ADDITIONAL FACTORS

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

In May 2023, the Commission published its In-Depth Review for Hungary, which considered that Hungary was experiencing imbalances with vulnerabilities that relate to its large

external and government financing needs, against a background of high inflation. In November 2023, the Commission published its 13th Alert Mechanism Report (AMR 2024) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review was warranted for Hungary. In April 2024, the Commission published an In-Depth Review for Hungary. Taking into account the assessment in the In-Depth Review, the Commission, in its Communication 'European Semester – 2024 Spring Package' <sup>(37)</sup>, considers that Hungary is experiencing macroeconomic imbalances. The 2024 In-Depth Review found that external factors mitigated some vulnerabilities of the Hungarian economy. Lower energy prices and the economic recession contributed to the improvement of the current account balance and the decrease of inflation. At the same time, the recession also contributed to a persistently high budget deficit. Policy inconsistencies had also contributed to the build-up of vulnerabilities, but progress has been limited in this regard, keeping Hungary vulnerable to potential external and domestic shocks.

Hungary's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, to boost its competitiveness and stimulate sustainable growth and reduce the country's territorial and social disparities. The RRF funding provides Hungary with EUR 10.4 billion over the 2021-2026 period.

While some reforms (e.g., reducing barriers to the development of renewable energy, conducting regular spending reviews, combatting aggressive tax planning) and investments, (e.g., energy efficiency, renewable energy) have already started, the implementation of the Hungarian RRP faces significant delays. Hungary has not submitted any payment requests so far. Structural challenges linked to implementing the necessary measures to ensure the protection of the EU's financial interests call for swift action to ensure that reforms and investments can be completed on time.

In addition, cohesion policy provides Hungary with EUR 21.7 billion for the 2021-2027 period. Cohesion policy financing aims to further support Hungary's competitiveness, including innovation and the uptake of advanced technologies, green transition, and upward social convergence, including by addressing poverty and developing education systems and skills. While Hungary has made progress in implementing cohesion policy, challenges remain and significant social and regional disparities persist.

#### 4.6.1. Developments in the balance of payments

Hungary's external balance (i.e. the combined current and capital account) deteriorated from -1.6% of GDP in 2021 to -6.4% in 2022, when a multi-year trend deterioration, driven by strong domestic demand, was compounded by the worsening of the terms of trade. Rising energy import prices widened the energy trade deficit to 10% of GDP in 2022. The income balance also deteriorated that year due to the rising financing cost of external debt. Lower energy prices and the fall in import demand due to the economic recession led to a sharp improvement in the current account balance, from -8.4% of GDP in 2022 to 0.3% in 2023. The surplus of the capital account decreased somewhat in 2023 due to a slower absorption of EU funds, which overall resulted in the external balance reaching a surplus of 1.2% in 2023.

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<sup>(37)</sup> COM(2024) 600 final, 19.06.2024.

Table 4.4:

Hungary - Balance of payments		(percentage of GDP)				
	2018	2019	2020	2021	2022	2023
Current account	0.2	-0.8	-1.1	-4.1	-8.4	0.3
of which: Balance of trade in goods	-1.7	-2.5	-1.0	-2.9	-9.1	0.1
Balance of trade in services	5.9	4.8	2.9	3.1	4.7	5.0
Primary income balance	-3.7	-2.5	-2.5	-3.2	-2.9	-3.5
Secondary income balance	-0.4	-0.6	-0.5	-1.1	-1.0	-1.3
Capital account	2.3	1.9	2.1	2.5	2.0	0.9
External balance <sup>1)</sup>	2.5	1.1	1.0	-1.6	-6.4	1.2
Financial account	0.8	0.3	-1.6	-4.5	-9.3	-1.1
of which: Direct investment	-2.2	-0.1	-1.9	-2.5	-2.9	-1.7
Portfolio investment	-0.1	1.0	-1.9	0.4	-2.7	-4.7
Other investment <sup>2)</sup>	0.5	-0.8	-2.2	-4.7	-4.5	3.9
Change in reserves	2.7	0.2	4.5	2.4	0.7	1.3
Financial account without reserves	-1.9	0.1	-6.1	-6.9	-10.0	-2.4
Errors and omissions	-1.7	-0.7	-2.6	-2.9	-3.0	-2.3
Gross capital formation	26.8	28.4	27.2	30.6	34.0	25.3
Gross saving	26.8	27.4	26.3	26.6	25.7	25.6
Net international investment position	-50.7	-49.6	-52.5	-53.6	-52.1	-46.6

1) The combined current and capital account.

2) Including financial derivatives.

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

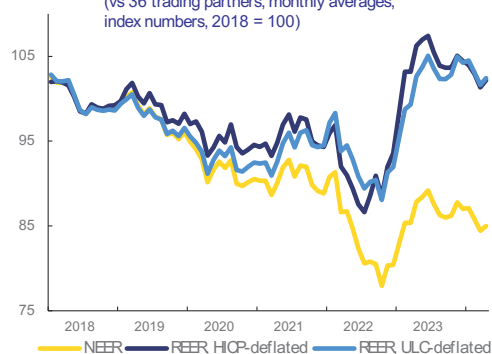
The financial account showed a deficit of 9.3% in 2022, mainly reflecting a rise in debt-generating capital inflows. The share of non-residents in government financing increased in 2022, while high central bank policy rates attracted deposits by non-residents. These trends abated in 2023, narrowing the financial account balance to -1.1% of GDP.

Price and cost competitiveness indicators improved in 2022 but worsened in 2023. The growth of ULC and consumer prices was higher in Hungary than in its trade partners in both years. The nominal exchange rate depreciated significantly in 2022 but appreciated again in 2023. Hungary's export market share (measured at current prices) decreased in 2022-23.

According to the Commission's Spring 2024 Economic Forecast, which is based on national accounts data, the external balance is expected to deteriorate again in 2024 and 2025. This is mainly driven by the recovery of domestic demand following the 2023 recession. Large FDI projects in manufacturing are set to improve the trade balance in the medium term but also lead to higher income outflows, mitigating the overall impact on the current account balance. The current account deficit is projected to widen to 1.4% of GDP by 2025.

As the budget deficit remained persistently high in 2022-2023, the external borrowing of the government sector also rose, leading to debt-generating portfolio investment inflows, and rising gross external debt. Meanwhile, direct investments continued to register net inflows in

Graph 4.9: Hungary - Effective exchange rates  
(vs 36 trading partners; monthly averages;  
index numbers, 2018 = 100)



Source: European Commission.



2022-2023. The net international investment position posted slight improvements in both years.

#### 4.6.2. Market integration

Hungary's economy is highly integrated with the euro area through trade and investment linkages. The economy is strongly embedded into continental and global value chains. Trade openness (see Table 4.5 for a definition) increased considerably in 2022 to 104.3%, but fell to 89.2% in 2023. Flows with the euro area dominate trade, accounting for more half of the total trade in goods and services in 2023. Hungary's main euro area goods trading partners in 2023 were Germany, Slovakia, Austria, and Italy. Outside the euro area, the main trading partners were China and Poland.

Table 4.5:  
Hungary - Market integration

	2018	2019	2020	2021	2022	2023
Trade openness <sup>1)</sup> (%)	92.5	90.8	87.6	91.1	104.3	89.2
Trade with EA in goods & services <sup>2)+3)</sup> (%)	53.6	52.7	50.7	52.2	58.9	50.8
IMD World Competitiveness Ranking <sup>4)</sup>	47	47	47	42	39	46
Internal Market Transposition Deficit <sup>5)</sup> (%)	0.9	0.5	1.0	0.7	1.5	0.2
Real house price index <sup>6)</sup>	135.0	150.9	153.2	167.9	176.6	163.0

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

2) (Imports + Exports of goods with EA-20 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-20 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) International Institute for Management Development (IMD).

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

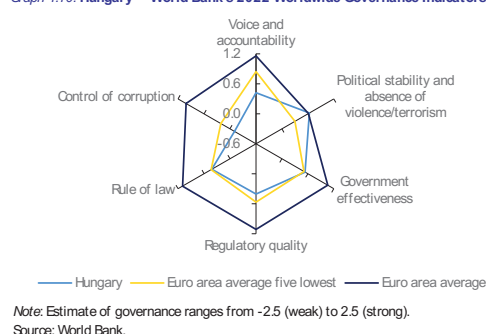
6) Deflated house price index (2015=100) (Eurostat).

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

The stock of FDI in Hungary amounted to about 60.1% of GDP in 2022 (excluding special purpose entities, 'SPEs' <sup>(38)</sup>), with FDI mainly originating from Germany, the Netherlands and Austria. Manufacturing and services account for 47% and 42% of inward FDI, respectively, suggesting that FDI plays an important role in enhancing Hungary's export capacity and contributes significantly to economic integration with the euro area.

Concerning the business environment, Hungary performs in general worse than many euro area Member States in international rankings, even if certain features of Hungary's business environment, such as low corporate taxes, flexible labour market regulations and the authorities' supportive attitude towards export-oriented FDI, make the country attractive for the more labour-intensive and cost-sensitive tasks within global value chains. According to the 2024 Country Report, the unpredictable business environment increases the cost of doing business. In recent years, there has been increased government intervention in the form of sector-specific taxes, tailor-made legislation and government decisions targeting business transactions. Moreover, specific companies and industries benefit from generous state subsidies and supportive regulation. These interventions have reduced competition and hindered the growth of more

Graph 4.10: Hungary - World Bank's 2022 Worldwide Governance Indicators



<sup>(38)</sup> The Hungarian statistics introduced the notion of special purpose enterprise (SPE) for those passive financial intermediaries that have financial relations only with non-residents, and allocated them to the financial corporations sector as private financial intermediaries (S.127). They are typically related to tax optimization by holdings. See [a-nem-penzugyi-vallalatok-penzugyi-szamlai-en.PDF \(mnb.hu\)](#), page 8.



efficient companies. Concerns remain about the anti-corruption framework and the quality of lawmaking, which have an additional bearing on the business environment.

Table 4.6:

**Hungary - Allocation of assets by financial sub-sector**

	HU		EA		Ratio to GDP (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Financial corporations (total)	229	392	689	715	174	190
Central bank	24	39	53	68	46	52
Monetary financial institutions	91	107	266	290	87	93
Other financial intermediaries	91	222	181	163	16	18
Non-MMF investment funds <sup>1)</sup>	13	17	101	113	4	5
Insurance co. and Pension Funds	11	8	87	81	21	22

	HU		EA		Share of total (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Central bank	11	10	8	10	27	27
Monetary financial institutions	40	27	39	40	50	49
Other financial intermediaries	40	57	26	23	9	10
Non-MMF investment funds	6	4	15	16	2	3
Insurance co. and Pension Funds	5	2	13	11	12	11

1) MMF stands for money market funds.

Source: Eurostat.

According to the World Bank's 2022 Worldwide Governance Indicators, Hungary performs lower than the average five lowest euro area Member States in relation to indicators that measure voice and accountability, regulatory quality and control of corruption <sup>(39)</sup> <sup>(40)</sup>. It also performs lower than the euro area average in terms of government effectiveness and the rule of law. According to the latest data, Hungary's transposition deficit of EU Directives increased to 1.5%, exceeding the EU average (0.7%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

<sup>(39)</sup> According to the World Bank's methodology, 'voice and accountability' captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. See <https://www.worldbank.org/content/dam/sites/govindicators/doc/va.pdf>.

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

Table 4.7:

**Hungary - Financing of the economy<sup>1)</sup>**

	HU		EA		Ratio to GDP (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Liabilities (total)	442	603	706	696	316	304
Loans	123	188	228	219	109	103
Non-financial co. debt securities	1	4	12	12	3	2
Financial co. debt securities	6	11	66	58	3	4
Government debt securities	67	56	78	71	47	42
Listed shares	18	13	60	63	12	10
Unlisted shares	49	45	176	184	54	53
Other equity	141	244	53	54	56	58
Trade credits and advances	36	42	34	35	31	32

	HU		EA		Share of total (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Loans	28	31	32	32	34	33
Non-financial co. debt securities	0	1	2	2	1	1
Financial co. debt securities	1	2	9	8	1	1
Government debt securities	15	9	11	10	15	14
Listed shares	4	2	9	9	3	3
Unlisted shares	11	7	25	26	19	19
Other equity	32	41	7	8	17	18
Trade credits and advances	8	7	5	5	10	11

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

Source: Eurostat.

Transposition of the 4th and the 5th Anti-Money Laundering Directive by Hungary is now considered complete. Concerning conformity, the Commission after its assessment came to the conclusion that parts of the 5th Anti-Money Laundering Directive had not been transposed in a conform manner. A Letter of Formal Notice was addressed to Hungary in that regard in September 2023 and the infringement procedure is still pending.

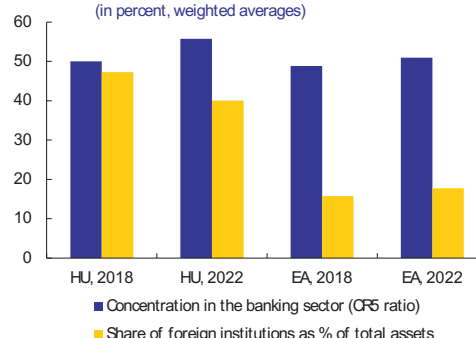
The Hungarian labour market has remained resilient to the recent weakness in economic activity, with the employment and participation rates rising steadily and remaining above the euro area average in 2022-2023. Nonetheless, challenges remain related to skills shortages and the low activation rate of certain groups, such as the low-skilled, Roma and persons with disabilities. Wage growth has been high, driven by labour shortages and sizeable minimum wage hikes. Overall, the minimum wage has grown faster than consumer prices in 2022-2023. The financial sector in Hungary is smaller and less developed than in the euro area. Assets managed by the financial sector amounted to 392% of GDP in 2022 and to 182% of GDP when excluding SPEs, which perform no financial intermediation in the domestic economy. This is much less than in the euro area (715% of GDP) and comparable to the euro area Member States with the least developed financial sectors. At the same time, the financial sector has expanded faster than in the euro area since 2018, even when excluding SPEs. Due to the presence of SPEs, the structure of the financial sector is different from that of the euro area, where the banking sector is the largest sub-sector in the

financial sector. In Hungary, the share of the banking sector in the total assets managed by the financial sector decreased from 40% in 2018 (close to the euro area average of 39% of GDP) to 27% in 2022, while the share of other financial intermediaries, which include SPEs, increased from 40% to 57% <sup>(41)</sup>. However, when excluding SPEs, the banking sector represents a large and stable share of the financial sector, with 61% of total assets in 2018 (and 59% in 2022). With this correction, the financial system can be assessed as more bank-based than in the euro area. The weight of the central bank is also higher than in the euro area when excluding SPEs (21% of total assets in 2022). Insurance companies and pension funds are clearly underdeveloped compared with the euro area and with its five Member States with the smallest financial sectors (2% of the total assets of the financial sector).

As to the financing of the economy, outstanding liabilities stood at 603% of GDP in 2022 (vs. 696% of GDP in the euro area). The structure of the financial sector is reflected in the financing of the economy: with 41% of total liabilities in 2022 (vs. 8% in the euro area), other equity is the main source of funding due to the presence of foreign holdings and SPEs <sup>(42)</sup>. Loans are the second dominant source of funding (31% of total liabilities, close to the euro area average). However, the importance of loans is also inflated by SPEs. Debt and equity markets are smaller than in the euro area and market financing (debt securities and listed shares) is relatively underdeveloped. Listed equity and private-sector debt markets represented 2% and 3% of total liabilities respectively. This compares to 9% of total liabilities for listed stocks and 10% for private-sector debt in the euro area. Hungary is still broadly comparable to the five euro area Member States with the smallest financial needs. The government bond market is relatively smaller than in the euro area, reflecting a lower debt-to-GDP ratio.

The Hungarian banking sector is well-integrated into the euro area financial sector, posting a level of foreign ownership in its banking system that is well above the one of the euro area. The share of foreign-owned institutions in total bank assets fell from 47% in 2018 to 40% in 2022, with the corresponding figure for the euro area being at around 18%. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, increased from 50% in 2018 to 56% in 2022, a somewhat higher value than the euro area average (51% in 2022).

Graph 4.11: Hungary - Foreign ownership and concentration in the banking sector  
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

<sup>(41)</sup> As indicated above, this likely reflects the large presence of foreign holdings in Hungary for tax optimization purposes.

<sup>(42)</sup> The most important impact of SPEs on liabilities concern other equity (SPEs responsible for 63% of all other equity) and loans (SPEs responsible for 31% of all loans).



## 5. POLAND

### 5.1. LEGAL COMPATIBILITY

#### 5.1.1. Introduction

The main rules governing the Narodowy Bank Polski (NBP – Polish national bank, hereafter NBP) are laid down in the Act on the Narodowy Bank Polski (the NBP Act) which was adopted on 29 August 1997. The consolidated version of the NBP Act was published in Dziennik Ustaw of 2022, item 2025. The NBP Act has been slightly amended since the Commission's 2022 Convergence Report <sup>(43)</sup>. In absence of any legislative action regarding the issues mentioned in the Commission's 2022 Convergence Report, the comments provided in the latter report remain relevant and are repeated in the 2024 assessment.

#### 5.1.2. Central bank independence

The Polish Constitution and the NBP Act do not explicitly prohibit the NBP and members of its decision-making bodies from seeking or taking outside instructions; they also do not expressly prohibit the Government from seeking to influence members of NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB related tasks. The absence of such an explicit reference to Article 130 TFEU and Article 7 of the ESCB/ECB Statute or its content constitutes a clear incompatibility. However, the Polish Constitutional Court has recognised that the central bank's independence is based on Article 227(1) of the Constitution. In this respect, it is noted that at the occasion of a future amendment to the Polish Constitution, the Polish authorities should seize the opportunity to clarify in the Constitution that the principle of central bank independence as enshrined in Article 130 TFEU and Article 7 of the ESCB/ECB Statute applies. Alternatively, or in addition, the NBP Act could also be amended to ensure compatibility with the principle of central bank independence.

The Commission recalls the rulings of the Polish Constitutional Tribunal which considered certain provisions of the EU Treaties incompatible with the Polish Constitution, expressly challenging the primacy of EU law <sup>(44)</sup>. The primacy of EU law is essential as regards the compatibility between the national legislation, including the statute of its national central bank, and Articles 130 and 131 TFEU and ESCB/ECB Statute. The Commission considers that these rulings of the Constitutional Tribunal are in breach of the general principles of autonomy, primacy, effectiveness and uniform application of Union law and the binding effect of rulings of the Court of Justice of the European Union. Moreover, the Commission considers that the Constitutional Tribunal of Poland no longer meets the requirements of an independent and impartial tribunal previously established by law <sup>(45)</sup>. It should therefore be ensured that the primacy of Union law, in particular of Articles 130 and 131 TFEU and the ESCB/ECB Statute, over national law is respected by Polish public authorities and courts.

Article 23(1)(2) of the NBP Act provides that the NBP's Governor has, inter alia, to provide draft monetary policy guidelines to the Council of Ministers and the Minister of Finance. This procedure provides for the opportunity for the Government to exert influence on the monetary and financial policy of the NBP and thus constitutes an incompatibility in the area of independence with Article 130 TFEU and Article 7 of the ESCB/ECB Statute. Article

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<sup>(43)</sup> The amendments stem from the Act of 11 March 2022 on Homeland Defence (Journal of Laws 2022, item. 2305) amending the Act on Narodowy Bank Polski.

<sup>(44)</sup> Polish Constitutional Tribunal, Judgment No. P 7/20 of 14 July 2021; Polish Constitutional Tribunal, Judgment No. K 3/21 of 7 October 2021.

<sup>(45)</sup> On 22 December 2021, the Commission launched an infringement procedure concerning the Constitutional Tribunal and its case-law; see Commission press release IP/21/7070. On 15 July 2022, the Commission decided to send a reasoned opinion to Poland, to which Poland replied on 14 September 2022, rejecting the reasoning of the Commission. The Polish reply did not address the Commission's concerns, therefore on 15 February 2023, the Commission decided to refer Poland to the Court of Justice of the European Union.

23(1)(2) of the NBP Act should be revised in order to ensure that the monetary policy guidelines are provided to the Council of Ministers and the Minister of Finance, if ever, only after their approval by the NBP and for information purposes only.

Article 9(3) of the NBP Act provides that the Governor of the NBP shall assume his/her duties after taking an oath before the Parliament. This oath refers to the compliance with the provisions of the Polish Constitution and other laws, the economic development of Poland and the well-being of its citizens. The Governor of the NBP acts in dual capacity as a member of NBP's decision-making bodies and of the relevant decision-making bodies of the ECB. Article 9(3) of the NBP Act needs to be adapted to reflect the status and the obligations and duties of the Governor of the NBP as member of the relevant decision-making bodies of the ECB. Moreover, the oath does not contain any reference to the requirement of central bank independence as enshrined in Article 130 TFEU. The oath as it stands now is an imperfection and should be adapted to be in line with the TFEU and the ESCB/ECB Statute.

The wording of Article 9(5) of the NBP Act containing grounds for dismissal of the NBP's Governor could lead to interpretative issues and is an imperfection. In addition, under Article 25(3) in conjunction with Article 3 and Article 1(1)(3) of the State Tribunal Act<sup>(46)</sup>, the Governor of the NBP may also be removed from office if he or she violates the Constitution or a law.

To provide for legal certainty and ensure correctness, these provisions would need to be clarified in the sense that these grounds correspond to a lack of fulfilment of conditions required for the performance of the Governor's duties or a serious misconduct of which the Governor has been guilty, as set out in Article 14.2 of the ESCB/ECB Statute, and do not extend those grounds in any way.

The State Tribunal Act<sup>(47)</sup> provides for the suspension of the Governor from his/her duties following a procedure that contains some imperfections as regards the Union law principle of central bank independence and Article 14.2 of the ESCB/ECB Statute. Pursuant to the second sentence of Article 11(1) of the State Tribunal Act read in conjunction with its Articles 3 and 1.1(3), the Governor of the NBP can be suspended as a result of an indictment by the Parliament for violating the Constitution or an act of law when performing his/her duties even before the State Tribunal has delivered its judgment on the removal from the office. While suspending a Governor for the purpose of a (criminal) investigation may be provided for, the Governor concerned is always entitled to bring an action for annulment against such a temporary measure before the Court of Justice of the European Union (CJEU) pursuant to Article 14.2 of the ESCB/ECB Statute. In that context, the Governor may also request the CJEU to adopt interim measures pursuant to Article 279 TFEU. The purpose of such an action pursuant to Article 14.2 of the ESCB/ECB Statute is to enable the CJEU to review the legality of such a temporary prohibition of performing a Governor's duties, which is only possible if there are sufficient indications that he/she has engaged in serious misconduct capable of justifying such a measure<sup>(48)</sup>. Such a guarantee is a reflection of the Union law principle of central bank independence and is of significant importance, especially in case of a suspension from office on grounds of serious misconduct further to an indictment by a parliamentary body depriving the Governor of the possibility to continue exercising the duties. In the absence of any clear reference in the NBP Act or Constitution to the Union law principle of central bank independence, the NBP Act would

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<sup>(46)</sup> Ustawa o Trybunale Stanu of 26 March 1982. Consolidated version published in Dziennik Ustaw of 2024, item 95.

<sup>(47)</sup> State Tribunal Act, Dziennik Ustaw of 2019, item 2122.

<sup>(48)</sup> Judgment of the Court of Justice of the EU (Grand Chamber) of 26 February 2019 Ilmārs Rimšēvičs and European Central Bank v Republic of Latvia, Joined Cases C-202/18 and C-238/18, ECLI:EU:C:2019:139. In this ruling, the CJEU declared it has jurisdiction to hear and determine an action of annulment brought against a temporary measure like a suspension of performing duties as a Governor under Article 14.2 of the ESCB/ECB Statute.

need to recall that the Governor of the NBP has the possibility to seek legal redress against his/her dismissal, or suspension before the CJEU, as enshrined in Article 14.2 of the ESCB/ECB Statute.

According to Article 203(1) of Poland's Constitution, the Supreme Audit Office (Najwyższa Izba Kontroli (NIK)) is entitled to examine the NBP's activities as regards its legality, economic prudence, efficiency and diligence. The NIK controls are not performed in the capacity of an independent external auditor, as laid down in Article 27.1 of the ESCB/ECB Statute and thus, should for legal certainty reasons be clearly defined so as to respect Article 130 TFEU and Article 7 of the ESCB/ECB Statute. Furthermore, the provision's relationship with Article 69.1 of the NBP Act is also unclear. The relevant provision of the Constitution is therefore incompatible and needs to be adapted in order to comply with Article 130 TFEU and Article 7 of the ESCB/ECB Statute.

### 5.1.3. Prohibition of monetary financing and privileged access

Article 42 in conjunction with Article 3(2)(5) of the NBP Act allow the NBP to extend refinancing loans to banks in order to replenish their funding and also extend refinancing to banks for the implementation of bank rehabilitation programmes, subject to conditionality under Article 42(4) of the same Act. Against this background, the current wording of Article 42(3) and (4) can be interpreted as allowing an extension of refinancing loans to banks experiencing rehabilitation proceedings which, however, could end in insolvency of the banks concerned. Effective preventive measures and more explicit safeguards should be provided in the NBP Act to ensure the compatibility of those provisions with Article 123 TFEU.

Article 43 of the NBP Act in conjunction with Articles 270 and 306 of the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring<sup>(49)</sup> provides for NBP's powers to grant short-term credit to the Bank Guarantee Fund related to the financing of its deposit guarantee function, if a threat to financial stability arises and in view of its urgent needs. The Bank Guarantee Fund qualifies as a 'body governed by public law' within the meaning of Article 123(1) TFEU. The Bank Guarantee Fund is closely dependent on public sector entities referred to in Article 123(1) TFEU, as the majority of the members of the Bank Guarantee Fund's Council are appointed by the Minister competent for financial institutions and the Chairman of the Financial Supervisory Authority (Article 7(4) of the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring). Therefore, the provisions laid down in the NBP Act and the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring regarding the possibility of NBP granting loans to the Bank Guarantee Fund are not compatible with the prohibition of monetary financing. The relevant legal framework should be amended accordingly.

As such, there is also no direct reference to the prohibition on monetary financing in the NBP Act. While Article 220(2) of the Polish Constitution provides that the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State's central bank, and this could be interpreted as a reference to the rationale of Article 123 TFEU, this provision is not compatible with Article 123 TFEU. At the occasion of a future amendment to the Polish Constitution, Article 220(2) should be amended to ensure compatibility with the aforementioned principle.

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<sup>(49)</sup> Ustawa o Bankowym Funduszu Gwarancyjnym, systemie gwarantowania depozytów oraz przymusowej restrukturyzacji of 10 June 2016. Consolidated version published in Dziennik Ustaw of 2024, item 487.



#### 5.1.4. Integration into the ESCB

##### Objectives

Article 3(1) of the NBP Act sets the objectives of the NBP. It refers to the economic policies of the Government while it should make reference to the general economic policies in the Union, in line with Article 127(1) TFEU. This constitutes an incompatibility with respect to Article 127(1) TFEU and Article 2 of the ESCB/ECB Statute.

##### Tasks

The incompatibilities in the NBP Act and in the Polish Constitution in this area are linked to the following ESCB/ECB/EU tasks:

- limitation of the NBP's activities to the territory of the Republic of Poland (Article 2(3) of the NBP Act) and absence of a general reference to the BNB as an integral part of the ESCB (Article 227(1) of the Constitution and Article 1 of the NBP Act);
- definition and implementation of monetary policy (Articles 227(1) and (6) of the Constitution, Articles 3(2)(5), 12, 23, 38-50a, and 53 of the NBP Act);
- holding of foreign reserves; management of foreign exchange and the definition of foreign exchange policy (Articles 3(2)(2), 3(2)(3), 17(4)(2), 24 and 52 of the NBP Act);
- competences of the ECB and of the EU for banknotes and coins (Article 227(1), second sentence of the Constitution and Articles 4, 31-37 of the NBP Act). The NBP shall exercise its responsibility for issuing currency as part of the ESCB/Eurosystem;
- appointment of independent auditors - Article 69(1) of the NBP Act foresees that NBP accounts are examined by external auditors. The NBP Act does not take into account that the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the Council. It is incompatible with Article 27.1 of the ESCB/ECB Statute.

There are also some imperfections regarding the following issues:

- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 3(2)(1) of the NBP Act);
- incomplete recognition of the role of the ECB and of the EU in the collection of statistics (Article 3(2)(7) and 23 of the NBP Act);
- non-recognition of the role of the ECB in the field of international cooperation (Article 5(1) and 11(3) of the NBP Act).

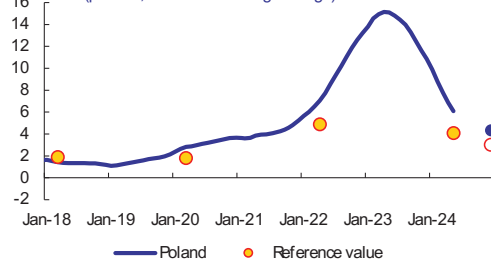
#### 5.1.5. Assessment of compatibility

As regards the independence of the central bank, the prohibition of monetary financing and the central bank's integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the NBP Act and the Constitution of the Republic of Poland is not fully compatible with the requirements of Article 131 TFEU, for the reasons set out above. The Polish authorities should remedy the abovementioned incompatibilities and imperfections.

## 5.2. PRICE STABILITY

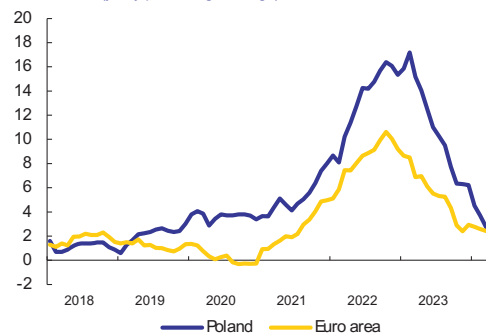
### 5.2.1. Respect of the reference value

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



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of Poland in December 2024. The reference values for 2018, 2020 and 2022 refer to the reference values calculated in the previous convergence reports.  
Source: Eurostat, Commission's Spring 2024 Economic Forecast.

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



Source: Eurostat.

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Poland in 2022. It continued to increase almost uninterruptedly to reach 13.2% by end 2022 and peaked in May 2023 at 15.1%. This point marked the beginning of a disinflationary phase in the economy, with the rate dropping to 10.9% by end-2023. In May 2024, the reference value was 4.1%, calculated as the average of the 12-month average inflation rates in the Netherlands, Italy and Latvia plus 1.5 percentage points. The corresponding inflation rate in Poland was 6.1%, i.e. 2.0 percentage points above the reference value. The 12-month average inflation rate is projected to remain above the reference value in the coming months.

### 5.2.2. Recent inflation developments

Poland recorded a significant and broad-based increase in annual HICP inflation in 2022 followed by rapid disinflation in the second half of 2023. Overall, headline inflation averaged 13.2% in 2022 and 10.9% in 2023. In 2022, inflation was driven by rising energy and food prices as well as accelerating HICP inflation excluding energy and food. Consumer energy and food prices increased in spite of sizeable government measures aimed at curbing energy price increases and a reduction of the VAT rate on some food products (both were introduced at the beginning of the year). Annual inflation peaked in February 2023 at 17.2% and gradually fell to 6.2% by the end of 2023 on the back of an easing of energy and food price pressures. In 2022 and 2023, annual HICP inflation in Poland was persistently higher than in the euro area.

*Table 5.1:*  
**Poland - Components of inflation**

	(percentage change) <sup>1)</sup>							weights in total
	2018	2019	2020	2021	2022	2023	May-24	2023
HICP	1.2	2.1	3.7	5.2	13.2	10.9	6.1	1000
Non-energy industrial goods	-0.3	0.4	0.9	2.4	7.7	7.9	4.4	298
Energy	3.7	0.0	-1.0	12.2	29.5	10.7	1.1	134
Unprocessed food	3.0	5.4	6.9	2.8	15.4	13.2	3.1	48
Processed food	1.8	3.7	3.9	2.7	11.9	15.0	9.4	218
Services	0.8	3.5	7.8	7.3	12.3	10.7	8.2	302
HICP excl. energy, food, alcohol and tobacco	0.2	1.9	4.3	4.8	9.8	9.3	6.3	600
HICP at constant tax rates	1.2	2.1	3.5	5.1	16.1	9.6	5.1	1000
Administered prices HICP	0.8	1.2	6.7	5.9	10.7	12.7	6.9	145

1) Measured by the arithmetic average of the latest 12-monthly indices relative to the arithmetic average of the 12-monthly indices in the previous period.  
Source: Eurostat, European Commission calculations.

HICP inflation excluding energy and food increased to 9.8% in 2022 and 9.3% in 2023. The upward trend of HICP inflation excluding energy and food in 2022 was broadly spread across all HICP categories, reflecting the secondary effect of increasing commodity prices and persistent supply chain bottlenecks on production costs. Labour shortages and a large increase in the minimum wage of about 20% in 2023 also played a role, in particular for service inflation. Relatively strong demand allowed businesses to pass higher production costs to consumers. HICP inflation excluding energy and food peaked in the first quarter of 2023 and slowed gradually in the second half of the year in a context of declining producer prices, deceleration of economic activity, fall in consumption and demand pressures, as well as more restrictive monetary policy.

### 5.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and growth developments

While the economy remained resilient in 2022 and posted a real GDP growth of 5.5%, growth slowed to 0.2% in 2023. The main growth drivers in 2022 were domestic demand, in particular private consumption, inventories and investment, alongside a positive contribution from net exports. Despite weakening sentiment and high inflation, private consumption was propped up by significant policy support, low unemployment, a drawdown of savings, and the inflow of displaced persons from Ukraine. In 2023, domestic demand including inventories decreased significantly while activity was held up by resilient net exports as non-EU exports continued to increase and imports fell reflecting weak domestic demand. Buoyant investments in 2023 benefitted from continued high profitability of companies and the culmination of EU funding from the 2014-20 programming period. Growth is set to pick up in 2024 and 2025.

The fiscal stance was strongly expansionary in 2022 at -3.2% of GDP, driven by fiscal measures adopted to compensate for high energy prices and the cost of aid to refugees <sup>(50)</sup>. The energy support measures and aid to refugees continued in 2023. Indexation of pensions, public salary increases and growing expenditure on defence also contributed to higher public spending. In result, the fiscal stance remained expansionary at -0.8% of GDP in 2023. According to the Commission's Spring 2024 Economic Forecast, the fiscal stance is expected to remain expansionary at -2.4% of GDP in 2024, due to growth in nationally-financed primary current expenditure, including the impact of new social benefits (pensions, family allowances), public salary increases (teachers, public administration) and defence

<sup>(50)</sup> The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

expenditures (continued costs related to investment in increasing the potential of the army). In 2025, the fiscal stance is set to become contractionary at 0.7% of GDP.

Table 5.2:

Poland - Other inflation and cost indicators

(annual percentage change)

	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
<b>HICP inflation</b>								
Poland	12	2.1	3.7	5.2	13.2	10.9	4.3	4.2
Euro area	1.8	1.2	0.3	2.6	8.4	5.4	2.5	2.1
<b>Private consumption deflator</b>								
Poland	1.5	2.2	3.5	5.4	14.0	10.8	4.5	4.2
Euro area	1.5	1.1	0.6	2.3	6.8	6.0	2.4	2.0
<b>Nominal compensation per employee</b>								
Poland	7.6	8.6	5.3	4.7	9.1	13.4	10.1	7.1
Euro area	2.1	2.2	-0.4	4.2	4.5	5.1	4.2	3.1
<b>Labour productivity</b>								
Poland	5.4	4.5	-2.0	4.3	1.7	0.0	2.8	3.3
Euro area	0.1	0.2	-4.7	4.4	1.1	-1.0	0.1	0.9
<b>Nominal unit labour costs</b>								
Poland	2.1	3.9	7.5	0.4	7.3	13.3	7.0	3.6
Euro area	2.0	1.9	4.6	-0.2	3.3	6.2	4.1	2.2
<b>Imports of goods deflator</b>								
Poland	2.9	1.7	-0.4	12.3	24.3	-6.7	-1.5	2.0
Euro area	2.6	-0.6	-3.8	9.7	21.6	-4.9	0.4	1.8

1) Commission's Spring 2024 Economic Forecast.

Source: Eurostat, Commission's Spring 2024 Economic Forecast.

## Wages and labour costs

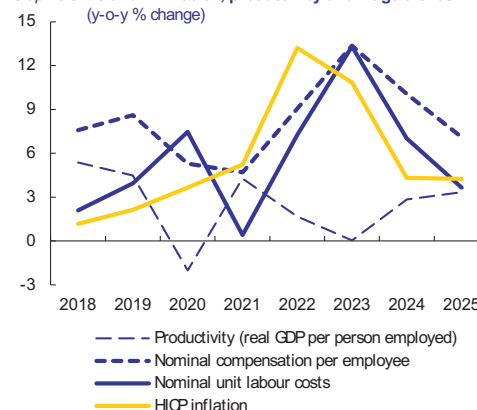
Nominal labour costs rose rapidly in 2022 and 2023 in the context of high inflation and a tight labour market but their growth is set to ease in 2024 and 2025. Nominal compensations per employee, as well as nominal unit labour costs growth surpassed the euro area average in 2022 and 2023. Labour productivity increased by 1.7% in 2022, which was above the euro area average (1.1%), and remained on the same level in 2023, while euro area productivity declined by 1%. At close to 3%, the unemployment rate remained historically low in both years, and was one of the lowest in the EU. Companies continued to report labour shortages, albeit the vacancy rate started to ease in the second half of 2023, suggesting some softening of labour demand. In 2024, wages of most public administration employees are set to increase by 20% and of teachers by 30%.

Minimum wage increased by close to 20% in 2023 and is set to rise by about 20% also in 2024. Looking ahead, labour productivity is set to grow faster than the euro area average in 2024 and 2025 as economic growth accelerates, according to the Commission's Spring 2024 Economic Forecast.

## External factors

Buoyant import prices have played a critical role in the acceleration of inflation in 2022 but slowed visibly in 2023. Prices of imported goods increased rapidly by 24.3% in 2022 reflecting energy and food price hikes and surpassing the euro area average of 21.6%. In 2023, the imported goods inflation turned

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



Source: Eurostat, Commission's Spring 2024 Economic Forecast.

negative (-6.7%), as global energy and commodity price pressures eased, while the imported good inflation in the euro area was -4.9%.

The zloty's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated on average by 2.3% in 2022, contributing to push up import prices, but appreciated strongly by 4.8% in 2023, more than reversing its inflationary effect of the previous year.

#### Administered prices and taxes

Administered prices rose more slowly than headline HICP inflation in 2022, but faster in 2023. While headline inflation slowed in 2023, administered prices accelerated from 10.7% in 2022 to 12.7% in 2023. At the same time the weight of administered priced in the HICP basket increased from 12.4% in 2022 to 14.5% in 2023 and was above the euro area average (13% in 2023).

The key driver of the growth of administered prices in 2022 and 2023 were energy prices <sup>(51)</sup> in the context of the Russia's full-scale invasion of Ukraine and turbulence in global energy commodity prices. Administered energy prices contributed by 7.6 percentage points to the increase in overall administered prices in 2022 and by 9.8 percentage points in 2023. The Polish government adopted a number of measures in 2022 and 2023 that reduced the passthrough of global energy price increases to household prices in Poland. These included lower VAT and excise duties on electricity and heat energy in 2022, electricity and gas prices freezing in 2023, and a possibility to buy coal for a set price introduced in 2022 and valid also in 2023.

The impact of tax changes on headline inflation was more pronounced in 2022 and 2023 than in previous years. In 2022, the changes in taxes and excise duties reduced inflation by 2.9 percentage points, while in 2023 the expiration of the 2022 measures increased headline HICP by 1.3 percentage points. In 2022, new temporary measures included a reduced VAT rate on some food products, electricity, gas, heating, fuels, as well as a decrease in excise duties on electricity, gas and some fuels. The lower VAT and excise rates introduced in 2022 expired in December 2022, apart from the VAT on basic food products, which has been extended beyond 2023.

#### Medium-term prospects

Looking ahead, inflation is expected to decelerate in 2024 and 2025 but remain high in a historical perspective. The Commission's Spring 2024 Economic Forecast projects that annual HICP inflation will average 4.3% in 2024 and 4.2% in 2025, and reflects a more gradual unfreezing of energy prices in 2024-H2 and high services price pressures amid large wage increases. Core inflation is set to remain elevated with a visible contribution from robust services prices reflecting strong wage growth and a sizeable minimum wage increase of about 20% in 2024. The inflation outlook remains uncertain due to downside risks from weaker than projected domestic demand and, on the upside, a tight labour market.

The level of consumer prices in Poland was at around 57% of the euro area average in 2022. This suggests a potential for price level convergence in the long term, as GDP per capita in purchasing power standards (PPS), representing about 77% of the euro area average in 2023, increases towards the euro area average.

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<sup>(51)</sup> In 2022, administered energy prices included electricity, gas, and heat energy tariffs and were set by the Energy Regulatory Office reflecting energy providers' costs and market prices. In 2023, administered energy prices also included coal due to government steps to keep consumer prices of coal low.

### 5.3. PUBLIC FINANCES

#### 5.3.1. Recent fiscal developments

In 2022, the general government deficit amounted to 3.4% of GDP, up from 1.8% of GDP in 2021. Public finances were impacted by the cost of aid to people fleeing Ukraine, which covered social benefits, accommodation subsidies as well as expenditures on education and healthcare. The government also took a series of measures to mitigate the impact of high energy prices, including lowering VAT rates and excise duties, cash heating subsidies to households and a multi-annual support scheme for energy-intensive industries. These costs, combined with the decreased revenues resulting from the personal income tax reform <sup>(52)</sup>, put pressure on public finances. On the other hand, the budgetary balance was supported by soaring revenues from corporate income taxes owing to the high profits of companies. The general government deficit further increased to 5.1% of GDP in 2023. The main expenditure measures included: increased spending on defence, higher salaries in the public sector and extraordinary subsidies to farmers related to turbulences on the local grain markets. Social benefits also increased, due to high indexation of pensions based on the high inflation in 2022. At the same time, lower than assumed nominal growth, which was driven by the gradual disinflation, resulted in a shortfall of revenues from indirect taxes. The estimated net cost of energy-related support measures moderated due to falling commodity prices. Besides, the electricity and gas prices freeze schemes were partly funded by levies on windfall profits of energy producers. The total net cost of energy support was estimated at 1.9% of GDP in 2022 and 0.6% of GDP in 2023. Most of the measures were not targeted, while they tended to preserve price signals.

The Commission report under Article 126(3) concludes that, after considering the opinion of the **Economic and Financial Committee**, the Commission intends to propose to open an excessive deficit procedure for Poland, by proposing to the Council to adopt a Decision under Article 126(6) establishing the existence of an excessive deficit. On 19 June 2024, the Commission adopted a report under Article 126(3) of the TFEU. The report assessed the budgetary situation of Poland, as its government deficit in 2023 exceeded the Treaty reference value of 3% of GDP. The report concluded that the general government deficit in 2023 exceeded and was not close the Treaty reference value of 3% of GDP. The excess over the Treaty reference value was not considered to be exceptional and was not expected to be temporary.

Despite a high general government deficit, the public debt ratio decreased in 2022 thanks to the debt-decreasing snowball effect driven by high nominal growth, owing both to inflation and real growth. The debt ratio declined by 4.4 percentage points, down to 49.2% of GDP. In 2023, while the debt-decreasing contribution of inflation remained strong, the contribution of real GDP growth declined significantly in line with the economic slowdown. At the same time, both the primary deficit and interest expenditure increased, raising the debt ratio by 0.4 percentage point to 49.6% of GDP.

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<sup>(52)</sup> The 2022 'Polish Deal' and 'Low Taxes' reforms overhauled personal income taxation in Poland, including raising of the tax-free amount to PLN 30 000, decreasing the lower personal income tax rate from 17% to 12% and increasing the threshold to PLN 120 000, from which the 32% upper tax rate applies.



Table 5.3:

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

<b>Outturn and forecast <sup>1)</sup></b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024<sup>1)</sup></b>	<b>2025<sup>1)</sup></b>
General government balance	-0.2	-0.7	-6.9	-1.8	-3.4	-5.1	-5.4	-4.6
- Total revenue	41.2	41.1	41.3	42.3	40.2	41.6	44.0	43.9
- Total expenditure	41.4	41.9	48.2	44.1	43.6	46.7	49.4	48.5
of which:								
- Interest expenditure	1.4	1.4	1.3	1.1	1.5	2.1	2.2	2.4
p.m.: Tax burden	35.9	36.0	36.4	37.6	35.2	35.9	37.7	37.6
Primary balance	1.2	0.6	-5.6	-0.7	-1.9	-3.0	-3.2	-2.2
Fiscal stance <sup>2)</sup>					-3.2	-0.8	-2.4	0.7
Recommended growth in net nationally financed primary expenditure (%)							7.8	-
Growth in net nationally financed primary expenditure (%)							12.8	-
Government gross debt	48.7	45.7	57.2	53.6	49.2	49.6	53.7	57.7
p.m.: Real GDP growth (%)	5.9	4.5	-2.0	6.9	5.6	0.2	2.8	3.4

1) Commission's Spring 2024 Economic Forecast.

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

Source: European Commission.

### 5.3.2. Medium-term prospects

The 2024 budget was adopted on 18 January 2024. It targets a general government deficit of 5.1% of GDP. According to the budget law, the key policies of the previous year will be continued, in particular regarding social benefits (pensions, family allowances) and defence (investments in increasing military potential of the army). By a revision of the original proposal from September 2023, the new coalition government added to the 2024 budget new measures reflecting its economic programme. These include a 30% salary increase for teachers, a 20% general salary increase in the public administration and a new family benefit to support working parents. Regarding energy support measures, the price freezing schemes for electricity and gas that were bound to be phased out at the end of 2023 were extended for 6 months, however without increasing net costs to the budget, as they were assumed to be fully financed by levies on energy producers. However, in April 2024 the government decided to extend the energy measures beyond June 2024, in form of price ceilings for electricity, gas and district heating, to ensure their gradual withdrawal. Total net cost of energy support is estimated at 0.5% of GDP in 2024.

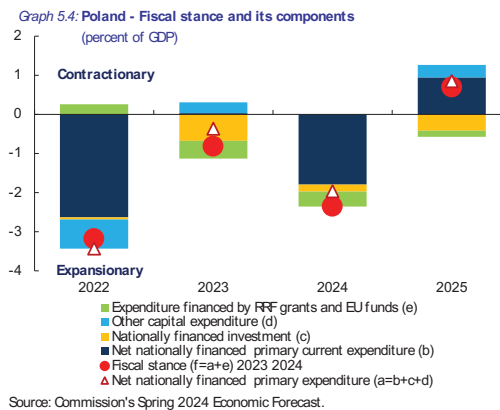
On 30 April 2024, Poland adopted its Multiannual State Financial Plan 2024-2027, no more including Convergence Programme. According to the Plan, the headline deficit is projected to remain at 5.1% of GDP in 2024 and decline gradually to 4.4% in 2025, 3.8% in 2026 and 3.3% in 2027. The public debt to GDP ratio is forecast to increase to 53.4% in 2024, 57.3% in 2025, 60.5% in 2026 and 61.3% in 2027. Poland is expected to submit its medium-term fiscal-structural plan, including additional consolidation measures, under the EU's new economic governance framework by mid-October 2024.

The Commission's Spring 2024 Economic Forecast, which is based on a no-policy change assumption, projects a general government deficit of around 5.4% of GDP in 2024. The difference from the planned deficit in the Multiannual State Financial Plan stems, in particular, from a less optimistic macroeconomic scenario with lower real and nominal GDP growth. In addition, the Commission forecast includes the impact of the extension of energy support measures beyond their earlier planned termination in June 2024, which is not



reflected in the macroeconomic scenario underpinning the Plan due to its earlier cut-off date. This leads to a lower inflation rate and higher fiscal costs in the Commission forecast. The Commission projects the general government debt at 57.7% of GDP in 2025 as the projected deficits are higher and the nominal GDP lower than in the forecast of the Multiannual State Financial Plan.

Based on the Commission's estimates, the fiscal stance is projected to be strongly expansionary at -2.4% of GDP in 2024, following an expansionary fiscal stance of -0.8% of GDP in 2023. The expansionary fiscal stance in 2024 is primarily driven by net nationally financed primary current expenditure (-1.8% of GDP) and expenditure financed by the RRF and the EU grants (-0.4% of GDP). Nationally financed investment also provides an expansionary contribution (-0.2% of GDP) while other capital expenditure provides a neutral contribution (0.0% of GDP).



On 14 July 2023, the Council recommended that Poland ensures a prudent fiscal policy, in particular by limiting the nominal increase in nationally financed net primary expenditure in 2024 to not more than 7.8%. According to the Commission's Spring 2024 Economic Forecast, Poland's net nationally financed primary expenditure is projected to increase by 12.8% in 2024, which is above the recommended maximum growth rate. This excess spending over the recommended maximum growth rate in net nationally financed primary expenditure corresponds to 2.0% of GDP in 2024.

Moreover, the Council recommended that Poland takes action to wind down the emergency energy support measures in force, using the related savings to reduce the government deficit, as soon as possible in 2023 and 2024. The Council further specified that, should renewed energy price increases necessitate new or continued support measures, Poland should ensure that these were targeted at protecting vulnerable households and firms, fiscally affordable, and preserve incentives for energy savings.

According to the Commission's Spring 2024 Economic Forecast, the net budgetary cost of energy support measures is projected at 0.6% of GDP in 2023, 0.5% in 2024, and 0.0% in 2025. The energy support measures are not projected to be wound down as soon as possible in 2023 and 2024. If the related savings were used to reduce the government deficit, as recommended by the Council, these projections would imply a fiscal adjustment of 0.21% of GDP in 2024, whereas net nationally financed primary expenditure provides an expansionary contribution to the fiscal stance of 2.0% of GDP in that year. Therefore, the related savings from the winding down of energy measures are not projected to be fully used to reduce the government deficit.

In addition, the Council also recommended that Poland preserves nationally financed public investment and ensures the effective absorption of Recovery and Resilience Facility grants and other EU funds, in particular to foster the green and digital transitions. According to the Commission's Spring 2024 Economic Forecast, nationally financed public investment is projected to increase to 4.0% of GDP in 2024 compared to 3.8% of GDP in 2023 and, therefore, it is expected to be preserved. In turn, the total public expenditure financed from revenues from EU funds, including Recovery and Resilience Facility grants, is expected to increase to 1.9% of GDP in 2024 (from 1.5% of GDP in 2023).

The general government deficit is projected to decrease gradually to 4.6% of GDP in 2025, reflecting no policy change in government expenditures and the increase of government revenues in line with the Commission's Spring 2024 Economic Forecast. In turn, the general government debt is projected to increase gradually to 57.7% of GDP in 2025, driven by the

high budgetary deficits and substantial stock-flow adjustments related to the timing of payment and deliveries of military investments. General government investment is projected to increase gradually to 5.4% of GDP in 2025, due to the high level of investments financed by the RRF and other EU funds as well as continued high level of national investments in defence.

Debt sustainability risks appear high over the medium run. Government debt is projected to increase steadily from around 54% in 2024 to around 85% of GDP in 2034. This projection assumes that the structural primary deficit slightly increases from 2.5% of GDP in 2023 to 2.6% of GDP in 2024 and remains at that level (excluding changes in the cost of ageing) over the projection period <sup>(53)</sup>.

The sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if the interest-rate growth differential were 1 percentage point higher than in the baseline scenario, the projected debt ratio in 2034 would be more than 6 percentage points of GDP higher than in the baseline and breach the 90% of GDP threshold.

Some factors increase risks, such as the recent increase in interest rates, potential legal costs associated with Swiss franc-denominated loans, the negative net international investment position and some exposure to non-performing loans. On the other hand, risk-mitigating factors include relatively stable financing sources (and with a large domestic investor base) and the currency denomination of debt (about three-quarters of outstanding debt is denominated in local currency).

The fiscal framework in Poland has been revised in the last two years, including via measures included in the Recovery and Resilience Plan. The numerical fiscal rules remain at the centre of the framework. While the debt ceilings anchored in the Constitution cover the central government, a separate debt rule concerns local government units. The latter was loosened in 2020 to allow for exclusions for pandemic-linked revenue loss; in addition, for 2020, the limit was lowered to 80% of the total revenue. The stabilising expenditure rule was broadened by including additional units and special purpose funds, in particular the National Fund for Environmental Protection and Water Management. Unlike until 2021, any newly created special purpose fund is now automatically included in the expenditure rule. Furthermore, the budget acts for 2023 and 2024 set limits on spending of a broader set of institutions including special purpose funds, thereby strengthening the parliamentary and public scrutiny during the budget approval process. While the four-year Multiannual State Financial Plan serves as basis for the preparation of annual budgets, it does not provide targets. Poland does not have a fully-fledged fiscal council and activities related to the monitoring of fiscal rules are scattered among several bodies, with the Supreme Audit Office taking a more central role. In late 2023, the new government announced plans to establish a fiscal council. The main features of the new institution are described in the Multiannual State Financial Plan. The fiscal council will initially play an advisory role to the Ministry of Finance and shall aim to fulfil the minimum requirements included in the amended Budgetary Framework Directive (2011/85/EU). The amended Directive extends the independence safeguards for independent fiscal institutions to all EU Member States and assigns some tasks to these institutions. In addition, the mandate of the new Polish fiscal council is expected to include some tasks related to the implementation of the national stabilising expenditure rule.

#### 5.4. EXCHANGE RATE STABILITY

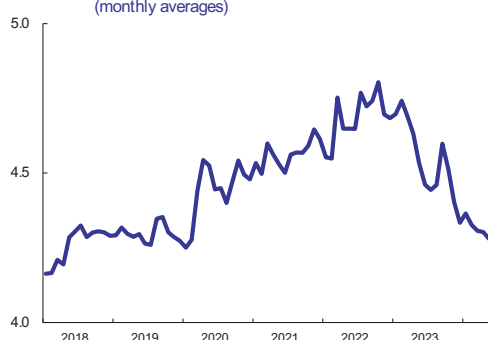
The Polish zloty does not participate in ERM II. Since April 2000, Poland has been operating a free-floating exchange rate regime, with the NBP preserving the right to intervene in the foreign exchange market, if it deems this necessary, in order to achieve the inflation target.

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<sup>(53)</sup> For details on the methodology, see European Commission (2024), Debt Sustainability Monitor 2023, Institutional Paper 271, March 2024.

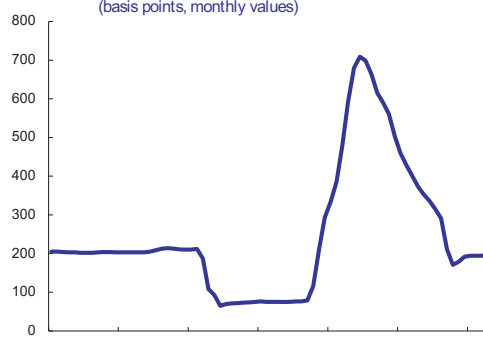
Throughout 2022 the zloty continued to trade at its weakest levels against the euro in almost two decades in the context of heightened risk aversion due to Russia's full-scale invasion of Ukraine. The exchange rate fluctuated between 4.60 and 4.80 PLN/EUR. This was followed by a period of appreciation during the first half of 2023, up to around 4.45 PLN/EUR between June and August. The appreciation phase was briefly interrupted mid-September when the currency weakened, likely due to an unexpectedly large interest rate cut by NBP. The last quarter of 2023 was again marked by a gradual appreciation, with the exchange rate averaging 4.33 PLN/EUR in December, reflecting increased investor confidence, expectations of EU funds inflow and changing perceptions on the future directions of monetary policy. Since then, the currency has traded at around 4.30 PLN/EUR with relatively minor fluctuations, returning to its pre-pandemic levels. In May 2024, zloty's exchange rate against the euro averaged 4.28.

Graph 5.5: Poland - PLN/EUR exchange rate  
(monthly averages)



Source: ECB.

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



Source: Polish National Bank, Eurostat and Thomson Reuters.

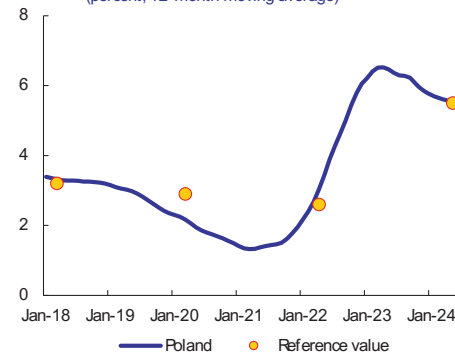
International reserves held by the NBP increased from EUR 144 billion in early 2022 to around EUR 192 billion in May 2024. The reserve-to-GDP ratio was at around 23.4% at end-2023.

The short-term interest rate differential with the euro area peaked at over 700 basis points in June 2022. The spread then gradually narrowed to 361 basis points by December 2022 as the three-month euro rate experienced larger increases compared to the slightly upward trend of the Polish rate, with NBP's final hike occurring in September 2022. In 2023, the euro area rate continued to rise, while the Polish 3-month rate stabilised, contributing to further spread decreases. After the NBP's policy rate cuts in September and October 2023, the spread differential stabilized at around 190 basis points – a level similar to that prevailing before the pandemic. In May 2024, the spread increased to 205 basis points, reflecting the cut in the key ECB interest rate.

## 5.5. LONG-TERM INTEREST RATES

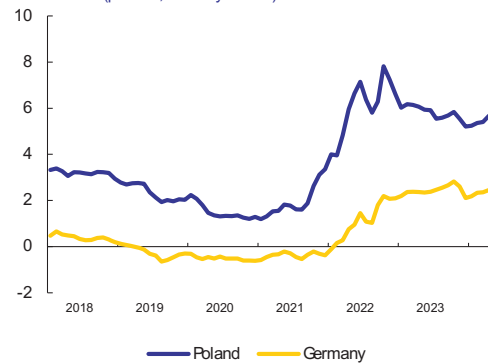
The long-term interest rates in Poland used for the convergence assessment reflect secondary market yields on a single benchmark government bond with a residual maturity of around 9 years.

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



Source: European Commission.

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



Source: Eurostat.

The Polish 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was 0.4 percentage point above the reference value at the time of the last convergence assessment in April 2022. It gradually increased from 3.0% at that time to about 6.1% by end-2022, peaking at 6.5% in April 2023. Since then, it has been on a downward path, reaching 5.8% by end-2023. In May 2024, the latest month for which data are available, the reference value, given by the average of long-term interest rates in the Netherlands, Italy and Latvia plus 2 percentage points, stood at 5.5%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 5.6%, i.e. 0.1 percentage point above the reference value.

The long-term interest rate of Poland initially continued its upward trend in 2022, peaking at 7.8% in October – the highest level since 2002. This reflected monetary policy rate increases, strong inflationary pressures and heightened risk aversion including due to Russia's full-scale invasion of Ukraine. Over that period, the long-term interest rate spread vis-à-vis the German benchmark bond repeatedly reached record levels of over 560 basis points, albeit with strong fluctuations. October 2022 marked a turning point, coinciding with the end of NBP's hiking cycle, after which the long-term interest rate entered a period of gradual decrease, reaching 5.7% in May 2024. As a result, the spread versus the German benchmark bond narrowed steadily until early 2024, before stabilising at around 315 basis points.

## 5.6. ADDITIONAL FACTORS

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

In November 2023, the Commission published its 13th Alert Mechanism Report (AMR 2024) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which assessed that overall risks in Poland remain limited but highlighted developments related to unit labour costs. Nominal unit labour costs increased in 2022 and 2023 in excess of the euro area average, raising cost competitiveness risks in the medium term. External sustainability concerns remain contained, and the current account balance improved to a surplus of 1.7% of GDP in 2023. A more robust growth of nominal house prices was broadly in line with fundamentals, as incomes rose sharply and house prices declined in real terms in both 2022 and 2023. The 2024 AMR concluded that no In-Depth Review was warranted.

Poland's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, to

boost its competitiveness and stimulate sustainable growth and reduce the country's territorial and social disparities. The RRF funding provides Poland with EUR 59.8 billion over the 2021-2026 period.

The implementation of Poland's recovery and resilience plan is underway, however timely completion requires increased efforts. Poland has submitted one payment request, corresponding to 38 milestones and targets in the plan and resulting in a disbursement of EUR 6.3 billion on 15 April 2024. The Commission has so far disbursed a total of EUR 11.4 billion to Poland, of which EUR 8.1 billion in loans, including EUR 5.1 billion of pre-financing payments. The size and complexity of the plan, and challenges linked to absorption capacity, call for accelerating investments and addressing emerging delays while strengthening administrative capacities to ensure that reforms and investments can be completed on time. While Poland is taking some measures to address the lack of administrative capacity, challenges remain in particular in terms of finishing the largest investments within the lifetime of the RRF.

In addition, cohesion policy provides Poland with EUR 75.5 billion for the 2021-2027 period. Cohesion policy financing aims particularly to further support Poland's competitiveness by boosting R&D investment and high-tech exports, digitalisation, the green and just transition and the development of skills and public services, including access to formal childcare for children under three years of age. Poland has made progress in implementing cohesion policy but challenges remain and regional disparities between eastern regions and the rest of the country have continuously widened.

#### 5.6.1. Developments in the balance of payments

Poland's external balance (i.e., the combined current and capital account) was volatile in 2022-23. The 2022 deficit (-1.9% of GDP) became a surplus in 2023 (1.8% of GDP), largely driven by developments in the current account. The current account deteriorated in 2022 due to a deeper negative balance of trade in goods, following substantial increase in imported energy prices. In 2023, the current account turned positive as imported energy prices fell, leading to improved terms of trade and imports dropped in a context of weaker domestic demand including inventories. Exports continued to increase in 2023, in particular to non-EU trading partners. The balance of trade in services remained positive in 2022 and 2023 with improvement including in IT services.

The income balance remained negative over 2022-2023 reflecting negative primary and increasingly also secondary income balances. The negative primary income balance both reflected a negative income balance, particularly in relation to reinvested earnings on FDI, and, to a lesser extent, a negative balance of the compensation of employees. The secondary income balance was slightly negative in 2022 and 2023.

Table 5.4:

Poland - Balance of payments		(percentage of GDP)				
	2018	2019	2020	2021	2022	2023
Current account	-1.9	-0.2	2.5	-1.3	-2.4	1.6
of which: Balance of trade in goods	-2.3	-0.8	1.3	-1.3	-3.7	0.8
Balance of trade in services	4.3	4.5	4.4	4.6	5.6	5.3
Primary income balance	-4.2	-4.2	-3.8	-4.5	-3.9	-4.2
Secondary income balance	0.2	0.2	0.5	-0.1	-0.3	-0.3
Capital account	1.6	1.7	1.8	0.7	0.5	0.2
External balance <sup>1)</sup>	-0.3	1.4	4.2	-0.6	-1.9	1.8
Financial account	-0.1	1.0	3.4	-0.5	-1.8	1.3
of which: Direct investment	-2.8	-2.0	-2.4	-3.8	-3.6	-2.3
Portfolio investment	0.8	2.0	1.3	1.7	-0.4	0.6
Other investment <sup>2)</sup>	0.8	-0.7	1.4	-1.1	0.3	0.4
Change in reserves	1.2	1.7	3.1	2.8	2.0	2.5
Financial account without reserves	-1.3	-0.7	0.3	-3.2	-3.8	-1.3
Errors and omissions	0.3	-0.4	-0.8	0.1	0.1	-0.5
Gross capital formation	21.5	20.5	18.8	21.8	22.1	18.1
Gross saving	19.5	20.2	21.1	20.4	19.6	20.1
Net international investment position	-54.7	-48.8	-43.9	-39.8	-33.3	-31.4

1) The combined current and capital account.

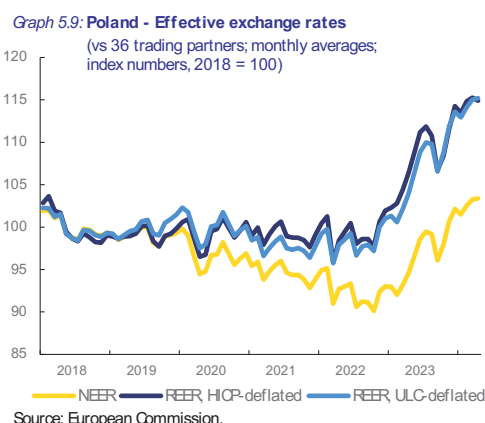
2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, the National Bank of Poland.

The negative balance of the financial account deepened in 2022 before turning positive in 2023. The volatility was mainly due to portfolio investments, which turned negative in 2022 (-0.4% of GDP), but rebounded swiftly in 2023 (+0.6% of GDP). The direct investment balance remained strongly negative, close to -2.3% of GDP.

Poland's external competitiveness deteriorated somewhat in 2022 and 2023. Poland's export performance (as measured by the growth of its exports relative to its foreign markets) stagnated in 2022 and declined in 2023. The nominal effective exchange rate depreciated in 2022 but appreciated in 2023.

The real effective exchange rate (REER) was broadly unchanged in 2022 and appreciated substantially in 2023. The net international investment position (NIIP) as a share of GDP improved significantly from -39.8% in 2021 to -31.4% in 2023. It is now below the indicative threshold set in the MIP scoreboard (-35% of GDP). Moreover, external vulnerabilities remain contained, as major part of the NIIP consists of the accumulated stock of foreign direct investments.



## 5.6.2. Market integration

Poland's economy is well-integrated with the euro area, through both trade and investment linkages. Trade openness (see Table 5.5 for a definition) decreased from 65% in 2022 to 57% of GDP in 2023. The share of trade with euro area partners expressed in percentage of GDP saw a slightly upward trend in recent years, before dropping to 32.3% in 2023.



Poland's main goods trading partners in 2023 were Germany, the Netherlands, Czechia, China and France.

FDI inflows to Poland have originated mainly from the Netherlands, Germany, Luxembourg and France, which together provided more than a half of the FDI stock at the end of 2023. Reinvested earnings constituted a big part of the capital inflow in 2023, following high profitability of companies. Apart from the significant size of the domestic market as well as access to the EU market, efforts to increase the resilience of supply chains by nearshoring in the context of the geopolitical tensions might have also contributed to Poland's attractiveness as a place for investment.

Table 5.5:  
Poland - Market integration

	2018	2019	2020	2021	2022	2023
Trade openness <sup>1)</sup> (%)	54.7	54.3	53.1	59.5	64.8	57.1
Trade with EA in goods & services <sup>2)+3)</sup> (%)	31.1	30.7	30.5	34.2	36.2	32.3
IMD World Competitiveness Ranking <sup>4)</sup>	34	38	39	47	50	43
Internal Market Transposition Deficit <sup>5)</sup> (%)	1.0	0.8	1.8	1.5	2.1	1.6
Real house price index <sup>6)</sup>	109.9	116.9	124.8	129.2	126.8	124.4

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

2) (Imports + Exports of goods with EA-20 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-20 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) International Institute for Management Development (IMD).

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

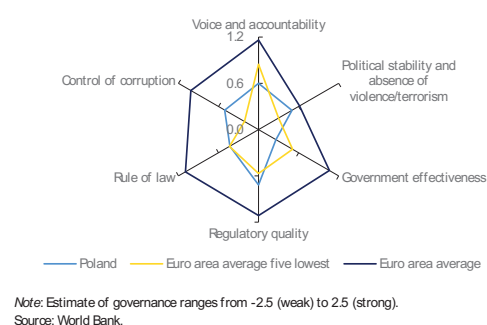
6) Deflated house price index (2015=100) (Eurostat).

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

On the basis of selected indicators relating to the institutional environment, Poland ranks below the average of euro area Member States. According to the World Bank's 2022 Worldwide Governance Indicators, Poland ranks lower than the average of the five euro area Member States with the lowest scores in relation to indicators that measure voice and accountability, and government effectiveness (<sup>54</sup>) (<sup>55</sup>). Poland ranks higher than the average five lowest euro area Member States for political stability and absence of violence/terrorism, and control of corruption.

In the IMD's World Competitiveness Index, Poland's position worsened in 2022 (placing 50th) before improving somewhat in 2023 (placing 43rd), but it remained weaker than in the previous years. In the Single Market Scoreboard, according to the latest data, Poland lags behind in the transposition of EU directives as the deficit was at 1.6% in 2023, which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

Graph 5.10: Poland - World Bank's 2022 Worldwide Governance Indicators



The legal and institutional framework to prevent and combat corruption is largely in place and Poland has adopted a comprehensive reform of the disciplinary regime applicable to judges. Building on these reform measures, Poland has also committed to implement further reforms in an Action Plan on the rule of law.

<sup>(54)</sup> A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage point lower (higher) than that of the average of this group of five euro area Member States.

<sup>(55)</sup> According to the World Bank's methodology, 'voice and accountability' captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. See <https://www.worldbank.org/content/dam/sites/govindicators/doc/va.pdf>.



Poland presented an Action Plan on 'rule of law' to the General Affairs Council in February 2024. This plan aims to address concerns raised by the Commission under the Article 7(1) TEU procedure (relating the certain aspects of the independence of the Polish judiciary).

Table 5.6:

**Poland - Allocation of assets by financial sub-sector**

	PL		EA		Ratio to GDP (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Financial corporations (total)	154	144	689	715	174	190
Central bank	21	29	53	68	46	52
Monetary financial institutions	90	82	266	290	87	93
Other financial intermediaries	11	10	181	163	16	18
Non-MMF investment funds <sup>1)</sup>	15	10	101	113	4	5
Insurance co. and Pension Funds	18	13	87	81	21	22
	PL		EA		Share of total (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Central bank	14	20	8	10	27	27
Monetary financial institutions	58	57	39	40	50	49
Other financial intermediaries	7	7	26	23	9	10
Non-MMF investment funds	10	7	15	16	2	3
Insurance co. and Pension Funds	11	9	13	11	12	11

1) MMF stands for money market funds.

Source: Eurostat.

Poland has notified a complete transposition of the 5th Anti-Money Laundering Directive. The Commission has assessed the transposition as complete and in conformity. Poland has further achieved a satisfactory level of transparency of legal persons, arrangements, and their beneficial ownership, although deficiencies remain in the application of the requirement for determining and verifying the identity of beneficial owners. More efforts are required to identify and assess certain money laundering and terrorism financing (ML/TF) threats and vulnerabilities. There are shortcomings in applying effective, proportionate and dissuasive sanctions and administrative penalties for breaches of anti-money laundering and countering the financing of terrorism (AML/CFT) requirements.

The labour market has performed well in 2022 and 2023 but challenges related to labour supply remain. The Commission's 2024 Country Report for Poland highlighted low labour market participation of some population groups, notably women, persons with disabilities and older people and skills mismatches. Several of the country's recovery and resilience plan (RRP) reforms are expected to improve labour market participation, strengthen public employment services, and improve access to childcare.

Table 5.7:

Poland - Financing of the economy<sup>1)</sup>

	PL		EA		Ratio to GDP (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Liabilities (total)	267	237	706	696	316	304
Loans	97	87	228	219	109	103
Non-financial co. debt securities	5	2	12	12	3	2
Financial co. debt securities	7	12	66	58	3	4
Government debt securities	43	35	78	71	47	42
Listed shares	26	18	60	63	12	10
Unlisted shares	26	19	176	184	54	53
Other equity	42	41	53	54	56	58
Trade credits and advances	22	23	34	35	31	32

	PL		EA		Share of total (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Loans	36	37	32	32	34	33
Non-financial co. debt securities	2	1	2	2	1	1
Financial co. debt securities	2	5	9	8	1	1
Government debt securities	16	15	11	10	15	14
Listed shares	10	8	9	9	3	3
Unlisted shares	10	8	25	26	19	19
Other equity	16	17	7	8	17	18
Trade credits and advances	8	10	5	5	10	11

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

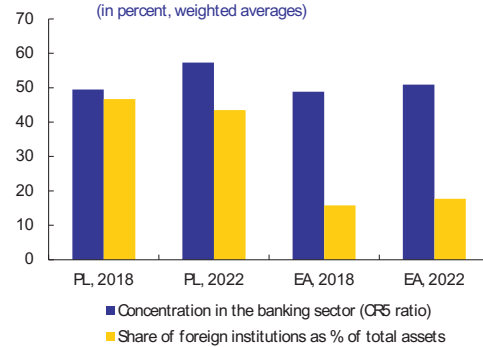
Source: Eurostat.

The financial sector in Poland is smaller and less developed than in the euro area. Relative to GDP, assets managed by the financial sector amounted to 144% of GDP in 2022, which is much less than in the euro area (715% of GDP). The financial sector's size has decreased slightly since 2018, in contrast to the small increase registered in the euro area. Banking dominates the Polish financial sector and made up 57% of the financial sector's assets in 2022. The central bank is the second largest holder of financial assets with a share of 20%. These shares are larger than for the euro area and reflect the relative underdevelopment of non-bank financial intermediaries and investment funds. They are comparable to that of the five euro area Member States with the smallest financial sectors, although the share of investment funds in total assets is more than twice as high in Poland as it is in these Member States. Based on its relative size in the assets held by the financial sector, the insurance and pension-fund sector in Poland is comparable to the euro area average, although it is much smaller relative to GDP (13% of GDP in 2022 vis-à-vis 81% of GDP in the euro area).

As to the financing of the economy, outstanding liabilities are much lower than in the euro area (237% of GDP in 2022 vis-à-vis 696% of GDP in the euro area) and lower than in the five euro area Member States with the lowest financing needs. Like in the euro area, loans are the dominant source of funding (37% of outstanding liabilities in 2022). However, Poland has less developed bond and equity markets than the euro area, and market financing (debt securities and listed shares) is relatively less developed. Equity and private sector debt markets represented 14% of liabilities in 2022 (and only 32% of GDP altogether), compared to 19% of liabilities in the euro area, where private-sector debt and listed stocks amounted to 70% and 63% of GDP respectively. However, Poland is still relatively comparable to the five euro area Member States with the smallest financing needs and its listed equity market is more developed than in these Member States. As a share of GDP, the government debt market is less than half as large as that of the euro area average, which reflects the lower level of public debt in Poland.

Poland's banking sector is well-integrated into the euro area financial sector, in particular through a high level of foreign ownership in its banking system. The share of foreign-owned institutions in total bank assets stood at 44% in 2022. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased notably since 2018, and reached 57% in 2022, almost 7 percentage points above the euro area average.

Graph 5.11: Poland - Foreign ownership and concentration in the banking sector  
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

## 6. ROMANIA

### 6.1. LEGAL COMPATIBILITY

#### 6.1.1. Introduction

The Banca Națională a României (BNR – Romanian national bank, hereafter ‘BNR’) is governed by Law No. 312 on the Statute of the Bank of Romania of 28 June 2004 (hereinafter ‘the BNR Law’) which entered into force on 30 July 2004.

The BNR law has not been amended since the Commission’s 2022 Convergence Report. Therefore, the comments provided in the Commission’s 2022 Convergence Report remain relevant and are repeated in this year’s assessment.

#### 6.1.2. Central bank independence

As regards central bank independence, a number of incompatibilities and imperfections have been identified with respect to the TFEU and the ESCB/ECB Statute.

According to Article 33(10) of the BNR Law, the Minister of Finance and one of the State Secretaries in the Ministry of Finance may participate, without voting rights, in the meetings of the BNR Board. Although a dialogue between a central bank and third parties is not prohibited as such, this dialogue should be framed in such a way that the Government should not be in a position to influence or to appear to influence the central bank’s decision-making in areas for which its independence is protected by Union law. The active participation of the Minister and one of the State Secretaries, even without voting rights, in discussions of the BNR Board where BNR policy is set could structurally offer to the Government the possibility to influence the central bank, or to appear to be able to do so, when taking its key decisions. Against this background, Article 33(10) of the BNR Law is incompatible with Article 130 TFEU.

Article 3(1) of the BNR Law needs to be amended with a view to ensuring full compatibility with Article 130 TFEU and Article 7 of the ESCB/ECB Statute. Pursuant to Article 3(1) of the BNR Law, the members of the BNR’s decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority. First, to ensure legal certainty, it should be clarified that the BNR’s institutional independence is also protected vis-à-vis national, foreign and Union institutions, bodies, offices or agencies. Moreover, Article 3 should expressly oblige the government not to seek to influence the members of the BNR’s decision-making bodies in the performance of their tasks.

The BNR Law should be supplemented by rules and procedures ensuring a smooth and continuous functioning of the BNR in case of the Governor’s termination of office (e.g. due to expiration of the term of office, resignation or dismissal). So far, Article 33(5) of the BNR Law provides that in case the Board of BNR becomes incomplete, the vacancies shall be filled following the procedure for the appointment of the members of the Board of BNR. Article 35(5) of the BNR Law provides that in case the Governor is absent or incapacitated to act, the First Deputy Governor shall replace the Governor.

Pursuant to Article 33(9) of the BNR Law, the decision to recall a member of the BNR Board (including the Governor) from office may be appealed to the Romanian High Court of Cassation and Justice. However, Article 33(9) of the BNR Law remains silent on the possibility of judicial review by the Court of Justice of the European Union, pursuant to Article 14.2 of the ESCB/ECB Statute, in the event of the Governor’s dismissal. This imperfection should be corrected.

Article 33(7) of the BNR Law provides that no member of the Board of BNR may be recalled from office for other reasons or following a procedure other than those provided in Article 33(6) of this Law. Law 161/2003 on certain measures for transparency in the exercise of public dignities, public functions and business relationships and for the prevention and

sanctioning of corruption and the Law 176/2010 on the integrity in the exercise of public functions and dignities define the conflicts of interest incompatibilities applicable to the Governor and other members of the Board of the BNR and require them to report on their interests and wealth. For the sake of legal certainty, this imperfection should be removed and it should be clarified that the sanctions for the breach of obligations under those laws do not constitute extra grounds for dismissal of the Governor, in addition to those contained in Article 33 of the BNR Law.

According to Articles 21 and 23 of the Law concerning the organisation and functioning of the Court of Auditors (No 94/1992), the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including the BNR's financial resources, and to audit the performance in the management of the funds of the BNR. Those provisions constitute an imperfection as regards Article 27.1 of the ESCB/ECB Statute and thus, to ensure legal certainty, the Law should state clearly that the scope of audits by the Court of Auditors is without prejudice to the activities of the BNR's independent external auditors.

Article 43 of the BNR Law provides that the BNR must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. Such a procedure might, in certain circumstances, be seen as an intra-year credit (see Section 6.1.3.) which negatively impacts on the financial independence of the BNR. A Member State may not put its central bank in a position where it has insufficient financial resources to carry out its ESCB tasks, and also its own national tasks, such as financing its administration and own operations. Article 43(3) of the BNR Law also provides that the BNR sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Finance. The central bank must be free to independently create financial provisions to safeguard the real value of its capital and assets. Article 43 of the BNR Law is therefore incompatible with Article 130 TFEU and Article 7 of the ESCB/ECB Statute and should be amended to ensure that the above arrangements do not undermine the ability of the BNR to carry out its tasks in an independent manner.

#### 6.1.3. Prohibition of monetary financing and privileged access

According to Article 26 of the BNR Law, the BNR, under exceptional circumstances and only on a case-by-case basis, may grant loans to credit institutions which are unsecured or secured with assets other than assets eligible to collateralise the monetary or foreign exchange policy operations of the BNR. It cannot be excluded that such lending results in the provision of solvency support to a credit institution that is facing financial difficulties and thereby would breach the prohibition of monetary financing and be incompatible with Article 123 TFEU. Article 26 of the BNR Law should be amended to preclude such lending operations.

Articles 6(1) and 29(1) of the BNR Law prohibit direct purchases by the BNR in the primary market of debt instruments issued by the State, national and local public authorities, autonomous public enterprises, national corporations, national companies and other majority state-owned companies. Article 6(2) of the BNR Law extends this prohibition to the debt instruments issued by other bodies governed by public law and public undertakings of other Union Member States. Article 7(2) of the BNR Law prohibits the BNR from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority state owned companies. Article 7(4) of the BNR Law extends this prohibition to other bodies governed by public law and public undertakings of Member States. These provisions do not fully mirror the entities listed in Article 123 TFEU (amongst others, a reference to Union institutions is missing). In consequence, they have to be amended.

Pursuant to Article 7(3) of the BNR Law, majority state-owned credit institutions are exempted from the prohibition on granting overdraft facilities and any other type of credit facility under Article 7(2) of the BNR Law and benefit from loans granted by the BNR in the same way as any other credit institution eligible under the BNR's regulations. Article 7(3) of the BNR Law is incompatible with Article 123(2) TFEU, which only exempts publicly owned credit institutions 'in the context of the supply of reserves by central banks'. The national provisions should be aligned.

As noted above in point 6.1.2., Article 43 of the BNR Law provides that the BNR shall transfer to the State, on a monthly basis, 80% of its net revenues left after deduction of the expenses related to the financial year and the uncovered loss of the previous financial years. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year but suffer losses during the second half. The adjustment would be made by the State only after the closure of the financial year and would thus imply an intra-year credit to the State, which would breach the prohibition on monetary financing. This provision is, therefore, incompatible with the Article 123 TFEU and must be amended.

#### 6.1.4. Integration into the ESCB

##### Objectives

Pursuant to Article 2(3) of the BNR Law, the secondary objective of the BNR is to support the State's general economic policy. Article 2(3) of the BNR Law contains an imperfection as it should contain a reference to the objective of supporting 'the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union', as per Article 127(1) TFEU and Article 2 of the ESCB/ECB Statute.

##### Tasks

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

- absence of a general reference to the BNR as being an integral part of the ESCB (Article 1 of the BNR Law);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(2)(a), 5, 6(3), 7(1), 8, 19, 20, 21(1) and (2), 22(3) and 33(1)(a) and (e) of the BNR Law);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)(a) and (d), 9 and 33(1)(a) of the BNR Law);
- holding and management of foreign reserves (Articles 2(2)(e), 9(2)(c), 30 and 31 of the BNR Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11 of the BNR Law);
- lack of reference to the role of the ECB in payment systems (Articles 2(2)(b), 22 and 33(1)(b) of the BNR Law).

There are also imperfections regarding the following issues:

- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 49 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor (Article 36(1) of the BNR Law);



- absence of an obligation to comply with the ESCB/ECB regime for the financial reporting of NCB operations (Articles 37(3) and 40 of the BNR Law);
- non-recognition of the ECB's right to impose sanctions (Article 57 of the BNR Law).

#### 6.1.5. Assessment of compatibility

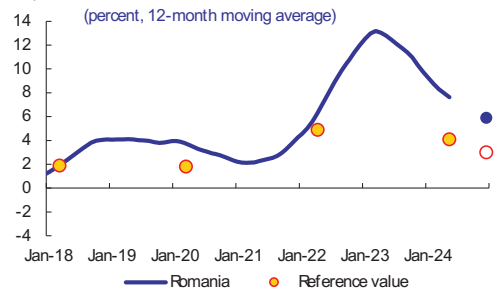
As regards the independence of the BNR, the prohibition of monetary financing and the BNR's integration into the ESCB at the time of euro adoption, the legislation in Romania, in particular the BNR Law, is not fully compatible with the requirements of Article 131 TFEU, for the reasons set out above. The Romanian authorities should remedy the above-mentioned incompatibilities and imperfections.

### 6.2. PRICE STABILITY

#### 6.2.1. Respect of the reference value

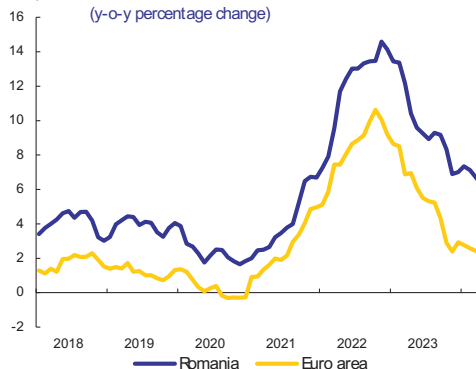
At the time of the last convergence assessment of Romania in 2022, the 12-month average inflation rate, which is used for the convergence assessment, was above the reference value. From 6.4% in April 2022, the 12-month average inflation rate increased steadily to 13.0% by April 2023. It then decreased to 9.7% by the end of 2023. In May 2024, the reference value was 4.1%, calculated as the average of the 12-month average inflation rates in the Netherlands, Italy and Latvia plus 1.5 percentage points. The corresponding inflation rate in Romania was 7.6%, which was 3.5 percentage points well above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the coming months.

Graph 6.1: Romania - Inflation criterion  
(percent, 12-month moving average)



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of Romania in December 2024. The reference values for 2018, 2020 and 2022 refer to the reference values calculated in the previous convergence reports.  
Source: Eurostat, Commission's Spring 2024 Economic Forecast.

Graph 6.2: Romania - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

#### 6.2.2. Recent inflation developments

Annual HICP inflation in Romania stood at 9.7% in 2023, down from 12% in 2022. Already in 2021, HICP inflation had accelerated slightly above the upper band of the target of the National Bank of Romania, already driven by energy prices. In 2022, the sharp rise in oil, gas and food commodity prices in global markets was passed on to the domestic industry and to retail food and energy prices. Therefore, energy prices increased by close to 32%, while food prices rose by almost 15% year-on-year in Romania. The inflation shock from terms of trade was, however, less acute than in many other EU economies, partly due to less energy intensive imports and the energy price cap scheme introduced by the government in early 2022. HICP inflation soared to a peak of 14.6% in November 2022 and has decelerated since then due to the decline in energy prices and a tighter monetary policy and financial conditions. Inflation was back to single-digits by mid-2023 and reached 7% in December 2023. Yet, the disinflation path was more protracted than in other EU countries



as the prices of services accelerated to close to 10% and food price continued growing at a high rate of about 14% year-on-year in 2023. Over the past two years, annual HICP inflation in Romania was higher than in the euro area by around 4 percentage points on average.

HICP inflation excluding energy and food declined too, but at a slower pace and remains well above headline inflation. It fell from a high of 12.6% in February 2022 to 10.4% by December 2023. The persistence of core inflation is driven by strong price growth in services (6.3% and 9.9% in 2022 and 2023, respectively) and non-energy industrial goods (5.7% and 9.6% in 2022 and 2023, respectively). High HICP inflation excluding energy and food partly reflects rapid wage increases, which averaged about 12% in 2022 and 15% in 2023, also fuelled by large minimum wage hikes (43% cumulated over 2022 and 2023) and still high energy prices feeding into industrial goods prices.

*Table 6.1:*  
**Romania - Components of inflation**

	(percentage change) <sup>1)</sup>							weights in total
	2018	2019	2020	2021	2022	2023	May-24	2023
HICP	4.1	3.9	2.3	4.1	12.0	9.7	7.6	1000
Non-energy industrial goods	1.7	2.4	2.3	2.6	5.7	9.6	10.8	276
Energy	12.2	2.7	-7.4	15.2	31.7	-0.9	-1.5	135
Unprocessed food	5.3	6.2	5.3	1.8	14.6	14.9	7.7	113
Processed food	3.7	5.5	5.0	4.0	14.6	13.3	7.1	256
Services	2.7	3.6	2.7	2.7	6.3	9.9	9.8	220
HICP excl. energy, food, alcohol and tobacco	2.2	2.9	2.5	2.6	6.0	9.7	10.3	497
HICP at constant tax rates	3.8	3.7	2.3	3.9	12.2	9.5	7.2	1000
Administered prices HICP	4.2	2.6	1.2	1.8	7.3	3.9	6.0	140

1) Measured by the arithmetic average of the latest 12-monthly indices relative to the arithmetic average of the 12-monthly indices in the previous period.  
Source: Eurostat, European Commission calculations.

Lower energy demand and falling international energy prices resulted in a decrease in the energy component of HICP inflation in 2023. After having increased by close to a third in 2022, energy prices dropped by about 1% in 2023. The only other categories of the HICP that decelerated in 2023 were administered prices with growth down to 3.9% from 7.5% in 2022 and processed food inflation, which was marginally lower at 13.3% in 2023 from 14.6% in 2022.

### 6.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and growth developments

Romania recorded a strong post-pandemic rebound in economic activity, favoured by easy monetary and financial conditions, a high government deficit and robust investment/expenditure financed by the RRF and other EU funds. Real GDP grew by 4.1% in 2022, which was still slightly higher than Romania's potential growth rate, but lower than the 5.7% in 2021. The expansion was driven by robust domestic demand, fuelled by rapid credit growth, which accelerated to almost 18% year-on-year in mid-2022, and very rapid nominal wage increases at about 12% in 2022. Both private consumption and gross fixed capital formation increased by close to 6% year-on-year in 2022. International trade posted a similar buoyant activity with both exports and imports advancing by almost 10% year-on-year. Yet, net exports had a negative contribution to growth, while the current account deficit widened too.

Real GDP continued to grow in 2023, but at a slower pace of around 2.1%. The slowdown reflected the impact of high inflation on real disposable incomes, tighter monetary and financial conditions, and the weakening of global demand. Private consumption growth decelerated to below 3.0% in 2023. Government consumption grew stronger by almost 7.0%. Gross fixed capital formation accelerated by more than 14.0%, supported by EU-funded investment in public infrastructure and became the main contributor to growth. Exports and imports both declined by about 1.4% and net exports had a neutral contribution to real GDP growth. According to the Commission's Spring 2024 Economic Forecast, real

GDP growth is projected to accelerate to 3.3% in 2024 and 3.1% in 2025, supported by solid increases in real disposable income, the prospect of easing financial conditions, stronger private credit growth and a gradual pick-up in external demand. Private consumption is expected to accelerate and public consumption will likely remain robust in 2024. At the same time, growth in gross fixed capital formation will slow from 2023 due to still depressed residential construction and subdued private investment negatively impacted by uncertainty over the fiscal consolidation measures.

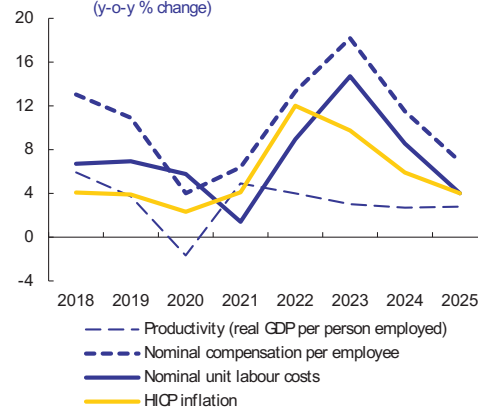
In 2023, the fiscal stance<sup>(56)</sup> turned slightly contractionary, at 0.4% of GDP, after being broadly neutral (0.0%) in 2022. Going forward, the Commission's Spring 2024 Economic Forecast projects a broadly neutral fiscal stance of -0.1% of GDP in 2024, reflecting an expansionary contribution from net nationally-financed primary current expenditure, as a result of the fast increase in current expenditure (see Section 6.3. below), and the contractionary impact of lower expenditure financed by the RRF and other EU funds. The no policy-change forecast for 2025 shows a broadly neutral fiscal stance of about -0.2% of GDP.

In response to rising inflation, Banca Națională a României (BNR), operating within an inflation targeting framework<sup>(57)</sup>, tightened its monetary policy stance by steadily raising the policy rate by a total of 400 basis points between April 2022 and January 2023. Thereafter, the policy rate remained stable at 7.0%, including by May 2024. In March 2023, the BNR resumed purchases of government securities in the secondary market, for the first time since May 2022. The reserve requirement ratio on accounts opened with BNR for the foreign currency holdings of the credit institutions, which stood at 6% in February 2020, was reduced to 5% in November of the same year and has been kept unchanged since then. The reserve requirement ratio for leu denominated holdings has been unchanged since May 2015 at 8%.

#### Wages and labour costs

Labour market conditions improved steadily after their deterioration due to the COVID-19 shock in 2020, due to strong growth and the phasing out of pandemic restrictions, which allowed the services sector to scale up employment. The employment rate increased from a low of 64% in the second quarter of 2020 to 68.5% in 2022 and to 68.7% in 2023. Despite this increase, the employment rate remains below the EU average (75.3% in 2023) and represents a challenge, also due to the relatively low participation to the labour force. The unemployment rate continued to decrease from 6.7% in June 2020 to 5.6% in both 2022 and 2023. The unemployment rate is below the EU average and is forecast to decline slightly in 2024 and 2025.

Graph 6.3: Romania - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission's Spring 2024 Economic Forecast.

The relatively low employment rate reflects a larger share of semi-subsistence agricultural workers (who are not counted in the labour force according to Eurostat methodology), high

<sup>(56)</sup> The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

<sup>(57)</sup> As from 2013, the BNR follows a flat multi-annual inflation target of 2.5% ( $\pm 1$  percentage point).

net outward migration and a large contingent of people who work in other countries but maintain their residence in Romania (IMF, 2023, Selected issues). The labour force participation rate appears low across all population groups, but lower skilled women, older man with secondary education and the youth stand out. The latter groups also display higher unemployment rates on average.

The decrease in labour market slack, coupled with the recovery in economic activity and the rise in inflation, increased wage pressures. As a result, nominal compensation per employee increased by 13.3% in 2022, which was above the average headline inflation of 12.0%. In 2023, wage pressures increased further due to high public sector wage increases in education (albeit from a low level in that sector), a tight labour market with skill shortages and large increases in minimum wages. The standard minimum wage was raised three times by a cumulated 43.5% during 2022 and 2023. The nominal compensation per employee increased by around 18% in 2023, which corresponds to about 8% growth in real terms, exceeding labour productivity. Wage growth is forecast to remain strong at a double-digit rate in 2024 as well, driven by rapidly rising public sector wages. Romania committed in the RRP to create a new mechanism formula to set the minimum wage level objectively.

Table 6.2:

Romania - Other inflation and cost indicators

	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
<b>HICP inflation</b>								
Romania	4.1	3.9	2.3	4.1	12.0	9.7	5.9	4.0
Euro area	1.8	1.2	0.3	2.6	8.4	5.4	2.5	2.1
<b>Private consumption deflator</b>								
Romania	3.9	5.4	2.3	4.6	14.5	9.8	6.8	4.7
Euro area	1.5	1.1	0.6	2.3	6.8	6.0	2.4	2.0
<b>Nominal compensation per employee</b>								
Romania	13.0	10.9	4.0	6.4	13.3	18.2	11.5	6.9
Euro area	2.1	2.2	-0.4	4.2	4.5	5.1	4.2	3.1
<b>Labour productivity</b>								
Romania	5.9	3.7	-1.7	4.9	4.0	3.0	2.7	2.8
Euro area	0.1	0.2	-4.7	4.4	1.1	-1.0	0.1	0.9
<b>Nominal unit labour costs</b>								
Romania	6.7	6.9	5.8	1.4	8.9	14.7	8.6	4.0
Euro area	2.0	1.9	4.6	-0.2	3.3	6.2	4.1	2.2
<b>Imports of goods deflator</b>								
Romania	4.8	0.2	-2.5	10.2	17.9	0.7	2.8	2.6
Euro area	2.6	-0.6	-3.8	9.7	21.6	-4.9	0.4	1.8

1) Commission's Spring 2024 Economic Forecast.

Source: Eurostat, Commission's Spring 2024 Economic Forecast.

As economic output grew strongly and capital deepening advanced further in Romania, labour productivity per person increased by 4.0% in 2022, above the euro area average of 1.1%. In 2023, labour productivity improved at a slower rate of 3.0%, in line with the more subdued output growth. As labour compensation grew more than labour productivity, an increase in nominal unit labour costs (ULC) took place, which was higher than the euro area average in both 2022 and 2023.

### External factors

Due to the openness of the Romanian economy and strong trade links with other EU member states, import prices play a significant role in domestic price formation. As Romania is a net importer of energy and a large buyer of imported food products, the large volatility in energy and food prices on global markets in 2022 and 2023 was transmitted to inflation in Romania. Import price inflation (measured by the imports of goods deflator) accelerated to about 18% in 2022, in line with international prices and about 6 percentage points above HICP inflation. But it was still lower than in the euro area because of a relatively smaller

weight of the energy bill in imports. In 2023, however, imported price inflation decelerated strongly to below 3% and drove down HICP inflation. Looking ahead, imported inflation is expected to continue contributing favourably to HICP inflation, reflecting the relatively higher domestic inflation pressures in Romania.

After having depreciated during the pandemic, the leu's nominal effective exchange rate (measured against a group of 36 trading partners) started to appreciate again. Helped by sustained capital inflows, including EU funds, net FDI and portfolio investment, it strengthened by more than 3% over 2022 and 2023.

#### Administered prices and taxes

The weight of administered prices in the 2023 Romanian HICP basket (14%) is slightly above the euro area average (13.2%). The average annual change in administered prices was 7.3% in 2022, below the headline inflation rate by 4.7 percentage points. A similar evolution took place in 2023 when administered prices increased by only 3.9%, much below the 9.7% headline figure. The favourable impact of administered prices on the headline inflation rate mainly reflects the measures adopted by the government in late 2021 to cap gas and electricity prices, with reduced tariffs for lower energy consumption brackets. The support measures were extended also in 2023. Other measures, such as a sharp increase in the price of medicines in August 2023, contributed to higher inflation.

Tax changes had a marginal influence on inflation in Romania in the last two years. HICP inflation measured at constant taxes was broadly similar to headline HICP inflation. In 2022, the former stood at 12.2%, 0.2 percentage point above the headline inflation figure. In 2023 it was 9.5%, 0.2 percentage point lower than the headline HICP inflation rate.

#### Medium-term prospects

Prices are set to decelerate further over the forecast horizon, except for a brief pause at the beginning of 2024 as a result of some increases in indirect taxes. In the Commission's Spring 2024 Economic Forecast, average annual HICP inflation is projected at 5.9% in 2024 before slowing to 4.0% in 2025 and thereby approaching the Central Bank inflation target band (2.5%  $\pm$  1 percentage point). The disinflation path is expected to be supported by relatively low energy prices and moderate import prices. At the same time, the decline in HICP inflation excluding energy and food is expected to continue lagging behind, in particular due to high inflation for services and industrial goods, reflecting the tight labour market and large increases in real disposable incomes.

Risks to the inflation outlook are tilted towards a more gradual reduction in headline HICP inflation if salaries and pensions continue to increase fast. Increases in public wages have spread from education to other sectors in 2024. Other aspects, such as potential additional changes in taxation due to fiscal consolidation, in particular in 2025, and the easing of pressures on a tight labour market, add to the uncertainty of the inflation forecast. According to the Commission's Spring 2024 Economic Forecast, the ULC growth rate in Romania is expected to decelerate moderately in 2024 and more significantly in 2025. It will still remain above the average growth rates in the euro area, and the labour productivity differential, in particular in 2024.

In 2022, the level of consumer prices in Romania increased to about 56% of the euro area average. The GDP per capita further converged to around 75% of the euro area average in PPS terms in 2023. Due to the process of catching-up of the Romanian economy, price level convergence is expected to continue over the next years.

### 6.3. PUBLIC FINANCES

#### 6.3.1. Recent fiscal developments

The general government deficit remained high in 2023, reaching 6.6% of GDP, up from 6.3% in 2022. This is 2.2 percentage points of GDP above the level planned in the 2023 budget and in Romania's 2023 Convergence Programme. This is mainly due to continued high government spending growth, particularly in goods and services, social transfers and personnel expenditure. A slowdown in government revenue, due to weaker than expected nominal GDP growth, also played a role but to a lesser extent since the deceleration in revenue started to intensify only in the second part of the year. In a context of declining but still elevated inflation, government expenditure increased much faster than planned and recommended by the Council on 18 June 2021 (see below). Net primary expenditure growth (adjusted for one-offs and fiscal policy measures on the revenue side) increased by 11.8%, driven by faster than expected growth in personnel expenditure (particularly reflecting large increase in wages in the education sector) and transfers to households.

Romania is subject to an excessive deficit procedure <sup>(58)</sup>. On 18 June 2021, the Council adopted a recommendation under Article 126(7) of the Treaty (TFEU), with a view to bringing an end to the situation of an excessive government deficit in Romania by 2024 at the latest. Romania was recommended to reduce the general government deficit to 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023, and 2.9% of GDP in 2024. This was consistent with a nominal growth rate of net primary government expenditure of 3.4% in 2021, 1.3% in 2022, 0.9% in 2023 and 0.0% in 2024. It corresponded to an annual structural adjustment of 0.7% of GDP in 2021, 1.8% of GDP in 2022, 1.7% of GDP in 2023 and 1.5% of GDP in 2024. The recommendation also specified that any windfall gains should be used to reduce the general government deficit. Romania was also asked to report every six months on action taken to implement the recommendation, until the excessive deficit has been corrected. The headline deficit ratio in 2023 was well above that recommended by the Council. According to the Commission's Spring 2024 Economic Forecast, the growth in net primary expenditure in 2023 is estimated at 11.8%, well above the limit recommended by the Council, while the structural adjustment in 2023 is estimated at -0.1 percentage point of GDP. Therefore, on 19 June 2024, the Commission recommended a Council Decision establishing that Romania had not taken effective action in response to the Article 126(7) recommendation.

The general government debt-to-GDP ratio rose from 48.5% of GDP in 2021 to 48.8% in 2023. The increases in 2022 and 2023 were mainly driven by the high primary deficit. The snow-ball effect contributed to the decrease in the debt ratio in these two years, while stock-flow adjustments contributed to an increase.

#### 6.3.2. Medium-term prospects

The budget for 2024, published on 14 December 2023, targeted a reduction of the general government deficit to 4.9% of GDP in 2024. In October 2023, Romania adopted a fiscal consolidation package worth around 1.2% of GDP, to be implemented in 2024. The package included spending cuts, generated through measures to streamline public administration and tighter eligibility conditions for public servants to benefit from holiday vouchers and food allowances. On the revenue side, new measures are expected to yield additional revenue amounting to 1% of GDP. They included an increase in corporate taxation (introduction of a minimum turnover tax of 1% for non-financial companies with a turnover of more than EUR 50 million and of a turnover tax for credit institutions), a phasing-out of preferential tax regimes for the construction and agriculture sectors, and the elimination of reduced VAT rates for selected goods and services.

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<sup>(58)</sup> Following the expansionary fiscal stance and the high fiscal deficit recorded in 2019 and previous years, Romania entered an Excessive Deficit Procedure (EDP) in the spring of 2020.



This package supports the reduction of Romania's high government deficit in 2024 but is insufficient to reach the targets recommended by the Council. The reason for the still high deficit in 2024 (see below) and 2025 is related to fast planned growth in public wages and pensions. The latter reflects the short-term cost of the recently adopted pension reform.

In November 2023, Romania adopted a broad reform of the general pension system which entails the recalculation of pensions through a new formula that aims at significantly increasing incentives for longer working lives. The reform introduces a new pension indexation rule, a mechanism against ad-hoc increases in pensions, aligns the retirement age between men and women, tightens eligibility conditions to 'special working conditions' status and associated benefits, and introduces a link between future changes in life expectancy and system parameters. Based on calculations done by the World Bank, acting as technical advisor, the reform, if successfully implemented, is expected to generate large savings in the medium to long term, with total pension expenditure to peak at slightly above 10% of GDP in the reform scenario, compared to 12% of GDP in the baseline without the reform.

Table 6.3:

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

<b>Outturn and forecast <sup>1)</sup></b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024<sup>1)</sup></b>	<b>2025<sup>1)</sup></b>
General government balance	-2.8	-4.3	-9.3	-7.2	-6.3	-6.6	-6.9	-7.0
- Total revenue	31.7	32.0	32.5	32.9	33.7	33.6	34.2	34.3
- Total expenditure	34.5	36.3	41.8	40.0	40.0	40.2	41.1	41.3
of which:								
- Interest expenditure	1.0	1.2	1.4	1.5	1.5	2.0	2.0	2.0
p.m.: Tax burden	26.6	26.7	26.9	27.2	27.6	26.8	28.0	28.0
Primary balance	-1.9	-3.2	-7.9	-5.7	-4.8	-4.6	-4.9	-5.0
Fiscal stance <sup>2)</sup>					0.0	0.4	-0.1	-0.2
Recommended growth in net nationally financed primary expenditure (%)							7.5	-
Growth in net nationally financed primary expenditure (%)							14.3	-
Government gross debt	34.4	35.1	46.7	48.5	47.5	48.8	50.9	53.9
p.m.: Real GDP growth (%)	6.0	3.9	-3.7	5.7	4.1	2.1	3.3	3.1

1) Commission's Spring 2024 Economic Forecast.

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

Source: European Commission.

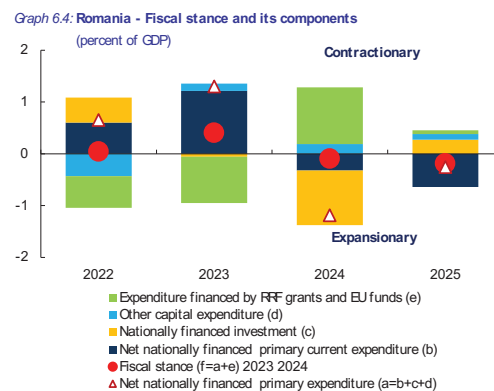
In their latest report on 'actions taken to correct the excessive deficit', Romania confirmed the 2024 government deficit target of 4.9% of GDP. On 10 May 2024, the Romanian authorities reported on 'actions taken to correct the excessive deficit'. This report confirmed the 2024 government deficit target of 4.9% of GDP included in the budget but also stressed that budgetary execution in the first three months of the year resulted in a government budget deficit (cash definition) of 2.06% of GDP, 0.6 percentage point of GDP above the deficit recorded in the same period last year, when the full-year deficit was 6.6% of GDP. Over the first four months of the year, the cumulative deficit reached 3.3% of GDP, much higher than the 1.7% of GDP recorded in the same period of 2023. These developments are consistent with the Commission's forecast of a government deficit approaching 7% of GDP in 2024.

The Commission's Spring 2024 Economic Forecast, which is based on a no-policy change assumption, projects a general government deficit of 6.9% of GDP in 2024. The difference from the planned deficit in the budget stems, in particular, from a difference in some

revenue items that are not fully supported by enacted measures and therefore not taken into account in the Commission's forecast and from a much higher projected increase in current expenditure, mostly driven by public wages. The Commission projects the general government deficit to remain elevated at 7.0% of GDP in 2025. The short-term cost of the pension reform is expected to contribute to the higher deficit. However, some moderation in capital spending is likely and growth in current expenditure excluding pensions is expected to slow down. The 2025 deficit forecast does not include the potential additional revenue stemming from the reform of the tax regime of microenterprises and the broad tax reform, which are part of the RRP and are currently being designed. General government debt is projected to increase to about 51% of GDP in 2024 and 54% in 2025.

In 2024, the fiscal stance is projected in the Commission's Spring 2024 Economic Forecast to be broadly neutral, following a contractionary fiscal stance of 0.4% of GDP in 2023 <sup>(59)</sup>. The neutral fiscal stance in 2024 reflects an expansionary contribution from net nationally-financed primary current expenditure, as a result of the fast increase in current expenditure, and the contractionary impact of lower expenditure financed by the RRF and other EU funds.

The no policy-change forecast for 2025 shows a neutral fiscal stance of about -0.2% of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to decrease by 0.1 percentage point of GDP. Nationally financed investment is projected to provide an contractionary contribution to the fiscal stance of 0.3 percentage point of GDP, whereas the growth in nationally financed primary current expenditure is projected to provide an expansionary contribution of -0.6 percentage point of GDP to the overall fiscal stance in 2025.



Debt sustainability risks appear high over the medium term. Government debt is projected to strongly increase rapidly from around 51% of GDP in 2024 to around 103% of GDP in 2034. This projection assumes that the structural primary deficit increases from 4.0% of GDP in 2023 to 4.4% of GDP in 2024 and remains at that level (excluding changes in the cost of ageing) over the projection period <sup>(60)</sup>.

The sensitivity to possible macro-fiscal shocks contributes to this assessment. In particular, if the interest-rate growth differential were 1 percentage point higher than in the baseline scenario, the projected debt ratio in 2034 would be more than 6 percentage points of GDP higher than in the baseline.

Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors are related to the recent increase in interest rates and public debt ratio, the share of debt held by non-residents, the currency denomination of debt, and the country's negative net international investment position. Though, the latter is low if non-defaultable instruments are excluded. On the other hand, risk-mitigating factors include the lengthening of debt maturity in recent years, and the low share of external, private, and short-term debt.

<sup>(59)</sup> For a definition of the fiscal stance used in this report, see the footnote in Section 6.2.3. on underlying factors and sustainability of inflation.

<sup>(60)</sup> For details on the methodology, see European Commission (2024), Debt Sustainability Monitor 2023, Institutional Paper 271, March 2024.



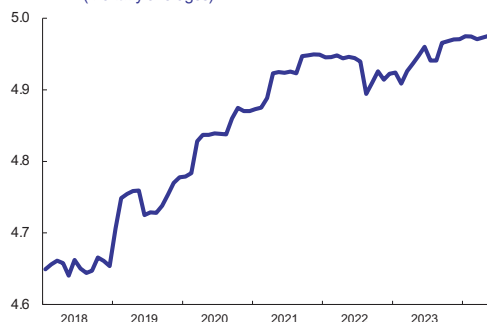
While the key elements of a robust fiscal framework are in place, some difficulties in implementation remain. The Romanian fiscal framework includes well-designed fiscal rules, a medium-term budgetary framework, and an independent fiscal council. However, the implementation of the national fiscal rules and medium-term budgetary framework has generally been weak, as indicated in past Convergence Reports (2022 and earlier). The Romanian Fiscal Council has a relatively broad mandate, including the monitoring of fiscal rules, assessment of macroeconomic and budgetary forecasts, and costings of the main discretionary revenues. However, it has struggled with access to information issues and poor policy dialogue with the government. The amended Budgetary Framework Directive (2011/85/EU), part of the Economic Governance Review, which was adopted on 29 April 2024, may affect some aspects of the Romanian fiscal framework, such as the tasks of the fiscal council. The amended Directive extends the independence safeguards for independent fiscal institutions to all EU Member States and assigns some tasks to these institutions.

#### 6.4. EXCHANGE RATE STABILITY

The Romanian leu does not participate in ERM II. Romania has been operating a managed floating exchange rate regime since 1991 with no preannounced path for the exchange rate <sup>(61)</sup>. De facto, the exchange rate regime moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2005, Romania shifted to a direct inflation targeting framework combined with a ‘crawl-like’ exchange rate arrangement that allows foreign exchange market interventions by the central bank. Exchange rate stability has been used by the BNR as an important mechanism to ensure financial stability and anchor inflation expectations. The BNR has, nonetheless, stressed that currency intervention remains available as a policy instrument and has actively used it.

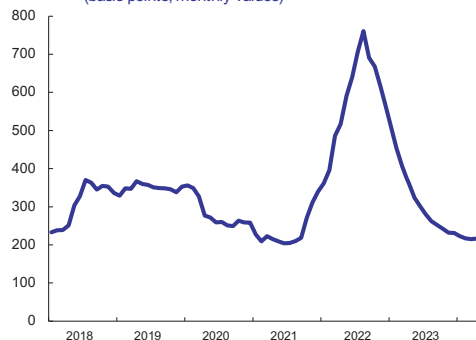
The leu has depreciated steadily against the euro since 2018, with the RON/EUR exchange rate increasing from an annual average of 4.65 in 2018 to 4.95 in 2023. The leu was relatively stable on average in the first half of 2022. After an appreciation of around 0.9% in August 2022 compared to the previous month, the leu weakened against the euro by around 1.5% between August 2022 and September 2023. Over this period, the volatility of the leu’s inter-day exchange rate was moderate compared to that of other floating currencies in Member States with a derogation. The leu remained stable during the last quarter of 2023, when it averaged around a RON/EUR level of 4.97. In May 2024, the leu’s exchange rate against the euro averaged around 4.98.

Graph 6.5: Romania - RON/EUR exchange rate  
(monthly averages)



Source: ECB.

Graph 6.6: Romania - 3-M Robor spread to 3-M Euribor  
(basis points, monthly values)



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

<sup>(61)</sup> On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion factor of 1 RON = 10,000 ROL. For convenience, however, the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.

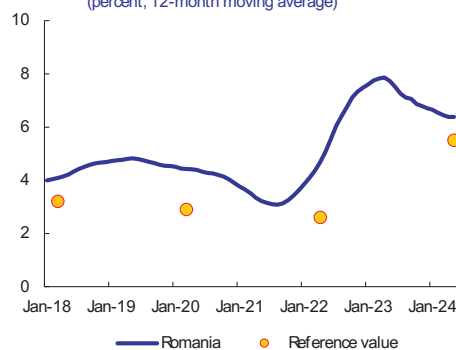
The gross international reserves held by the BNR followed an upward path over the 2022-2023 period. The reserves increased from EUR 46 billion in the first quarter of 2022 to around EUR 52 billion at the end of 2022. The reserves continued to increase in the first half of 2023 to close to EUR 59 billion, and rose further to a new high of around EUR 66 billion at the end of 2023, reaching close to 20% of GDP. Over this period, movements in the level of international reserves were influenced by changes in the foreign exchange reserve requirements of credit institutions, sovereign debt management decisions, such as euro- and US dollar-denominated government bond issuances and financing payments under the EU's Recovery and Resilience Facility. The reserves continued to increase in the first months of 2024 and stood at around EUR 72 billion in May 2024.

Short-term interest rate spreads vis-à-vis the euro area increased sharply, by around 400 basis points, between January and August 2022, reaching a high of around 760 basis points in August 2022, which was its highest level since 2010. This increase in the 3-month interest rate spread was driven by the early monetary policy tightening cycle in Romania compared to the euro area. In Romania, the key policy rate was raised from 2.0% in January 2022 to 5.5% in August 2022, whereas the ECB's key interest rate was almost unchanged over this period. Subsequently, the 3-month spread decreased steadily during the last 4 months of 2022 and throughout 2023 and in early 2024, reaching 216 basis points by April 2024. The significant narrowing of the short-term spread between August 2022 and April 2024 reflected the combined effects of the tightening of the euro area's monetary policy, with the ECB's key interest rate increasing from 0.0% in August 2022 to 4.0% in September 2023, and a fall in the 3-month interest rates in Romania, mirroring a smaller increase in the key policy rate in Romania and the sizeable liquidity surplus in Romania's money market. The 3-month interest rate spread relative to the euro increased to around 225 basis points in May 2024, close to levels seen in late-2017, reflecting the cut in the key ECB interest rate.

## 6.5. LONG-TERM INTEREST RATES

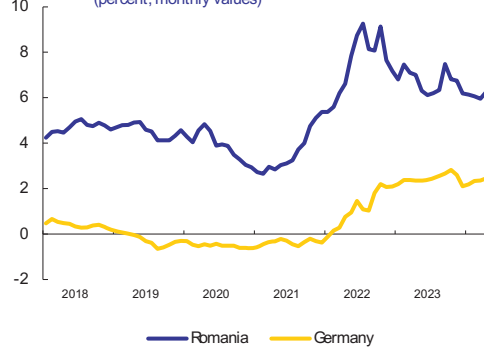
The long-term interest rates in Romania used for the purpose of the convergence examination reflect secondary market yields on a single government benchmark bond with a residual maturity of around 11 years.

Graph 6.7: Romania - Long-term interest rate criterion  
(percent, 12-month moving average)



Source: European Commission.

Graph 6.8: Romania - Long-term interest rates  
(percent, monthly values)



Source: Eurostat.

The Romanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the time of the last convergence assessment of Romania in 2022. From 4.7% in April 2022, it increased gradually to around 7.9% by April 2023 but fell throughout the rest of 2023 and in the first months of 2024. In May 2024, the reference value, which is calculated as the average of long-term interest rates in the Netherlands, Italy and Latvia plus 2 percentage points, stood

at 5.5%. In that month, the 12-month moving average of the yield on the Romanian benchmark bond was at 6.4%, i.e. 0.9 percentage points above the reference value.

The long-term interest rate in Romania increased sharply in the first half of 2022, rising from 5.4% in January 2022 to 9.3% in July 2022, which was its highest level since 2009. This increase largely reflected the above-mentioned rise in the policy interest rate in response to the surge in inflation and increased market risk aversion. The 10-year interest rate for the German government bond, which is the benchmark security in European financial markets, rose by 1 percentage point over this period. Romania's long-term interest rate decreased steadily in the second half of 2022 and throughout most of 2023, in part reflecting the outlook for lower inflation. The long-term interest rate of Romania was broadly stable during the first 5 months of 2024, although at 6.3% in May 2024, it remained at a relatively high level. The long-term spread versus the German benchmark bond stood at 377 basis points in May 2024, down from 818 basis points in July 2022.

## 6.6. ADDITIONAL FACTORS

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

In November 2023, the Commission published its 13th Alert Mechanism Report (AMR 2024) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review (IDR) was warranted for Romania. In April 2024, the Commission published an In-Depth Review for Romania. Taking into account the assessment in the In-Depth Review, the Commission, in its Communication 'European Semester – 2024 Spring Package' <sup>(62)</sup>, considers that Romania is experiencing excessive macroeconomic imbalances. Vulnerabilities relate to external accounts and are mainly linked to large government deficits, while price and cost pressures have increased, with a potential negative impact on cost competitiveness. At the same time, policy action has been weak.

Romania's current account deficit has remained high, in parallel with persistently large government deficits. With strong price dynamics, concerns grew about high growth in wages that could undermine cost competitiveness. As of 2023, there has been some positive development as external accounts have been improving and price dynamics moderating. The current account deficit has been partly financed by sizeable EU funds and foreign direct investment (FDI), strengthening Romania's productivity and output growth. Policy action has been forthcoming in the monetary and financial supervision areas, but has not sufficiently tackled the large fiscal deficit, which continues to fuel the sizeable current account deficit. This may push up external indebtedness, albeit from a relatively low level, leaving Romania vulnerable to change in investor sentiment and exogenous shocks. In addition to fiscal consolidation, an acceleration of structural reforms is needed, including via determined implementation of Romania's RRP, in order to improve competitiveness and potential growth.

Romania's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, to boost its competitiveness and stimulate sustainable growth and reduce the country's territorial and social disparities. The RRF funding provides Romania with EUR 28.5 billion over the 2021-2026 period. Romania has submitted three payment requests, resulting in an overall disbursement of EUR 9.4 billion on 29 September 2023.

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<sup>(62)</sup> COM(2024) 600 final, 19.06.2024.

While some reforms (e.g., reducing the regulatory burden of the business environment and the size of the shadow economy, education, improving social cohesion) and investments, (e.g., energy renovation of buildings, digitalisation, financing of SMEs, sustainable transport infrastructure) have already started, the implementation of the Romanian RRP faces significant delays.] Structural challenges linked to limited administrative capacity and often the lack of involvement of other entities governing on various institutions, and different stakeholder in general call for specific actions to ensure that reforms and investments can be completed on time.

In addition, cohesion policy provides Romania with EUR 31 billion for the 2021-2027 period. Cohesion policy financing aims to further support Romania's competitiveness and upward social convergence, including innovation and digitalisation, the green and just transition, the modernisation of public employment services, the development of skills and increased quality and inclusiveness of education and training, as well as the reduction of poverty. Romania has made progress in implementing cohesion policy but challenges remain and significant territorial disparities in investment and employment persist between the capital region and the other regions, as well as between urban and non-urban areas.

### 6.6.1. Developments in the balance of payments

Romania's external balance (i.e. the combined current and capital account) deteriorated from -5.1% of GDP in 2021 to -6.7% in 2022, before improving to -4.9% in 2023. The worsening of the external balance in 2022 was driven by a large increase in the current account deficit by about 2 percentage points of GDP, while the surplus of the capital account also increased slightly. In 2023, the capital account surplus decreased by about 0.4 percentage point of GDP and the current account deficit shrank by around 2.2 percentage points, leading to the large improvement in the external balance. But, the current account deficit remains large, mainly due to high and increasing government deficits and is not forecast to improve this year and next.

Table 6.4:

Romania - Balance of payments		(percentage of GDP)				
	2018	2019	2020	2021	2022	2023
Current account	-4.6	-4.9	-4.9	-7.2	-9.2	-7.0
of which: Balance of trade in goods	-7.4	-8.0	-8.6	-9.6	-11.3	-8.9
Balance of trade in services	4.1	3.9	4.3	3.9	4.6	4.2
Primary income balance	-1.8	-1.4	-1.5	-2.0	-3.0	-2.7
Secondary income balance	0.6	0.7	0.9	0.4	0.5	0.5
Capital account	1.2	1.3	1.9	2.2	2.5	2.1
External balance <sup>1)</sup>	-3.4	-3.6	-3.1	-5.1	-6.7	-4.9
Financial account	-2.5	-2.3	-3.5	-6.1	-5.4	-3.7
of which: Direct investment	-2.4	-2.2	-1.3	-3.7	-3.1	-2.0
Portfolio investment	-1.4	-1.1	-6.1	-1.4	-1.7	-4.4
Other investment <sup>2)</sup>	1.7	1.1	1.3	-1.9	-2.9	-1.4
Change in reserves	-0.4	-0.1	2.5	0.9	2.3	4.1
Financial account without reserves	-2.1	-2.2	-6.1	-7.0	-7.7	-7.8
Errors and omissions	0.9	1.3	-0.5	-1.0	1.3	1.2
Gross capital formation	23.3	24.3	24.5	26.3	27.1	25.7
Gross saving	18.9	19.7	17.8	18.9	18.2	19.0
Net international investment position	-43.4	-43.4	-47.6	-47.0	-40.8	-39.8

1) The combined current and capital account.

2) Including financial derivatives.

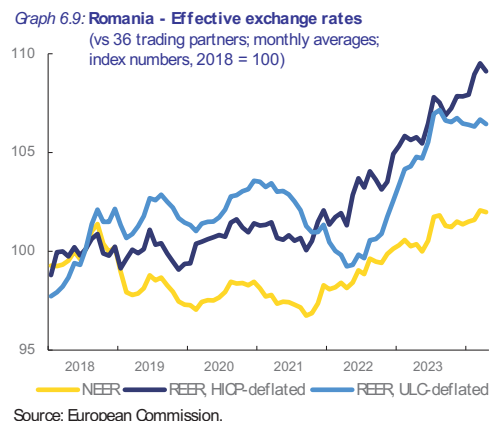
Sources: Eurostat, European Commission calculations, the National Bank of Romania.

Despite the double-digit growth of export goods in 2022 following the economic recovery from the pandemic, nominal imports advanced even faster due to the surge in global energy and commodity prices. As a result, the balance of trade in goods deteriorated markedly, from -9.6% of GDP in 2021 to -11.3% of GDP in 2022. It shrank again to -8.9% of GDP in 2023 on account of a lower external energy bill and overall declining imports driven by a sharp deceleration in domestic demand. The balance of trade in services, driven mainly by exports of transportation and IT services, remained positive at 4.6% of GDP in 2022 and 4.2% in 2023, partially offsetting the large deficit in the external trade of goods.

The negative balance of primary income widened to -3% of GDP in 2022 and -2.7% of GDP in 2023, reflecting mainly higher outflows of investment income linked to the country's negative net international investment position. The balance of secondary income, which consists primarily of remittances, continued to be positive, with a slight increase to about 0.5% of GDP in both 2022 and 2023, after a large drop in 2021. The capital account surplus increased to 2.5% of GDP in 2022 and 2.1% of GDP in 2023, benefiting from the positive impact of an increased uptake of projects financed by EU funds and RRP financing flows.

Net FDI inflows rebounded after their drop to 1.3% of GDP in 2020 due to the pandemic and increased to 3% of GDP in 2022, but decelerated again to 2% of GDP in 2023. Net portfolio inflows stood at 1.7% of GDP in 2022, but surged to 4.4% of GDP in 2023, as the large government deficit was increasingly financed from external sources. Other investments including financial derivatives remained positive to the tune of 2.9% of GDP in 2022, but almost halved to 1.4% of GDP in 2023 on account of a strong deceleration in domestic private credit growth. Due to valuation effects and strong growth in nominal GDP, Romania's net international investment position fell from 47% of GDP in 2021 to about 40% of GDP in 2023. The NIIP excluding non-defaultable instruments (NENDI), which takes into account Romania's large stock of net FDI, bolstering Romania's economic convergence with the euro area, remained low at about -5% of GDP in mid-2023.

Romania's external cost competitiveness started to deteriorate following the surge in inflation in the aftermath of the pandemic and the robust wage growth. The appreciation of the HICP-based REER accelerated in 2022 and 2023 as inflation in Romania was significantly above that of the euro area, while the RON appreciated slightly against the euro. The ULC-deflated real effective exchange rate (REER), also started appreciating more strongly as of 2023, when nominal wages grew by about 18% (by 8% in real terms), well above labour productivity.



According to the Commission's Spring 2024 Economic Forecast, the current account deficit is expected to stay slightly below 7% of GDP in 2024 and 2025, boosted by a still large government deficit and an acceleration of domestic demand. This will be partially offset by robust dynamics in the capital account, due to hefty inflows of EU funds and FDI.

#### 6.6.2. Market integration

Romania's economy is well integrated with the euro area through trade and investment linkages. The degree of trade openness (see Table 6.5 for a definition) decreased somewhat in 2023, reflecting the weak domestic demand from main trading partners, declining industrial output and a significant deceleration in domestic demand affecting imports. Trade openness in 2022 stood at 48.9% of GDP and decreased in 2023 to 43.6% of GDP. In 2023, Romania's main trading partners within the euro area were Germany, Italy and France, while outside the euro area Romania mainly traded with Hungary, Poland,

Bulgaria and Türkiye. Trade with the euro area also decreased from 26% of GDP in 2022 to below 24%% of GDP in 2023.

Since it joined the European Union, Romania attracted substantial amounts of FDI. The total stock of inward FDI reached almost EUR 108 billion or 38% of GDP in 2022, up by 12% from 2021 <sup>(63)</sup>. More than 86% of the FDI stock originated in the EU, mainly from euro area Member States, such as the Netherlands, Germany and Austria.

Romania under-performs in international rankings of competitiveness relative to many euro area Member States, but its position has gradually improved in recent years. Romania has advanced from the 51st place in 2022 to the 48th in 2023 from a total of 64 surveyed economies in the IMD's World Competitiveness Index. A patchy and unpredictable legal and regulatory framework, an inefficient judiciary system, poor infrastructure and public administration capacity, an uncompetitive tax regime and, at times, ineffective corporate governance of state-owned enterprises are some of the main obstacles to investment and productivity growth. According to the World Bank's 2022 Worldwide Governance Indicators, Romania ranks below the average of the five euro area Member States with the lowest scores in terms of voice and accountability, government effectiveness, regulatory quality and control of corruption. At the same time, Romania ranks higher than the average five lowest euro area Member States for political stability and absence of violence and at a broadly similar level in terms of rule of law, based on recent progress <sup>(64)</sup>. On a more positive note, according to the 2023 Single Market Scoreboard, Romania's transposition deficit of EU Directives declined to 0.2% in 2023, after a high of 2.9% in 2021. It follows a stable result of 1.1% for three consecutive years, very close to the EU average (1%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

Table 6.5:

Romania - Market integration

	2018	2019	2020	2021	2022	2023
Trade openness <sup>1)</sup> (%)	46.2	44.8	40.8	45.0	48.9	43.6
Trade with EA in goods & services <sup>2)+3)</sup> (%)	26.2	25.1	23.0	24.8	25.6	23.9
IMD World Competitiveness Ranking <sup>4)</sup>	49	49	51	48	51	48
Internal Market Transposition Deficit <sup>5)</sup> (%)	1.1	1.1	1.1	2.9	0.3	0.2
Real house price index <sup>6)</sup>	110.5	108.5	110.9	110.7	103.6	97.5

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

2) (Imports + Exports of goods with EA-20 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-20 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) International Institute for Management Development (IMD).

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

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

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

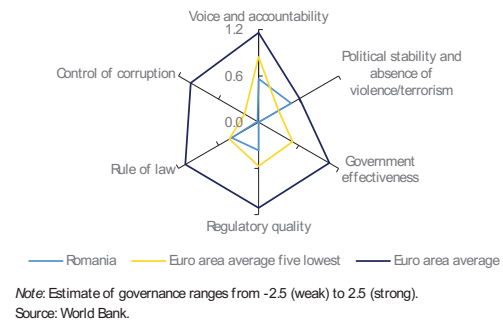
<sup>(63)</sup> National Bank of Romania (2023), report on Foreign Direct Investment in Romania in 2022.

<sup>(64)</sup> A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage point lower (higher) than that of the average of this group of five euro area Member States.



As part of the 2024 Country Report, the Commission has identified several obstacles undermining Romania's business environment and competitiveness, among which labour and skills shortages and mismatches, still limited access to finance for SMEs, volatile tax and regulatory environment holding back investment, certain aspects regarding the functioning of the judiciary, insufficient competition in public procurement, continued restrictions on access to some regulated professions, weak administrative capacity, especially at local and regional level, poor quality of education and training, large gaps in transport infrastructure and low level of digitalisation.

Graph 6.10: Romania - World Bank's 2022 Worldwide Governance Indicators



The 2024 Country Report highlights that the efficiency of justice has improved. Nevertheless, some remaining aspects as regards the quality and independence of justice need further action. Indicators on judiciary efficiency slightly worsened in 2022 from 2021, after a strong improvement in 2021. The quality of the justice system is good overall, despite the shortages in human resources. At the same time, the digitalisation of justice can be improved, though digital tools are widely used in courts. However, some concerns about judicial independence persist. The RRP aims to address these issues by increasing the independence and efficiency of the justice system, and the quality of legislative process.

Romania's progress in strengthening the rule of law enabled the European Commission to close the Cooperation and Verification Mechanism (CVM) which had been overseeing judicial reforms. The 2023 Rule of Law Report recommends to Romania to complete these reforms, in line with the recommendations from the Venice Commission, and to take measures to address concerns about the investigation and prosecution of criminal offences in the judiciary.

Romania has completed transposition of the 4th and the 5th Anti-Money Laundering Directive. As regards the conformity of the transposition, the Commission sent two letters of formal notice concerning the transposition of different provisions related to beneficial ownership registers. One infringement procedure is still pending.

In May 2023, the 5th round Mutual Evaluation Report of Romania was published. On matters of international cooperation, Romania has been rated at the highest level of effectiveness ('Substantial'). In addition, Romania was rated as largely compliant or compliant on 25 of the 40 Financial Action Task Force (FATF) Recommendations.

The Romanian labour market continues to face significant challenges. Aging population, continued emigration and low intra-country labour mobility are reducing the labour supply. Despite recent improvements, employment and activity rates remain below EU averages. Labour and skills shortages and job mismatches remain a pressing challenge for the labour market. High minimum wage increases above inflation and productivity growth continued in 2023, fuelling overall wage growth, with potential adverse consequences for inflation persistence and external competitiveness. The Romanian recovery and resilience plan stipulates the creation of a new mechanism for setting the minimum wage, based on objective criteria, consistent with job creation and competitiveness.



Table 6.6:

**Romania - Allocation of assets by financial sub-sector**

	RO		EA		Ratio to GDP (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Financial corporations (total)	86	90	689	715	174	190
Central bank	19	19	53	68	46	52
Monetary financial institutions	48	50	266	290	87	93
Other financial intermediaries	7	8	181	163	16	18
Non-MMF investment funds <sup>1)</sup>	5	3	101	113	4	5
Insurance co. and Pension Funds	8	10	87	81	21	22
	RO		EA		Share of total (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Central bank	22	21	8	10	27	27
Monetary financial institutions	56	56	39	40	50	49
Other financial intermediaries	8	9	26	23	9	10
Non-MMF investment funds	5	4	15	16	2	3
Insurance co. and Pension Funds	9	11	13	11	12	11

1) MMF stands for money market funds.

Source: Eurostat.

The financial sector in Romania is smaller and less developed than in the euro area. The size of assets managed by the financial sector stood at 90% of GDP in 2022, which is much less than in the euro area (715% of GDP) and less than the average of the five euro area Member States with the smallest financial sectors. The size of the financial sector has remained broadly unchanged since 2018 while it has increased in the euro area. Banking dominates the Romanian financial sector and made up 56% of the financial sector's assets in 2022. The central bank is the second largest holder of financial assets with a share of 21% in 2022. These shares of financial assets held by banks and the central bank are larger than in the euro area but relatively similar to those of the five euro area Member States with the smallest financial sectors. They mostly reflect the relative underdevelopment of non-bank financial intermediaries and investment funds compared to the euro area. Relative to GDP, the insurance and the pension-fund sector in Romania is eight-times smaller than in the euro area. However, the sector's share of the total financial sector assets stood at 11% in 2022, which is similar to that of the euro area.

Table 6.7:

Romania - Financing of the economy<sup>1)</sup>

	RO		EA		Ratio to GDP (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Liabilities (total)	198	207	706	696	316	304
Loans	58	57	228	219	109	103
Non-financial co. debt securities	0	0	12	12	3	2
Financial co. debt securities	0	1	66	58	3	4
Government debt securities	30	33	78	71	47	42
Listed shares	8	9	60	63	12	10
Unlisted shares	28	22	176	184	54	53
Other equity	30	41	53	54	56	58
Trade credits and advances	45	43	34	35	31	32

	RO		EA		Share of total (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Loans	29	27	32	32	34	33
Non-financial co. debt securities	0	0	2	2	1	1
Financial co. debt securities	0	1	9	8	1	1
Government debt securities	15	16	11	10	15	14
Listed shares	4	4	9	9	3	3
Unlisted shares	14	11	25	26	19	19
Other equity	15	20	7	8	17	18
Trade credits and advances	23	21	5	5	10	11

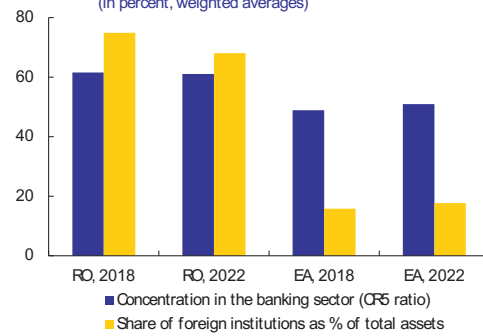
1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total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

Source: Eurostat.

As to the financing of the economy, outstanding liabilities are much lower in Romania than in the euro area (207% of GDP in 2022 vis-à-vis 696% of GDP in the euro area) and than in the euro area Member States with the smallest financing needs. Like in the euro area, loans are the dominant source of funding. They amounted to 27% of total liabilities in 2022. Trade credits and advances play an important role in the financing of the economy (21% of outstanding liabilities in 2022). Romania has less developed bond and equity markets than the euro area and market financing (debt securities and listed shares) is much less developed. Financing through private debt markets is practically inexistent, while equity markets are very small compared to those of the euro area. Equity and private sector debt markets represented 5% of liabilities in 2022 (10% of GDP). This compares to 19% of liabilities in the euro area (70% of GDP for private-sector debt and 63% of GDP for listed stocks). However, Romania is still comparable to the five euro area Member States with the smallest financial needs. The government bond market is smaller than in the euro area, reflecting the smaller debt-to-GDP ratio in the country.

Romania's banking sector is well integrated with the euro area's financial sector, in particular through a high level of foreign ownership in its banking system. Foreign-owned banks, the majority of which are subsidiaries of parent banks based in the euro area, had a share of assets in the total held by the Romanian banking sector of 68% in 2022, well above the euro area average of nearly 18%. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has remained stable since 2018, and stood at 61% in 2022. This is around 10 percentage points above the euro area average in 2022.

Graph 6.11: Romania - Foreign ownership and concentration in the banking sector  
(in percent, weighted averages)



Source: ECB, Structural financial indicators.



## 7. SWEDEN

### 7.1. LEGAL COMPATIBILITY

#### 7.1.1. Introduction

The legal rules governing the Swedish Central Bank (Riksbank) have been amended since the 2022 Convergence Report. Amendments to the Instrument of Government (as part of the Swedish Constitution), have been made, while the Riksbank Act from 1988, as amended, (the 'Riksbank Act'), has been replaced with a new central bank Act (the 'new Riksbank Act') which entered into force on 1 January 2023. Also, the Law on Exchange Rate Policy from 1998 has been amended. Certain incompatibilities and imperfections highlighted in the Commission's 2022 Convergence Report have been remedied. Other issues remain unsolved. Therefore, certain comments provided in the 2022 Convergence Report remain relevant and are repeated in this year's assessment, while new issues concerning, in particular, the central bank independence and privileged access are flagged.

#### 7.1.2. Central bank independence

Article 3 of Chapter 6 of the Riksbank Act obliged the Riksbank to inform the minister appointed by the Swedish Government about a monetary policy decision of major importance prior to its approval by the Riksbank. A dialogue between the central bank and third parties was not prohibited as such, but regular upfront information of government representatives about monetary policy decisions, especially when the Riksbank would have considered them as of major importance, could structurally have offered to the government an incentive and the possibility to influence the Riksbank when taking key decisions, or to appear to be able to influence it. Therefore, the obligation to inform the minister about a monetary policy decision of major importance prior to its approval by the Riksbank limited or appeared to limit the possibility for the Riksbank to take decisions independently and offered the possibility for the Government to seek to influence them. Such procedure was incompatible with the prohibition on giving instructions to the central bank, pursuant to Article 130 TFEU and Article 7 of the ESCB/ECB Statute.

Article 3 of Chapter 6 has now been repealed. Article 7 of Chapter 2 of the new Riksbank Act provides that monetary policy decisions of major importance are communicated to the minister after their approval by the Riksbank. Thus, the above incompatibility with Article 130 TFEU and Article 7 of the ESCB/ECB Statute has been solved.

Pursuant to Article 2 of Chapter 3 of the Riksbank Act and Article 13 of Chapter 9 of the Instrument of Government, the prohibition on the members of the Executive Board to seek or take instructions only covered monetary policy issues. The provisions did not provide for their independence in the performance of ESCB-related tasks directly entrusted by the Treaties. Both provisions, therefore, were considered incompatible with Article 130 TFEU and Article 7 of the ESCB/ECB Statute.

The new amendments to the Instrument of Government changed Article 13 of Chapter 9 which now provides that the Riksbank is responsible for: 1. formulating and implementing monetary policy; 2. carrying out foreign exchange interventions; 3. holding and managing foreign exchange reserves; 4. promoting the smooth operation of payment systems; 5. carrying out other basic tasks arising from a specific law. Under Article 15 of Chapter 9 of the newly amended Instrument of Government, no authority may decide how the Riksbank shall decide on matters for which it is responsible under Article 13 of Chapter 9. In these areas of responsibility, the Riksbank may not seek or take instructions from anyone. Therefore, the prohibition on the Riksbank to seek or take instructions covers the ESCB-related tasks, and the incompatibility with Article 130 TFEU and Article 7 of the ESCB/ECB Statute has been solved.

Pursuant to Article 4 of Chapter 10 of the Riksbank Act, the Swedish Parliament approved the central bank's profit and loss account and its balance sheet and determined the allocation of the central bank's profit. This practice impinged on the financial independence of the Riksbank and was incompatible with Article 130 TFEU. The Parliament must not be involved in the relevant decision-making process. Its right should be limited to approving the central bank's decision on the profit allocation.

Pursuant to Article 6 of Chapter 8 of the new Riksbank Act, the Swedish Parliament determines the balance sheet and the profit and loss account and approves the central bank's decision on the allocation of the central bank's profit. The Swedish Parliament may refuse to approve a decision only if it is contrary to Chapter 8 of the new Riksbank Act. If approval is refused, the central bank shall take a new decision. Thus, the incompatibility has only been solved in part.

Article 4 of Chapter 1 of the Riksbank Act provided for the replacement of the Governor, in case of absence or incapacity, by the Vice-Governors nominated by the General Council. It was unclear whether the notion 'absence' in Article 4 also referred to cases such as the expiry of the term of office, resignation, dismissal or other cause of termination of office. To ensure the smooth and continuous functioning of the Riksbank, the Riksbank Act would have benefited from some improvement and should have provided for clear procedures and rules regarding the succession of the Governor in case the notion 'absence' also referred to instances of termination of office as well as in case the Governor was incapacitated.

According to Article 12 of Chapter 7 of the new Riksbank Act, the Council may determine the order in which the Vice-Governors have to serve in place of the Governor. The preparatory works accompanying the new Riksbank Act point out that Article 12 focuses on the need for replacement in different situations. This could include replacement in case of illness, but also replacement for a period of time before a new Governor has taken up his duties. A replacement may also be envisaged if the current Governor is no longer in office, for example because he or she has resigned at own request or has been removed from employment by a decision of the Council, even if the decision may be challenged. Statements in preparatory works are a source of law in Swedish law. Given that preparatory works have clarified that this Article refers to instances of termination of office, as well as in case the Governor is incapacitated, the issue has been solved.

Article 3 of Chapter 2 of the new Riksbank Act provides that the central bank shall decide on the specification of the price stability target, after approval by the Swedish Parliament. The Parliament's right to approve any decision taken by the central bank on the design of the price stability objective is incompatible with the prohibition on giving instructions to the central bank as set out in Article 130 TFEU and Article 7 of the ESCB/ECB Statute.

The Commission notes the provisions on restoration of equity introduced in the new Riksbank Act. According to Article 15 of Chapter 8, if the equity is less than one third of the target level, the Riksbank shall make a submission to the Riksdag to restore equity. The submission shall be for an amount that restores equity to the base level unless unrealised gains on the balance sheet justify restoration to a lower level or not at all. If required to secure the Riksbank's ability to be self-financing in the long term, the submission may be for an amount corresponding, at most, to an amount that restores equity to the target level.

These provisions aim to safeguard the financial independence of the central bank which also implies that Riksbank should always be sufficiently capitalised in order to avoid any situations which may negatively impact the central bank's ability to perform its ESCB-related tasks but also its national tasks.

#### 7.1.3. Prohibition of monetary financing and privileged access

Under Article 8 of Chapter 6 of the Riksbank Act, the Riksbank could, in exceptional circumstances, grant credits or provide guarantees on special terms to banking institutions and Swedish companies that were under the supervision of the Financial Services Authority.

In order to comply with the prohibition of monetary financing of Article 123 TFEU it should have been clearly specified that the loan was granted against adequate collateral to ensure that the Riksbank would not suffer any loss in case of the debtor's default.

Pursuant to Article 4 first paragraph point 2 of Chapter 2 of the new Riksbank Act, the Riksbank may, in relation to financial undertakings, provide credit in Swedish krona and foreign currency against adequate security. Also, Article 6 point 1 of Chapter 3 of the new Riksbank Act provides that, if necessary to counteract a serious disturbance in the financial system in Sweden, the Riksbank may provide credit in Swedish krona or foreign currency against adequate security to: a) financial undertakings referred to in Chapter 1, Section 2(1); b) financial undertakings referred to in Chapter 1, Section 2(2) and operating from a branch in Sweden; c) financial undertakings referred to in Chapter 1, Section 2(1) and (2), which are central counterparties. Article 7 of Chapter 3 of the new Riksbank Act provides that the Riksbank may, against collateral and under other specific conditions, grant credit in Swedish krona or foreign currency to a viable financial company as referred to in Section 6 in order to temporarily satisfy the company's liquidity needs, if: 1) it is necessary to counteract a serious disturbance in the financial sector in Sweden or 2) there are other exceptional reasons.

Therefore, the incompatibility in the area of prohibition of monetary financing with Article 123 TFEU has been solved.

Pursuant to Article 1(3) of Chapter 8 of the Riksbank Act, the Riksbank shall not extend credits or purchase debt instruments 'directly from the State, another public body or institution of the European Union'. The Article did not enumerate the entities covered by the prohibition of monetary financing correctly. Therefore, Article 1 was incompatible with the wording of Article 123(1) TFEU and 21(1) of the ESCB/ECB Statute.

Article 6 of Chapter 1 of the new Riksbank Act provides that the Riksbank may not extend credit or purchase debt instruments directly from: 1) the State, municipalities, regions or associations of local authorities or legal persons over which the State, regions, municipalities, or associations of municipalities, separately or jointly, has a direct or indirect control; or 2) institutions, bodies, offices or agencies of the European Union, other central banks.

While the incompatibility has been partially solved by reference to the 'institutions, bodies, offices or agencies of the European Union', the new Article 6 of Chapter 1 of the new Riksbank Act does not enumerate the entities covered by the prohibition of monetary financing correctly. Therefore, Article 6 of Chapter 1 of the new Riksbank Act is incompatible with the wording of Article 123(1) TFEU and 21(1) of the ESCB/ECB Statute.

According to Article 1(4) of Chapter 8 of the Riksbank Act, the Riksbank could grant credit to and purchase debt instruments from financial institutions owned by the State or another public body. This provision of Article 1 did not fully comply with Article 123(2) TFEU and Article 21.3 of the ESCB/ECB Statute because the exemption only covered publicly owned institutions. Article 6 of Chapter 1 of the new Riksbank Act provides that the Riksbank may grant credit to or purchase debt instruments directly from publicly owned credit institutions under the same conditions as other credit institutions under the law. Thus, this incompatibility has been partially solved. For the sake of legal certainty, it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

The provisions of Article 4 of Chapter 10 on the allocation of the Riksbank's profit were supplemented by non-statutory guidelines on profit distribution, according to which the Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its contingency and balancing funds. Although these guidelines were not legally binding but accepted as a practice by Parliament for calculating profit allocation and as there was no statutory provision limiting the amount of profit that may be paid out, such



practice could constitute an incompatibility with the principle on the prohibition of monetary financing under Article 123 TFEU. The law should have ensured that the reserve capital of Riksbank was left unaffected in any case and that the actual contribution to the State budget did not exceed the amount of the net distributable profit.

The new Riksbank Act no longer refers to the non-statutory guidelines on profit distribution. According to Article 4 of Chapter 8 of the new Riksbank Act, the Council shall decide on the allocation of the results of the year. Pursuant to Article 6 of Chapter 8 of the new Riksbank Act, the Swedish Parliament approves the central bank's decision on the allocation of the central bank's profit. The Swedish Parliament may refuse to approve a decision only if it is contrary to Chapter 8 of the new Riksbank Act. If approval is refused, the central bank shall take a new decision. The law should ensure that the reserve capital of Riksbank is left unaffected in any case and that the actual contribution to the State budget does not exceed the amount of the net distributable profit.

Pursuant to Article 4 first paragraph point 5 of Chapter 2 of the new Riksbank Act, the Riksbank may, in relation to financial undertakings, buy and sell Swedish sovereign debt. Pursuant to Article 5 point 3 of Chapter 2 of the new Riksbank Act, the Riksbank may, if there are exceptional reasons, buy and sell financial instruments other than sovereign debt referred to in Article 4 first paragraph point 5 of Chapter 2. The restriction on Riksbank's ability to purchase and sell financial instruments other than Swedish sovereign debt instruments is incompatible with the prohibition of privileged access under Article 124. Article 124 TFEU prohibits any measure, not based on prudential considerations, establishing privileged access by, inter alia, central governments to financial institutions. Under Article 1(1) of Council Regulation (EC) No 3604/93, privileged access is understood as any law, regulation or other binding legal instrument adopted in the exercise of public authority which, inter alia, obliges financial institutions to acquire or to hold liabilities of, inter alia, central governments, or confers financial advantages that do not comply with the principles of a market economy, in order to encourage those institutions to acquire or hold such liabilities. Thus, as public authorities, national central banks may not take measures granting privileged access to financial institutions by the public sector if such measures are not based on prudential considerations. Article 2 of Regulation (EC) No 3604/93 defines 'prudential considerations' as those which underlie national laws, regulations or administrative actions based on, or consistent with, Union law and designed to promote the soundness of financial institutions so as to strengthen the stability of the financial system as a whole and the protection of the customers of those institutions. As the restriction on Sveriges Riksbank's ability to purchase and sell financial instruments other than Swedish sovereign debt instruments is not based on prudential considerations within the meaning of Article 124 TFEU, the restriction on Sveriges Riksbank's ability to purchase and sell financial instruments other than Swedish sovereign debt instruments is incompatible with the prohibition on privileged access under Article 124 TFEU.

#### 7.1.4. Integration into the ESCB

##### Objectives

Chapter 2, Article 1 of the new Riksbank Act should include a reference to the secondary objective of the ESCB to support the general economic policies in the Union in line with Article 127(1) TFEU.

##### Tasks

The incompatibilities with regard to the ESCB/ECB tasks are as follows:

- absence of a general reference to the Riksbank subordination to the ECB's legal acts (Chapter 1, Article 4 of the Act and Chapter 9, Article 13 of the Instrument of Government, as amended);

- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Chapter 2 of the Act; Chapter 9, Article 13 of the Instrument of Government as amended);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 2, Article 2 of the Act); Articles 1 to 4 of the Law on Exchange Rate Policy of 1998 as amended);
- right to authorise the issue of banknotes and the volume of coins and definition of the monetary unit (Chapter 4 of the Act; Chapter 9, Article 14 of the Instrument of Government as amended);
- ECB's right to impose sanctions.

There are furthermore some imperfections regarding the:

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Chapter 1, Article 11 of the Act);
- non-recognition of the role of the ECB in the functioning of payment systems (Chapter 3 of the Act);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor;
- non-recognition of the role of the ECB in the field of international cooperation (Chapter 6 of the Act).

#### 7.1.5. Assessment of compatibility

As regards independence of the central bank, the prohibition of monetary financing, privileged access and integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the new Riksbank Act, the newly amended Instrument of Government as part of the Swedish Constitution and the Law on Exchange Rate Policy as amended, is not fully compatible with the requirements of Article 131 TFEU for the reasons set out above.

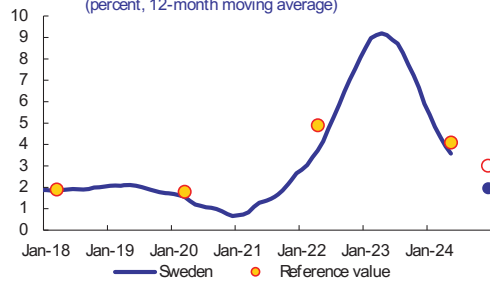
The Swedish authorities should remedy the above-mentioned incompatibilities and imperfections.

## 7.2. PRICE STABILITY

### 7.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Sweden in 2022. The 12-month average inflation rate in Sweden then gradually increased to a peak of 9.2% in April 2023, after which it gradually decreased, reaching 5.4% in January 2024. In May 2024, the reference value was 4.1%, calculated as the average of the 12-month average inflation rates in the Netherlands, Italy and Latvia plus 1.5 percentage points. The corresponding inflation rate in Sweden was 3.6%, i.e. below the reference value. The 12-month average inflation rate is projected to decrease and stay below the reference value in the coming months.

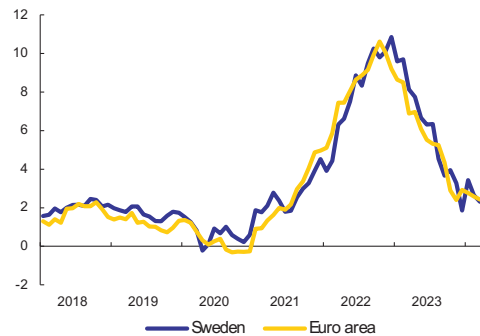
Graph 7.1: Sweden - Inflation criterion  
(percent, 12-month moving average)



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of Sweden in December 2024. The reference values for 2018, 2020 and 2022 refer to the reference values calculated in the previous convergence reports.

Source: Eurostat, Commission's Spring 2024 Economic Forecast.

Graph 7.2: Sweden - HICP inflation  
(y-o-y percentage change)



Source: Eurostat.

Table 7.1:

Sweden - Components of inflation	(percentage change) <sup>1)</sup>							weights in total
	2018	2019	2020	2021	2022	2023	May-24	2023
HICP	2.0	1.7	0.7	2.7	8.1	5.9	3.6	1000
Non-energy industrial goods	0.0	0.3	0.9	1.0	5.6	7.4	4.5	293
Energy	9.6	2.9	-8.8	15.3	31.4	-11.3	-15.0	108
Unprocessed food	4.5	2.3	2.6	-0.4	13.0	12.5	5.2	31
Processed food	1.8	2.8	1.9	0.9	8.9	11.1	5.6	158
Services	1.8	2.0	1.8	2.5	4.1	5.7	5.9	410
HICP excl. energy, food, alcohol and tobacco	1.0	1.3	1.4	1.8	4.8	6.6	5.4	703
HICP at constant tax rates	1.8	1.6	0.6	2.6	8.2	5.8	3.4	1000
Administered prices HICP	1.2	2.0	2.4	1.7	2.4	4.6	5.4	135

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

Source: Eurostat, European Commission calculations.

## 7.2.2. Recent inflation developments

HICP inflation in Sweden started picking up from the middle of 2021 as the dampening impact of the pandemic on prices receded and energy prices in particular started increasing. Inflation continued to rise rapidly throughout 2022, driven by the sharp rise in energy prices in the wake of Russia's full-scale invasion of Ukraine and by the emergence of supply bottlenecks. This resulted in price increases spreading broadly to a wide range of goods and services, partly also reflecting the lagged impact of a weaker effective exchange rate.

This culminated in HICP inflation reaching 10.8% in December 2022, by far the highest inflation rate on record since the harmonised consumer price index was first published in 1996. The average HICP inflation rate reached 8.1% in 2022, up from 2.7% in 2021. Subsequently, headline inflation rates started to fall steadily to 1.9% in December 2023 on the back of sharply lower energy prices and negative base effects, bringing annual average HICP inflation to 5.9%. However, food price increases remained above 5% throughout 2023 while services inflation only moderated slowly from its peak of 7.1% in July 2023 to slightly above 5% by year end. In 2022 and 2023, inflation in Sweden was on average broadly in line with that of the euro area.

Following the increase in headline inflation with a lag, HCIP inflation excluding energy, food, alcohol and tobacco climbed to 6.6% in 2023, from 1.8% in 2021. Compared with the euro area, underlying labour costs were more moderate on the back of moderate multi-annual wage agreements, which extend into 2025. Firms initially absorbed part of the cost increases caused by supply chain disruptions in their margins, but then proceeded passing them on to final consumer prices.

From the third quarter of 2021 to the first quarter of 2024, the behaviour of the HICP's main components exhibited pronounced up and downswings, along with noticeable volatility. This reflected the impact of a combination of globally induced demand and supply shocks affecting Swedish supply chains and consumption patterns. These shocks included the COVID-19 pandemic and its unwinding (with asymmetric supply and demand and price effects with respect to, for example, goods and contact-intensive services), the impact of Russia's full-scale invasion of Ukraine, notably affecting energy markets, as well as the emergence of additional, sometimes associated, supply bottlenecks. Over the largest part of the period in focus, the lagged impact of the weakening of the effective exchange rate of the krona from 2021 to the last quarter of 2023 contributed to price increases for imported goods and services. In the period of rising inflation, the pass-through of the exchange rate to consumer prices is estimated to have been particularly high, but it is expected to have normalised after inflation peaked. In the first quarter of 2024, a less strong fall in energy prices, which reflected base effects, accounted for an increase in headline inflation in January 2024, followed by resumed disinflation in the following months. In May 2024, annual HICP inflation stood at 2.5%. Non-energy industrial goods and food inflation continued to fall in the first months of 2024. By contrast, services inflation remained high and even increased somewhat in the first quarter of 2024, to just below 6%. In the period from January to May 2024, HICP inflation excluding energy and food continued to decrease.

### 7.2.3. Underlying factors and sustainability of inflation

#### Macroeconomic policy mix and growth developments

The Swedish economy experienced a strong but unevenly paced recovery from the pandemic. Overall, the economy expanded by 2.7% in 2022, driven by domestic demand, in particular private consumption and investment, mirroring the rebound in contact-intensive services and the progressive easing of disruptions in global supply chains. The economy stagnated in 2023, with real GDP contracting by 0.2% even as the labour market remained resilient. The slowdown reflects mainly sharply higher inflation, eroding disposable household income, in particular combined with higher interest rates. The latter affected the interest-rate sensitive Swedish economy to a greater extent than most EU countries, given the combination of high private debt ratios and the short fixation period for interest on housing loans in particular. This exercised a particularly strong drag on purchasing power and residential investment but also weighed on business and consumer confidence.

Real GDP even contracted slightly in the first quarter of 2024 but is poised to recover in the second half of 2024, as the Swedish economy is set to benefit from falling inflation and interest rates supporting disposable income. However, the pace of expansion would remain comparatively modest with average real GDP growth for 2024 projected at 0.2%. Real GDP is forecast to grow by around 2% in 2025, as the recovery is projected to become more broad-based with lower inflation, and easing financial conditions set to support the cyclical recovery. Housing construction, which had plummeted when interest rates started to rise, is expected to stabilise only towards the end of the forecast horizon, whereas non-residential construction is set to remain resilient, partly on account of defence spending. Other business investment, on the other hand, is projected to remain lacklustre, mirroring low-capacity utilisation. Relatively weak demand from abroad is set to dampen the growth of Swedish exports in the near term but exports are projected to contribute to growth in 2025.

The fiscal stance was contractionary in 2022, on account of the unwinding of Covid-19 crisis-related fiscal measures, while considerable support to households and enterprises to counter high energy prices was financed by extraordinary surpluses made by the state-owned electricity grid authority, thus not directly impacting public finances. It turned

expansionary in 2023 <sup>(65)</sup> but is expected to turn contractionary again in 2024, despite a reduction in certain taxes, such as on fuel, as well as measures aimed at addressing the economic impact of inflation on regional government finances and strengthening the military defence. In 2025, the fiscal stance is expected to be contractionary on the assumption of unchanged policies.

Monetary policy, conducted within an inflation targeting framework <sup>(66)</sup>, tightened substantially in the period covered by the report, as the Riksbank proceeded with the steepest increase in its policy rate in decades. Since April 2022, the Riksbank has raised its main policy rate eight times, from 0% to 4% in September 2023 in order to address high inflation and ensure that inflation expectations remained anchored. Furthermore, the Riksbank started normalising its balance sheet by reducing the stock of securities it accumulated over 2015-2022 as part of its monetary policy easing policies. The Riksbank stopped purchasing assets at the end of 2022. In February 2023, the Riksbank Executive Board decided to start selling real and nominal government bonds in order to reduce its asset holdings further. The sales of government bonds started in April 2023 and initially amounted to SEK 3.5 billion per month. Following a decision taken in June 2023, the Riksbank increased the pace of sales to SEK 5 billion per month in September 2023, and then increased it further to SEK 6.5 billion per month in February 2024. While the Riksbank did not actively sell its holdings of non-government bonds, these holdings also declined due to the maturing of the securities. Overall, the Riksbank's securities holdings decreased from a SEK 1012 billion peak in Q1 2022 to SEK 570 billion in May 2024. At its latest meeting in May 2024, the Riksbank cut its policy rate by 25 basis points, bringing it to 3.75 basis points. The Executive Board assessed that easing monetary policy was appropriate as inflation was approaching the 2% target while economic activity was weak. In accordance with the updated central bank law, on 2 April 2024, the Riksbank made a submission to the Swedish parliament for a capital injection amounting to SEK 43.7 billion to restore its equity to the statutory level following the losses stemming from bond portfolio purchases to counter the impact of the pandemic. On 13 June, the Swedish Parliament's finance committee proposed that the Riksbank receive a capital injection of SEK 25 billion. At the cut-off date of this report, no final decision was taken on this issue.

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

<sup>(66)</sup> Since 1995, the Riksbank has targeted increases in the domestic CPI with the aim of keeping inflation at 2%. In September 2017, the Riksbank changed its target from measuring inflation in terms of CPI to CPIF (CPI with the interest rate component kept unchanged).

Table 7.2:

Sweden - Other inflation and cost indicators

	(annual percentage change)							
	2018	2019	2020	2021	2022	2023	2024 <sup>1)</sup>	2025 <sup>1)</sup>
<b>HICP inflation</b>								
Sweden	2.0	1.7	0.7	2.7	8.1	5.9	2.0	1.8
Euro area	1.8	1.2	0.3	2.6	8.4	5.4	2.5	2.1
<b>Private consumption deflator</b>								
Sweden	2.5	2.1	0.8	1.8	6.8	6.3	2.7	1.0
Euro area	1.5	1.1	0.6	2.3	6.8	6.0	2.4	2.0
<b>Nominal compensation per employee</b>								
Sweden	3.9	2.9	2.5	4.6	2.8	4.1	4.1	3.0
Euro area	2.1	2.2	-0.4	4.2	4.5	5.1	4.2	3.1
<b>Labour productivity</b>								
Sweden	0.3	1.4	-0.8	4.9	-0.1	-1.6	0.5	1.6
Euro area	0.1	0.2	-4.7	4.4	1.1	-1.0	0.1	0.9
<b>Nominal unit labour costs</b>								
Sweden	3.6	1.5	3.4	-0.3	2.8	5.8	3.6	1.3
Euro area	2.0	1.9	4.6	-0.2	3.3	6.2	4.1	2.2
<b>Imports of goods deflator</b>								
Sweden	6.7	2.3	-5.3	5.2	23.7	4.4	1.5	2.3
Euro area	2.6	-0.6	-3.8	9.7	21.6	-4.9	0.4	1.8

1) Commission's Spring 2024 Economic Forecast.

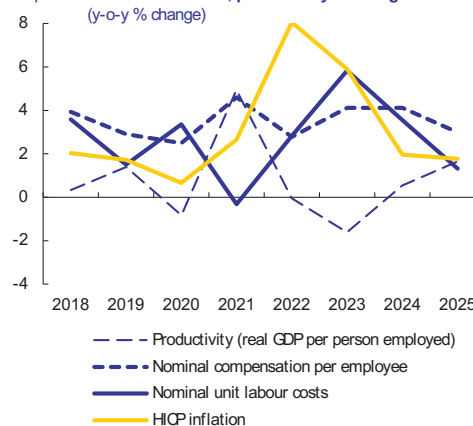
Source: Eurostat, Commission's Spring 2024 Economic Forecast.

## Wages and labour costs

Employment growth was quite strong in Sweden in the last decade. The labour force participation rate is the highest in the EU. However, seen over the last decade and a half, healthy employment growth and high labour force participation have not led to a marked decline in the unemployment rate, which stands above the euro area average. This is partly due to the relatively strong growth of the labour force, but also mirrors significant mismatches and skill shortages (including among persons from disadvantaged socio-economic and migrant backgrounds) which give employers an incentive to retain labour during periods of expected short-lived weakness in economic activity. In the aftermath of the pandemic, risks to the labour market were countered by sizable and frontloaded policy support to households affected by temporary unemployment and to businesses suffering from turnover losses. In 2023, the labour market remained resilient despite the broad stagnation in economic activity, probably partly on account of firms hoarding labour in a situation with tight supply of skilled personnel and partly enabled by high corporate profitability. This notwithstanding, unemployment is expected to rise somewhat in line with the usual cyclical lag. The unemployment rate is set to peak at close to 8.5% in 2024, before falling somewhat in 2025 on the back of improved employment growth.

The growth in nominal compensation per employee stood at 4.1% on average in 2023, up from 2.8% in 2022, that is well below inflation rates in both years. In Sweden, social partners typically first negotiate a benchmark agreement for exporting sectors aimed at maintaining cost competitiveness vis-a-vis major trading partners. Other sectors, including services, tend to follow this benchmark rather closely. The most recent multi-annual wage agreement extends into 2025. It provides for moderate compensation growth. Overall, the growth of

Graph 7.3: Sweden - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission's Spring 2024 Economic Forecast.



compensation per employee is expected to moderate somewhat in 2025 on the back of falling inflation. The current collective agreements should not contribute to upward pressure on inflation in 2024 and into the first months of 2025. However, wage demands, and wage drift might react with a certain lag to the earlier peak in inflation. Still, the Swedish wage negotiation framework tends to deliver outcomes supporting medium-term price stability and contributing to maintaining firms' price competitiveness. Moreover, overall healthy corporate profitability should allow firms to cushion some increases in compensation without adding to upward pressure on prices. Overall, the risks of significant second round effects of wage increase on inflation appear to be limited.

Sweden had moderate labour productivity growth in the years before 2019. In the period 2020-2022 the pandemic induced strong swings in economic activity while employment was cushioned by a combination of labour hoarding and various support schemes. As a result, aggregate measures of changes in labour productivity and unit labour costs were distorted. Unit labour costs growth rose subsequently to 5.8% in 2023 - similar to the euro area - reflecting a cyclical fall in overall labour productivity as employment remained resilient in the face of sluggish economic activity. Unit labour costs are set to fall markedly over the forecast horizon, to 1.3% by 2025.

#### External factors

Given the openness of the Swedish economy, developments in import prices traditionally play an important role in domestic price formation. Import price growth (measured by the deflator of imports of goods) has fluctuated significantly over the past years. This was for a large part due to large swings in energy and other commodity prices in the wake of the pandemic and military conflict, most prominently Russia's full-scale invasion of Ukraine. However, related trade, supply and demand disruptions increasingly played a role in pushing up import prices for a broader range of imports from 2022 onwards. The lagged effect of exchange rate movements also played a role, in particular the most recent phase of effective krona weakening during 2022 and most of 2023.

In all, import prices have been among the significant determinants of consumer price increases over the past couple of years. In 2022, the import deflator for goods rose by 23.7% and the one for services by just over 11%. Despite decelerating, the import deflator for goods was still high in 2023, at 4.4%. The impact of changes in import prices on consumer price inflation is difficult to gauge. During the pandemic it became very difficult to assess the pass-through of trade prices to consumer price inflation, given their high volatility and complex interactions with the price effects of supply chain disruptions, exchange rate movements, inventory adjustments, sales restrictions, and other pandemic-related factors. There is evidence that suggests that the pass-through strengthened significantly during the episode of high inflation but has normalised since. According to the Commission's Spring 2024 Economic Forecast, import price gains are expected to moderate over the projection horizon, at around 2% in 2024 and 2025.

The nominal as well as various measures of real effective exchange rates (measured against a group of 36 trading partners) showed a very similar pattern of a sustained weakening from the beginning of 2021 until the last quarter of 2023, when the effective exchange rates started strengthening before falling back slightly again in the last months covered by this report, closely reflecting movements in the nominal exchange rate. Over the period in focus there were no major discrepancies between the growth in domestic prices and the growth in domestic prices of Sweden's main trading partners. Likewise, for 2024 and 2025, major discrepancies between nominal and real effective exchange rates are not expected to occur. Overall, Swedish cost developments do not pose major challenges to competitiveness.



### Administered prices and taxes

The share of administered prices in the Swedish HICP basket amounts to just below 14%, a value similar to the euro area average. The most important item in the administered price basket is rents, which react to interest rates with a lag. Rent increases tend to be concentrated at the beginning of the year. In 2021 and 2022, overall administered price inflation remained well below headline HICP inflation. In 2023, administered price increases nearly doubled to 4.6% but remained below the overall inflation rate. Thus, administered prices have adjusted with a lag to the broad-based price increases witnessed in the economy. This change is accounted for by marked increases in both rents (which increased by 4.1% in 2023 up from 1.7% in 2022) and fully administered prices.

Tax changes contributed only marginally to headline inflation in both 2022 and 2023, as the pace at which HICP at constant taxes increased was below the headline number for both years. With a delayed response to increases in consumer prices, rents are expected to exert some limited upward impact on administered prices and thus overall HICP inflation in 2024 and possibly 2025.

### Medium-term prospects

According to the Commission's Spring 2024 Economic Forecast, inflation is set to moderate to close to 2% in 2024 and 2025 as the impact from previous inflationary shocks is set to fade and as the effect of trade and production bottlenecks should have withered. Firms' pricing plans have started to markedly adjust downwards against the background of weak domestic demand. The profile for expected inflation is further affected by the delayed effect of past swings in the effective exchange rate. In the period of rising inflation, the pass-through is estimated to have been particularly high, but it is expected to normalise over the forecast period. Domestic wage pressures are projected to remain relatively contained over the forecast horizon, in view of moderate increases in labour costs. Some limited upside risks to the labour cost outlook might emerge with a prospective economic recovery taking hold.

However, the country has a long tradition of social partners taking competitiveness and price stability into account in their wage agreements. Overall, Sweden should not experience major changes in cost competitiveness. In all, HICP inflation is forecast to average 1.9% in 2024 and 1.7% in 2025. HICP inflation excluding energy and food is set to continue to fall from 6.6% in 2023 to 3.0% in 2024 and 2.0% in 2025.

As of 2024, inflation is expected to broadly meet the Riksbank's target, as the economy is normalising, despite some risks of persistence, chiefly for services. Risks to the inflation outlook appear broadly balanced for 2024 and 2025. Upside risks are related to weak productivity trends, the costs of the energy transition, structural labour and skill shortages, and renewed supply disturbances resulting from the geopolitical environment. Downside risks could stem from commodity prices and a longer-than-expected period of weak economic activity. Surveys of market inflation expectations suggest that they have remained well anchored at close to the Riksbank's target over the medium term.

The level of consumer prices in Sweden relative to the euro area has increased since Sweden joined the EU in 1995. In 2022, the Swedish price level stood at 116% of the euro area average, down from 121% in 2021. The relative real GDP per capita level in Sweden has also slightly decreased since 2021, reaching about 113% of the euro area average in PPS terms in 2023.

### 7.3. PUBLIC FINANCES

#### 7.3.1. Recent fiscal developments

Sweden's general government balance weakened from a surplus of 1.2% of GDP in 2022 to a deficit of 0.6% of GDP in 2023. The expenditure-to-GDP ratio increased from 47.6% of GDP in 2022 to 48.0% in 2023 and the revenues-to-GDP ratio decreased from just below 49% of GDP in 2022 to 47.4% in 2023. This reflected mainly the final phasing out of some remaining COVID-19 measures during 2022 but also emergency measures related to steeply increasing energy prices and the situation in Ukraine. The main emergency energy support measures consisted in the several rounds of ex-post electricity cost compensation to households and businesses. Although these measures were not targeted and therefore relatively costly, they did not affect the fiscal balance since they were financed by the exceptionally high income generated from the large electricity transmission fees benefitting the state-owned enterprise *Svenska Kraftnät* (the national authority responsible for the electricity grid).

The general government debt-to-GDP ratio returned to its downward path in 2021, falling to a level of 31.2% of GDP in 2023, which is significantly lower than what it was before the pandemic. In addition to the effects of an improving nominal balance with the recovery in economic activity, some of the decrease in the general government debt-to-GDP ratio reflects the stepwise debt-reducing repayment of a Riksbank loan for foreign currency reserves during the 2021-2023 period, equivalent to around 3.5% of GDP.

#### 7.3.2. Medium-term prospects

The 2023 autumn additional budget and the 2024 annual budget taken together represented a relatively modest spending increase, of which some is due to government investment targeted at the build-up of defence spending towards the objective of 2% of GDP. On the revenue side, central government tax revenue remained strong and has kept the state in surplus. By contrast, and despite an increase in government grants, the regional and municipal levels taken together run a deficit due in part to high pension costs due to the sharp increase in inflation. The 2024 budget includes spending on green and digital items financed by grants from the Recovery and Resilience Facility, amounting to 0.2% of GDP.

On 26 April 2024, Sweden submitted its 2024 Convergence Programme. According to the Programme, the headline deficit is projected to increase somewhat to 1.2% of GDP in 2024 and decrease somewhat to 0.3% of GDP in 2025. Based on the Commission's Spring 2024 Economic Forecast, the remaining measures to mitigate the impact of high energy prices are estimated at less than 0.1% of GDP in 2024. The annual cost of humanitarian assistance to people displaced from Ukraine is projected at less than 0.1% of GDP.

The Commission's Spring 2024 Economic Forecast projects the general government deficit to reach 1.4% of GDP in 2024 and 0.9% in 2025. The projections for public finances in the 2024 Convergence Programme are thus close to the Commission's Spring 2024 Economic Forecast.

For 2024, the Commission's Spring 2024 Economic Forecast projects the fiscal stance to be slightly expansionary at -0.6% of GDP <sup>(67)</sup>. The growth in nationally financed primary current expenditure (net of new revenue measures) in 2024 is projected to provide an expansionary contribution of -0.5 percentage point of GDP to the overall fiscal stance. Expenditures financed by the Recovery and Resilience Facility grants and other EU funds are forecast to provide a positive contribution to economic activity amounting at 0.2 of a percentage point of GDP in 2024, unchanged compared to 2023.

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<sup>(67)</sup> For a definition of the fiscal stance used in this report, see footnote in Section 7.2.3. on underlying factors and sustainability of inflation.

Table 7.3:

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

<b>Outturn and forecast <sup>1)</sup></b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024<sup>1)</sup></b>	<b>2025<sup>1)</sup></b>
General government balance	0.8	0.5	-2.8	0.0	1.2	-0.6	-1.4	-0.9
- Total revenue	50.6	49.7	49.3	49.2	48.8	47.4	47.6	47.1
- Total expenditure	49.9	49.2	52.1	49.2	47.6	48.0	49.0	48.0
of which:								
- Interest expenditure	0.4	0.4	0.3	0.2	0.5	0.7	0.7	0.7
p.m.: Tax burden	44.5	43.5	43.1	43.3	42.4	41.4	41.6	41.3
Primary balance	1.2	0.9	-2.6	0.2	1.7	0.1	-0.7	-0.2
Fiscal stance <sup>2)</sup>					0.7	0.1	-0.6	0.9
Recommended growth in net nationally financed primary expenditure (%)							n.a.	-
Growth in net nationally financed primary expenditure (%)							5.9	-
Government gross debt	39.6	35.6	40.2	36.7	33.2	31.2	32.0	31.3
p.m.: Real GDP growth (%)	2.0	2.0	-2.2	6.1	2.7	-0.2	0.2	2.1

1) Commission's Spring 2024 Economic Forecast.

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

Source: European Commission.

On 14 July 2023, the Council recommended that Sweden maintain a sound fiscal position in 2024. According to the Commission Spring 2024 Economic forecast, Sweden's structural balance is projected at 0.0% of GDP in 2024, from 0.1% of GDP in 2023, thereby remaining above the country's medium-term budgetary objective (MTO) of a structural balance of -1.0% of GDP.

Moreover, the Council recommended that Sweden takes action to wind down the emergency energy support measures in force, using the related savings to reduce the government deficit in 2023 and 2024. The Council further specified that, should renewed energy price increases necessitate new or continued support measures, Sweden should ensure that these be targeted at protecting vulnerable households and firms, fiscally affordable, and preserve incentives for energy savings. According to the Commission's Spring 2024 Economic Forecast, the net budgetary cost of such energy support measures is projected at 0.2% of GDP in 2023, and less than 0.1% in 2024, the year in which they will be fully phased out. This is in line with what was recommended by the Council.

In addition, the Council also recommended that Sweden should preserve nationally financed public investment and ensure the effective absorption of Recovery and Resilience Facility grants and other EU funds, in particular to foster the green and digital transitions. According to the Commission's Spring 2024 Economic Forecast, nationally financed public investment is projected to remain stable at 5.1% of GDP in 2024 (from 4.9% of GDP in 2023) and, therefore, it is expected to be preserved.

In 2025, under the assumption of unchanged policy, the fiscal stance is projected to turn contractionary, at 0.9% of GDP. The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to remain stable at 0.1 of a percentage point of GDP in 2025. Nationally financed investment is projected to provide a neutral contribution to the fiscal stance <sup>(68)</sup>. Under the assumption of

<sup>(68)</sup> Other nationally financed capital expenditure is projected to provide a neutral GDP contribution.

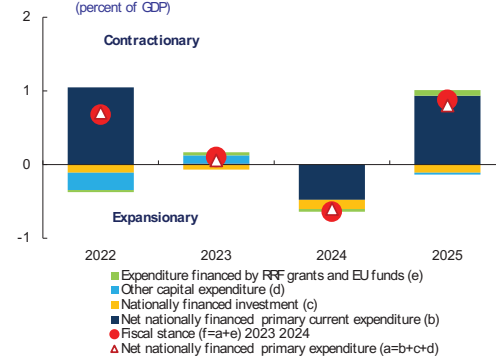
unchanged policy, the growth in net nationally financed primary current expenditure is projected to provide a contractionary GDP contribution to the overall fiscal stance in 2025.

Debt sustainability risks appear low over the medium term. The general government debt ratio is projected to decrease from around 32% of GDP in 2024 to around 22% of GDP in 2034. This projection assumes that the structural primary surplus (excluding changes in the cost of ageing) decreases slightly from 0.8% of GDP in 2023 to 0.7% of GDP in 2024 and remains at that level (excluding changes in the cost of ageing) over the projection period <sup>(69)</sup>.

The low sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if the interest-rate growth differential were 1 percentage point higher than in the baseline scenario, the projected debt ratio in 2034 would be less than 2 percentage points of GDP higher than in the baseline.

Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors include the relatively high share of short-term public debt and contingent liability risks stemming from the elevated private debt. On the other-hand, risk-mitigating factors include the stability of debt maturity in recent years, relatively stable financing sources (a relatively low share of public debt held by non-residents and historically low borrowing costs reflecting a long-standing strong creditor status). In addition, Sweden's positive net international investment position helps mitigating vulnerabilities.

Graph 7.4: Sweden - Fiscal stance and its components  
(percent of GDP)



Source: Commission's Spring 2024 Economic Forecast.

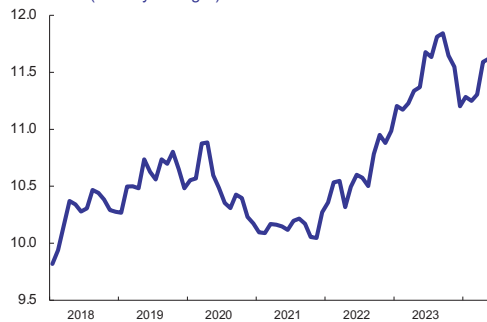
In December 2023, the government initiated a review of the fiscal framework with a view of possibly adjusting the current net lending target. It was initiated because of the government debt ratio having resumed its downward path after the Covid-19 crisis and of lessons learned after a succession of macroeconomic shocks in recent years. The Parliamentary Committee tasked with the Review is to report its findings by mid-November 2024. The latest revisions took effect in 2019 and implied, among other changes, the introduction of a debt anchor, set at 35% of GDP, and a lowering of the net lending target from 1% of GDP over the cycle to 0.33% of GDP. The government also decided to conduct regular reviews of the adequacy of the framework in the final year of every second 4-year legislature. The ongoing Review thus takes place two years earlier than envisaged. However, it fits well with the expected timeline of the Economic Governance Review, in particular the transposition period of the amended Budgetary Framework Directive (2011/85/EU). The amended Directive may affect some aspects of the Swedish fiscal framework, such as the tasks and status of the independent fiscal institutions. It extends the independence safeguards for independent fiscal institutions to all EU Member States and assigns some tasks to these institutions.

<sup>(69)</sup> For details on the methodology, see European Commission (2024), Debt Sustainability Monitor 2023, Institutional Paper 271, March 2024.

#### 7.4. EXCHANGE RATE STABILITY

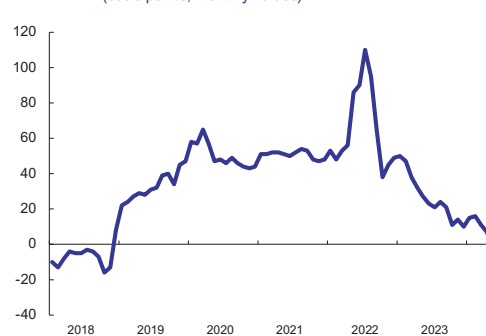
The Swedish krona does not participate in ERM II. As indicated above, the Riksbank pursues inflation targeting under a free-floating exchange rate regime, that allows foreign exchange market interventions by the central bank.

Graph 7.5: Sweden - SEK/EUR exchange rate  
(monthly averages)



Source: ECB.

Graph 7.6: Sweden - 3-M Stibor spread to 3-M Euribor  
(basis points, monthly values)



Source: Eurostat and Thomson Reuters.

The long-term trend of the krona depreciating against the euro started in 2013. The Swedish krona depreciated against the euro by more than 40% from its strongest point in March 2013 to September 2023. This depreciation trend continued over 2022 and 2023 despite volatility that also resulted in temporary episodes of appreciation. In particular, from the end of 2021 to September 2023, the Swedish krona entered a depreciation cycle that culminated with the krona reaching an all-time low of 12 Swedish krona to the euro in September 2023. The krona then regained some of its losses during the last quarter of 2023, reaching 11 Swedish krona to the euro at the end of 2023. Since the beginning of 2024, the Swedish krona has continued to depreciate against the euro and the bilateral exchange rate stood at 11.6 Swedish krona to the euro in May 2024. Overall, the volatility in the exchange rate has been significant, with short-term fluctuations reflecting changes in risk appetite and short-term funding flows, as well as changing perceptions of the future direction of monetary policy in the context of high uncertainty regarding the inflation outlook.

The 3-month STIBOR-Euribor spread has been volatile over 2022-2023. While it stood around 50 basis points in 2021, it increased rapidly in 2022 and peaked at 110 basis points in July 2022, reflecting an earlier monetary policy tightening in Sweden than in the euro area. The 3-month spread then decreased until the end of 2023 to levels around 10 basis points. It has decreased further since the beginning of 2024 and stood at just -2 basis points in May 2024. This decrease reflected that monetary conditions have become similar in Sweden and in the euro area.

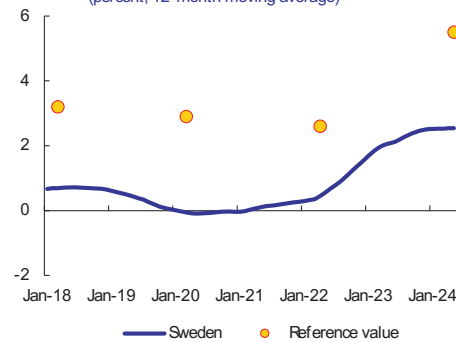
Since December 2015, the Riksbank can intervene on foreign exchange markets in order to prevent a de-anchoring of inflation expectations due to a strengthening krona. At the end of 2021, international reserves (foreign currency and gold) stood at SEK 461 billion. They increased to above SEK 570 billion in December 2022 before returning to levels around SEK 510 billion at the beginning of 2024 (8% of the 2023 GDP) and stood at SEK 540 billion in May 2024. These changes can be related to valuation effects and fluctuations could also be related to the Riksbank's decision to change the financing method for its foreign exchange reserves.

#### 7.5. LONG-TERM INTEREST RATES

Long-term interest rates used to assess adherence to the convergence criterion reflect secondary market yields on a single benchmark government bond with a residual maturity of around 10 years.

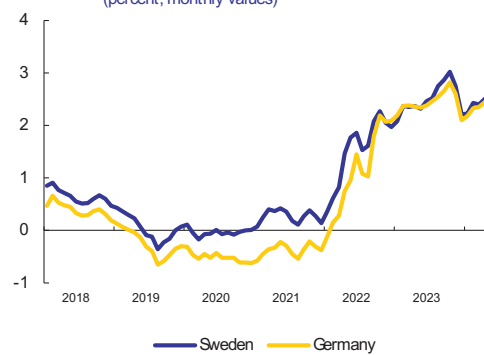
The Swedish 12-month moving average long-term interest rate, relevant for the assessment of the Treaty criterion was well below the reference value at the time of the 2022 convergence assessment of Sweden. After turning positive in 2021, the 12-month moving average long-term interest rate increased steeply in 2022 and 2023, from 0.3% in December 2021 to 2.5% in December 2023. In May 2024, the latest month for which data are available, the reference value, given by the average of long-term interest rates in the Netherlands, Italy and Latvia plus 2 percentage points, stood at 5.5%. In that month, the 12-month moving average of the yield on the Swedish benchmark bond stood at 2.5%, i.e. 3.0 percentage points below the reference value.

Graph 7.7: Sweden - Long-term interest rate criterion  
(percent, 12-month moving average)



Source: European Commission.

Graph 7.8: Sweden - Long-term interest rates  
(percent, monthly values)



Source: Eurostat.

As regards monthly data, long-term interest rates increased markedly over 2022-2023. The yield on the Swedish benchmark government bond increased from 0.1% at the end of 2021 to a peak of 3.0% in October 2023. This increase mainly reflects the actual and expected tightening of monetary policy by the Riksbank against persistent inflationary pressures. Long-term interest rates then eased, with the yield on the Swedish benchmark government bond decreasing to 2.2% in January 2024 before rebounding. It stood at 2.4% in May 2024.

The yields on the Swedish benchmark government bond remained relatively closely aligned to the German benchmark bond, in line with the safe-haven status of Swedish government bonds. However, the long-term interest spread vis-à-vis the German benchmark bond increased at the beginning of 2022 and reached 82 basis points in May 2022 before decreasing to negative levels slightly below -10 basis points in December 2022 and January 2023. It stood at -14 basis points in May 2024.

## 7.6. ADDITIONAL FACTORS

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

In November 2023, the Commission published its 13th Alert Mechanism Report (AMR 2024) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review was warranted for Sweden. In March 2024, the Commission published an In-Depth Review for Sweden. Taking into account the assessment in the In-Depth Review, the Commission, in its Communication 'European Semester – 2024 Spring Package' <sup>(70)</sup>, considers that Sweden is experiencing macroeconomic imbalances with

<sup>(70)</sup> COM(2024) 600 final, 19.06.2024.



vulnerabilities that relate to its real estate market and high private debt. Over the past decade, real estate prices have risen faster than income and rents, accompanied by a rise in private debt. This has exposed the Swedish economy to changes in monetary and financing conditions. The household debt-to-GDP ratio is very high and the debt servicing costs have increased, leaving households and the corporate sector more vulnerable to adverse economic developments. House prices have declined but still remain high. Commercial real estate (CRE) has also seen a correction in its valuation and is an additional source of concern due to its high leverage. The financial sector is highly exposed to real estate but is financially sound, with large buffers against adverse developments. Policy progress has been limited, and without firmer policy action some of the structural features behind the identified vulnerabilities will persist. The tax system has continued to favour home ownership through low recurrent property taxation and to promote debt-financed housing acquisition through the generous tax deductibility of mortgage interest payments. The rental market has seen limited reform and average rents are still well below market rents, resulting in long waiting lists and a very low vacancy rate relative to other EU countries. These policy factors behind the macroeconomic vulnerabilities still need to be addressed.

Sweden's recovery and resilience plan (RRP) includes measures to address a series of structural challenges, in synergy with other EU funds, including cohesion policy funds, to boost its competitiveness and stimulate sustainable growth and reduce the country's territorial and social disparities. The RRF funding provides Sweden with EUR 3.4 billion over the 2021-2026 period. Sweden has not submitted any payment requests so far.

While some reforms (energy efficiency, labour market, housing market and anti-money laundering) and investments (climate action, broadband and education) have been effectuated, the implementation of Sweden's RRP is, overall, significantly delayed.

In addition to the RRF funding, cohesion policy provides Sweden with EUR 1.7 billion for the 2021-2027 period. Cohesion policy financing aims particularly to further improve conditions for research and innovation, create opportunities for entrepreneurship and industrial transformation, and support digitalisation, internationalisation and competitiveness. Sweden has made progress in implementing cohesion policy but challenges remain and disparities persist between the capital region and the rest of the country.

#### 7.6.1. Developments in the balance of payments

According to Balance of Payments data, Sweden's current account surplus decreased to 5.4% of GDP in 2022 as domestic demand entered a phase of sustained recovery from the pandemic. Declines in the balance on goods and on services offset the further increase in the primary income balance that had trended up from 2017 onwards. In 2023, the current account surplus widened to 6.8% of GDP, driven by increasing surpluses in the trade balance and despite a slightly lower primary income balance as the domestic economy stalled. The solid export performance was supported by the strong competitive position of Swedish exporters. By contrast, as in earlier years, the secondary income balance continued to exert a negative impact on the current account balance, reflecting Sweden's foreign aid and net contributions to international organisations, as well as remittances transferred by foreign workers in Sweden to their home countries.

Sweden's net international investment position improved markedly to 31% of GDP in 2022 and is expected to have improved further in 2023. Sweden's financial account (net of changes in reserve assets) shows relatively large fluctuations over time. However, seen over a longer period, the financial account balance has been mostly in surplus and mainly reflects Sweden's role as a net FDI investor abroad. The balance of portfolio investments continues fluctuating appreciably from year to year, mirroring the interplay of financial market conditions and perceptions, exchange rate movements and relative cyclical positions. It registered deficits in 2022 and 2023.



Table 7.4:

Sweden - Balance of payments	(percentage of GDP)					
	2018	2019	2020	2021	2022	2023
Current account	2.5	5.3	5.9	7.1	5.4	6.8
of which: Balance of trade in goods	2.0	3.9	3.9	4.2	3.3	5.1
Balance of trade in services	0.3	0.5	0.5	0.6	-0.6	-0.5
Primary income balance	1.8	2.8	3.5	4.0	4.4	3.8
Secondary income balance	-1.6	-1.9	-2.1	-1.8	-1.8	-1.6
Capital account	0.0	0.0	0.1	0.0	0.1	0.0
External balance <sup>1)</sup>	2.5	5.4	5.9	7.1	5.5	6.8
Financial account	0.8	3.4	-2.8	8.8	0.5	3.8
of which: Direct investment	2.5	1.2	0.7	1.4	2.6	3.0
Portfolio investment	-1.8	2.2	-1.6	10.6	-3.7	-1.9
Other investment <sup>2)</sup>	0.1	1.3	-1.9	-4.2	0.3	3.6
Change in reserves	-0.1	-1.3	-0.1	0.9	1.3	-0.9
Financial account without reserves	0.8	4.7	-2.7	7.9	-0.8	4.8
Errors and omissions	-1.8	-2.0	-8.7	1.7	-5.0	-2.9
Gross capital formation	26.0	25.1	25.1	25.9	28.5	26.8
Gross saving	28.6	30.4	31.1	32.9	34.0	33.5
Net international investment position	8.2	13.3	7.4	19.0	31.0	33.2

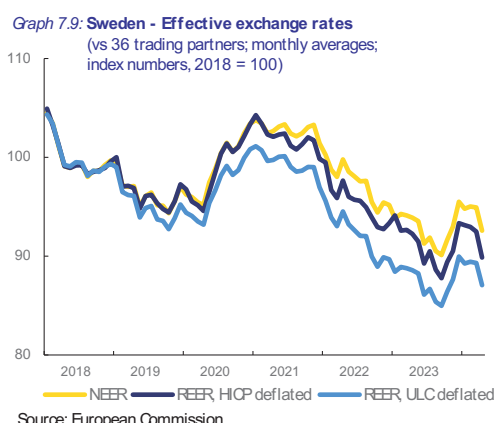
1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Statistics Sweden, European Commission calculations.

Since the early 2000s, Sweden's export market share has been declining, a phenomenon also witnessed in several other high-income countries. The trend decline in the export market shares is linked to changing global trade patterns and affects most mature, industrialised economies with a similar focus on high-value-added exports. Thus, this downward trend does not suggest any underlying competitiveness issues per se. It is difficult to assess short-term fluctuations in export shares given the high degree of volatility in global trade since 2020. It is therefore hard to separate specific structural factors that impact trade performance from cyclical effects and the idiosyncratic impact of supply and demand disturbances that have been affecting the global and Swedish economies in recent years.

This benign conclusion on competitiveness is buttressed by developments in cost competitiveness indicators. In recent years, the real effective exchange rates mainly mirrored changes in the nominal exchange rate, rather than major divergences in price or cost indicators between Sweden and its main trading partners. Various measures of effective exchanges rates moved together. They weakened appreciably over most of the period 2021 to 2023. Then, they strengthened somewhat in the last months of 2023. Unit labour costs exhibited large swings in recent years due to disparate behaviours in economic activity and employment metrics, all



affected heavily by the pandemic, large-scale policy intervention <sup>(71)</sup>, as well as the episode of high inflation and rapid monetary tightening. Allowing for such volatility, the underlying trend is that unit labour costs have been falling over the past number of years compared to Sweden's main trading partners. This has strengthened the competitive position of Swedish exporters.

### 7.6.2. Market integration

Sweden is well-integrated with the euro area through trade and investment linkages. Trade openness of the Swedish economy has been high, at 40% or more every year since 2005 (except in 2016, when it was just below that level). Trade openness (see Table 7.5 for a definition) fell in 2020 but started to recover in 2021. It increased steeply to just above 50% in 2022 and broadly maintained that level in 2023. The main euro area trading partners are Germany, the Netherlands and Finland, while among non-euro area countries Norway, Denmark, and the United States are the main trade partners.

Table 7.5:  
Sweden - Market integration

	2018	2019	2020	2021	2022	2023
Trade openness <sup>1)</sup> (%)	43.4	44.3	40.4	42.8	50.4	50.7
Trade with EA in goods & services <sup>2)+3)</sup> (%)	19.0	19.3	17.6	19.0	22.0	22.8
IMD World Competitiveness Ranking <sup>4)</sup>	9	9	6	2	4	8
Internal Market Transposition Deficit <sup>5)</sup> (%)	0.1	0.7	0.7	2.0	0.7	0.5
Real house price index <sup>6)</sup>	108.7	109.1	112.7	121.9	118.2	105.3

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

2) (Imports + Exports of goods with EA-20 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-20 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) International Institute for Management Development (IMD).

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

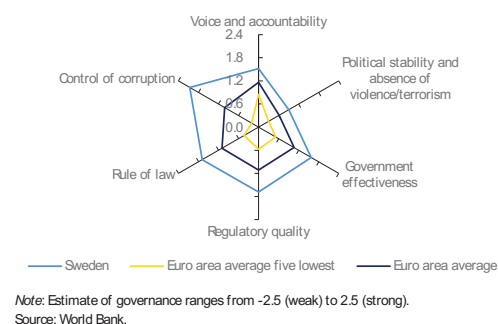
6) Deflated house price index (2015=100) (Eurostat).

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

The stock of inward FDI had remained broadly stable relative to GDP in recent years but went up to 78% of GDP in 2023, from around 70% of GDP in 2022. As regards net inward FDI the largest share originates from the euro area, whereas substantial flows originate from non-euro area countries, primarily Denmark, Norway and the UK, a well-established pattern over a longer period.

Regarding the business environment, Sweden regularly scores top positions in international rankings, well above most euro area Member State and currently ranks in the top ten at global level, with respect to the IMD World Competitiveness Ranking. According to the World Bank's 2022 Worldwide Governance Indicators, Sweden ranks higher than the average of the euro area Member States in all six categories, notably voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

Graph 7.10: Sweden - World Bank's 2022 Worldwide Governance Indicators



<sup>(71)</sup> Short-term movements in REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by various pandemic support schemes in several countries, including Sweden. The trend in this measure in recent years has, this notwithstanding, been very similar to price-based gauges of the REER.

regulatory quality, rule of law and control of corruption <sup>(72)</sup>. Sweden's deficit in the transposition of EU directives in 2023 stood at 0.5%, below the EU average and just at the 0.5% target as proposed by the European Commission in the Single Market Act (2011).

Sweden has notified a complete transposition of the 5th Anti-Money Laundering Directive. The Commission has assessed the transposition as complete and in conformity.

Table 7.6:

**Sweden - Allocation of assets by financial sub-sector**

	SE		EA		Ratio to GDP (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Financial corporations (total)	558	640	689	715	174	190
Central bank	19	25	53	68	46	52
Monetary financial institutions	273	302	266	290	87	93
Other financial intermediaries	59	70	181	163	16	18
Non-MMF investment funds <sup>1)</sup>	82	100	101	113	4	5
Insurance co. and Pension Funds	126	144	87	81	21	22
	SE		EA		Share of total (%) EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Central bank	3	4	8	10	27	27
Monetary financial institutions	49	47	39	40	50	49
Other financial intermediaries	11	11	26	23	9	10
Non-MMF investment funds	15	16	15	16	2	3
Insurance co. and Pension Funds	22	22	13	11	12	11

1) MMF stands for money market funds.

Source: Eurostat.

The Swedish labour market, largely governed by negotiations between social partners at sectorial level, is characterised by high employment rates. Sweden has the largest labour force participation rate in the EU. Relatively modest nominal wage increases, even in recent years with high inflation have contributed to the ongoing disinflation, by helping to avoid the emergence of wage-driven cost pressures. Sweden has one of the lowest wage dispersions in the EU, with high entry wages and relatively little wage progression. According to the 2019 OECD employment protection indicator, the employment protection of permanent workers is rather high compared to that of temporary workers. The dispersion of regional unemployment rates is relatively low, but persistent imbalances in the housing market and high costs of housing, not only in the larger cities but also in new industrial and green technology development poles (in particular in the north of the country) pose challenges to labour mobility. Substantial educational gaps depending on socio-economic status and geographical factors and early school leaving as well as the integration of low-skilled workers remain key challenges for the Swedish labour market. Education, competence and skills challenges are thus broad-based. Record high vacancy rates since the statistic reporting on this variable started in 2009 were registered during the recovery period after the pandemic. The vacancy ratio as reported by Eurostat slowly decreased in seasonally adjusted terms from a peak of 3.3% in the third quarter of 2022 to 2.5% in the fourth quarter of 2023. Relatively high vacancy rates persisting alongside high labour force participation in a period of cyclical weakness indicate a fairly high rate of labour market turnover and job-

<sup>(72)</sup> A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group of five euro area Member States.

Table 7.7:

**Sweden - Financing of the economy<sup>1)</sup>**

	SE		EA		Ratio to GDP (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Liabilities (total)	848	907	706	696	316	304
Loans	252	275	228	219	109	103
Non-financial co. debt securities	25	26	12	12	3	2
Financial co. debt securities	98	99	66	58	3	4
Government debt securities	30	20	78	71	47	42
Listed shares	119	149	60	63	12	10
Unlisted shares	239	259	176	184	54	53
Other equity	61	57	53	54	56	58
Trade credits and advances	22	21	34	35	31	32

	SE		EA		Share of total (%)	
					EA 5 smallest	
	2018	2022	2018	2022	2018	2022
Loans	30	30	32	32	34	33
Non-financial co. debt securities	3	3	2	2	1	1
Financial co. debt securities	12	11	9	8	1	1
Government debt securities	4	2	11	10	15	14
Listed shares	14	16	9	9	3	3
Unlisted shares	28	29	25	26	19	19
Other equity	7	6	7	8	17	18
Trade credits and advances	3	2	5	5	10	11

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

Source: Eurostat.

switching, but also point at mismatches and skills shortages extending to a wide range of branches of economic activity. Skills shortages remain particularly pronounced in education, health care, social work, information and communication technology, industry and construction.

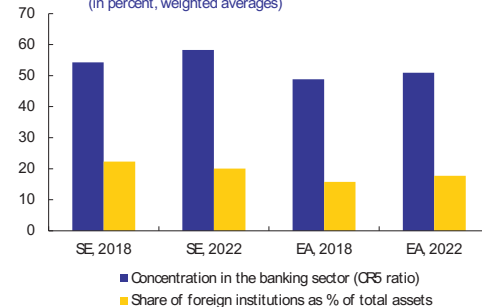
The financial sector in Sweden is highly developed and is proportional to that of the euro area. Relative to GDP, assets managed by the financial sector stood at 640% of GDP (vs. 715% of GDP in the euro area). Since 2018, the Swedish financial sector has grown significantly more than in the euro area. Banking dominates the Swedish financial sector and made up around 47% of the assets of the financial sector in 2022, which is more than in the euro area. The sector for insurance and pension-fund is the second largest financial assets manager in Sweden. It made up 22% of the assets held by the financial sector in 2022 (vs. 11% in the euro area). This reflects the high degree of development of the funded pension system. Non-money-market funds are at par with the euro area, and despite its past extensive asset-purchase programme, the Riksbank only holds a relatively small share of total financial assets (less than half of what the ECB accounts for). The investment-funds sector is of roughly equal size as in the euro area and plays a similar role.

As to the financing of the economy, outstanding liabilities are higher than in the euro area (907% of GDP in 2022 vs. 696% of GDP in the euro area). Like in the euro area, loans are

the dominant source of funding (30% of total liabilities in 2022), partly reflecting the high degree of household indebtedness. Sweden has among the most developed private-sector-debt and equity markets in the EU. Equity and private-sector-debt markets represented 30% of total liabilities in 2022 (274% of GDP altogether), compared to 19% of liabilities in the euro area (132% of GDP). In particular, the relative higher importance of listed shares in total liabilities reflects the larger share of market funding available in Sweden, and the traditional recourse to this type of funding. The relatively smaller size of the Government bond market in Sweden reflects the lower level of general government debt in the country.

Sweden's banking sector is well-integrated into the euro area's financial sector, through a high level of foreign ownership in its banking system, and because Stockholm acts as regional financial hub. The share of foreign-owned institutions in total bank assets stood at 20% in 2022, surpassing the euro area average by 2 percentage points. The share decreased by 2 percentage points between 2018 and 2022. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased to 58%, slightly above the euro area average, which was 51% at the end of 2022.

Graph 7.11: Sweden - Foreign ownership and concentration in the banking sector  
(in percent, weighted averages)



Source: ECB, Structural financial indicators.