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COVER NOTE

From:	Ms Christine LAGARDE, President of the European Central Bank
date of receipt:	24 June 2024
To:	Mr Vincent VAN PETEGHEM, President of the ECOFIN Council
Subject:	ECB Convergence Report 2024

Delegations will find attached the 2024 Convergence Report, pages 1–88 (1/2), by the European Central Bank and the accompanying cover letter by ECB President Christine Lagarde.

Encl.:
Cover letter
ECB Convergence Report June 2024

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EUROPEAN CENTRAL BANK

EUROSYSTEM

Christine LAGARDE
President

Mr Vincent Van Peteghem
President of the ECOFIN Council
Rue de la Loi 175
1048 Bruxelles

Frankfurt am Main, 24 June 2024
CL/24/109

Dear Mr. Van Peteghem,

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

Against this background, you will receive the English version of the ECB's Convergence Report 2024, as adopted by the ECB General Council, in advance of its publication through a secure platform in view of its discussion – along with the European Commission's Convergence Report – tentatively scheduled for the meeting of the ECOFIN Council on 16 July. Please note that the report is under embargo until its release via the websites of the ECB and the National Central Banks on 26 June at noon. We will inform you in case the embargo is lifted earlier.

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

Yours sincerely,

Cc: Mr Pascal Donohoe, President of the Eurogroup
Ms. Thérèse Blanchet, Secretary-General of the Council of the European Union

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EUROPEAN CENTRAL BANK

EUROSYSTEM

Convergence Report

June 2024

Contents

1 Introduction

The euro has already been introduced in 20 of the 27 EU Member States. This report examines six of the seven Member States that have yet to adopt the single currency, namely Bulgaria, Czech Republic, Hungary, Poland, Romania and Sweden. These countries are committed under the Treaty on the Functioning of the European Union (hereinafter the "Treaty") to adopt the euro, which implies that they must strive to fulfil all the convergence criteria.[1] The seventh Member State, Denmark, in 1992 notified the Council of the European Union (EU Council) of its intention not to participate in Stage Three of Economic and Monetary Union (EMU).[2] This means that Convergence Reports need only be provided for Denmark if it so requests. Given that no such request has been submitted, Denmark is not covered in this report.

In producing this report, the ECB fulfils its requirement under Article 140 of the Treaty. Article 140 states that at least once every two years, or at the request of an EU Member State with a derogation, the ECB and the European Commission must report to the EU Council "on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union". The six countries under review in this report have been examined as part of the regular two-year cycle. The European Commission has also prepared a report, and both reports are being submitted to the EU Council in parallel.

In this report, the ECB uses the framework applied in its previous Convergence Reports. It examines, for the six countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaties and the Protocol on the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the "Statute of the ESCB"), and whether the statutory requirements are fulfilled for the relevant national central bank (NCB) to become an integral part of the Eurosystem.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics must not be subject to political considerations or interference. EU Member States have been invited to consider the quality and integrity of their statistics as a matter of high priority, to ensure that a proper system of checks and balances is in place when these statistics are compiled, and to apply minimum standards in the domain of statistics. These standards are of the utmost importance in reinforcing the independence, integrity and accountability of the national statistical institutes and in supporting confidence in the quality of government finance statistics (see Chapter 6).

[1] Unless otherwise stated, all references in this report to the "Treaty" refer to the Treaty on the Functioning of the European Union, and the references to article numbers reflect the numbering in effect since 1 December 2009. Unless otherwise stated, all references in this report to the "Treaties" refer to both the Treaty on European Union and the Treaty on the Functioning of the European Union. These terms are also explained in the ECB's glossary.

[2] When the Maastricht Treaty was concluded in 1992, Denmark was granted an exemption clause or "opt-out" under which it does not have to participate in the third stage of EMU and, therefore, introduce the euro.

From 4 November 2014 it became mandatory for any EU Member State whose derogation is abrogated to join the Single Supervisory Mechanism (SSM) at the latest on the date on which it adopts the euro.[3] At that point, all SSM-related rights and obligations start to apply to that country. Therefore, it is of the utmost importance that the necessary preparations are made. In particular, the banking system of any Member State joining the euro area, and therefore the SSM, is subject to a comprehensive assessment.[4] Bulgaria is currently the only Member State that participates in the SSM under the close cooperation established with the ECB as part of the country's commitment to joining the banking union and the exchange rate mechanism (ERM II) simultaneously.[5] The close cooperation framework with Българска народна банка (Bulgarian National Bank) entered into force on 1 October 2020, following the fulfilment of the necessary supervisory and legislative prerequisites. On that date, the ECB assumed responsibility for (i) the direct supervision of the significant institutions in Bulgaria, (ii) the common procedures for all supervised entities, and (iii) the oversight of less significant institutions, which continue to be supervised by the national supervisor. ECB Banking Supervision and Българска народна банка (Bulgarian National Bank) collaborated very closely to ensure the smooth integration of the national competent authority into the SSM.[6]

This report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 provides a horizontal overview of the key aspects of economic convergence. Chapter 4 contains the country summaries, which provide the main results of the examination of economic and legal convergence. Chapter 5 examines in more detail the state of economic convergence in each of the six EU Member States under review. Chapter 6 provides an overview of the convergence indicators and the statistical methodology used to compile them. Finally, Chapter 7 examines the compatibility of the national legislation of the Member States under review, including the statutes of their NCBs, with Articles 130 and 131 of the Treaty.

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3 On 4 November 2014 the ECB assumed the tasks conferred on it by Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p.63). See Article 33(2) of that Regulation.

4 See recital 10 of Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) (OJ L 141, 14.5.2014, p.1).

5 See Decision (EU) 2020/1015 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Българска народна банка (Bulgarian National Bank) (ECB/2020/30) (OJ L 224I, 13.7.2020, p. 1).

6 See the ECB Annual Report on supervisory activities 2020, in particular Section 4.1 "Enlarging the SSM through close cooperation".

2 Framework for analysis

2.1 Economic convergence

To examine the state of economic convergence in EU Member States seeking to adopt the euro, the ECB makes use of a common framework for analysis. This common framework, which has been applied in a consistent manner in all European Monetary Institute (EMI) and ECB Convergence Reports, is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal balances and debt ratios, exchange rates and long-term interest rates, as well as in other factors relevant to economic integration and convergence. Second, it is based on a range of additional backward and forward-looking economic indicators considered to be useful for examining the sustainability of convergence in greater detail. Some elements of this framework have been enhanced over time. The examination of the Member State concerned based on all these factors also provides important information which helps to ensure that its integration into the euro area will proceed without major difficulties. Boxes 1 to 5 below outline the legal provisions and provide methodological details on the application of these provisions by the ECB.

This report builds on principles set out in previous reports published by the ECB in order to ensure continuity and equal treatment. In particular, a number of guiding principles are used by the ECB (and prior to that by the EMI) in the application of the convergence criteria. First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle is that the main purpose of the criteria is to ensure that only those Member States with economic conditions conducive to the maintenance of price stability and the coherence of the euro area can participate in it. Second, the convergence criteria constitute a coherent and integrated package, and they must all be satisfied. The Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of actual data rather than forecasts. Fourth, the application of the convergence criteria should be consistent, transparent and simple. Moreover, when considering compliance with the convergence criteria, sustainability is an essential factor, as convergence must be achieved on a lasting basis and not just at a given point in time. For this reason, the country examinations elaborate on the sustainability of convergence.

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence.

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is paid to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Strong governance, sound institutions and sustainable public finances are also essential for supporting price stability and sustainable output growth over the medium to long term. Overall, it is emphasised that ensuring the sustainability of economic convergence depends on the achievement of a strong starting position, the existence of sound institutions, resilience to shocks and the pursuit of appropriate policies after the adoption of the euro.

The common framework is applied individually to the six EU Member States under review. These examinations, which focus on each Member State's performance, should be considered separately, in line with the provisions of Article 140 of the Treaty.

The cut-off date for the statistics included in this Convergence Report was 19 June 2024. The statistical data used in the application of the convergence criteria are provided by the European Commission (see Chapter 6 as well as the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. In agreement with the Commission, the reference period for both the price stability criterion and the long-term interest rate criterion is from June 2023 to May 2024. For exchange rates, the reference period is from 20 June 2022 to 19 June 2024. Historical data on fiscal positions cover the period up to 2023. Account is also taken of forecasts from various sources and other information relevant to a forward-looking examination of the sustainability of convergence. The Commission's Spring 2024 Economic Forecast and its Alert Mechanism Report 2024, which are also taken into account in this report, were released on 15 May 2024 and 21 November 2023 respectively. This report was adopted by the General Council of the ECB on 21 June 2024.

This Convergence Report also considers the impact of the Russian war of aggression against Ukraine on the convergence assessment. In 2021 energy prices, particularly for gas, had already started to rise very strongly, owing in part to Russia restricting gas supplies to Europe. Its invasion of Ukraine in late February 2022 then exacerbated the surge in energy and food prices, causing sizeable fiscal pressures, trade disruptions and increased uncertainty. These developments hit the EU as it was still recovering from the effects of the COVID-19 pandemic. Countries with higher energy dependence on and stronger previous trade links with Russia were affected more than others. Given the relatively short time span, it is difficult to draw firm conclusions about the impact on the medium to long-term convergence path, which also depends on the future evolution of Russia's war against Ukraine and further geopolitical developments. The forward-looking part of the convergence assessment is therefore subject to greater uncertainty than usual.

With regard to price developments, the legal provisions and their application by the ECB are outlined in Box 1.

Box 1

Price developments

1. Treaty provisions

Article 140(1), first indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

"the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability".

Article 1 of Protocol (No 13) on the convergence criteria stipulates that:

"The criterion on price stability referred to in the first indent of Article 140(1) of the Treaty on the Functioning of the European Union shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions".

2. Application of Treaty provisions

In the context of this report, the ECB applies the Treaty provisions as outlined below.

First, with regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate has been calculated using the change in the 12-month average of the HICP in the reference period from June 2023 to May 2024 compared with the previous 12-month average. Inflation has been measured on the basis of the HICP, which was developed for the purpose of assessing convergence in terms of price stability on a comparable basis (see Section 6.2). Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rates of inflation of the three Member States with the lowest average inflation rates (excluding outliers).

It should be noted that the concept of "outlier" has been referred to in previous ECB Convergence Reports as well as in the Convergence Reports of the EMI. In line with those reports, a Member State is considered to be an outlier if two conditions are fulfilled: first, its 12-month average inflation rate is significantly below the euro area average; and, second, its price developments have been strongly affected by exceptional factors. The identification of outliers does not follow a mechanical approach. The outlier concept was introduced to deal appropriately with potential significant distortions in the inflation developments of individual countries that reduce the representativeness of the inflation rates in those countries as a benchmark for convergence.

The ECB's approach to identifying outliers in this report is in line with the approach followed in previous ECB Convergence Reports. In some cases, the identification of outliers may be a close call. The same methodology can lead to slightly different outcomes, depending, for example, on the way in which exceptional factors are interpreted.

The inflation rate of Finland was excluded from the calculation of the reference value. Price developments in this country over the reference period resulted in a 12-month average inflation rate of 1.9% in May 2024. Finland was treated as an outlier for the calculation of the reference value in this report because its inflation rate was significantly lower than the euro area average over the reference period and this was due to exceptional factors. In particular, the relatively subdued inflation developments in Finland reflect an adjustment of the price index for electricity implemented by Statistics Finland to correct an earlier double-counting error. The correction was introduced in August 2023, reducing the year-on-year HICP inflation rate by an estimated 0.7 percentage points.

On this basis, for the purposes of this report, the three best performing Member States in terms of price stability, excluding outliers, are therefore Belgium (1.9%), Denmark (1.1%) and the Netherlands (2.5%). Adding 1½ percentage points to the average of these three rates, the reference value for the price stability criterion is 3.3%.

It should be stressed that under the Treaty a country's inflation performance is examined in relative terms, i.e. against that of other Member States. The price stability criterion thus takes into account the fact that common shocks (stemming, for example, from global commodity prices) can temporarily drive inflation rates away from central banks' targets.

It should be acknowledged that it would also be possible to consider Belgium and Denmark as outliers given that the 12-month average inflation rates in these countries were significantly below the euro area average in May 2024 (by 1.5 and 2.3 percentage points respectively). The large difference in inflation dynamics vis-à-vis the euro area in these countries mainly resulted from stronger declines in the HICP energy component, owing to a faster pass-through from wholesale to retail energy prices, which mainly reflected specific characteristics of energy contracts.

In this report, the ECB does not treat Belgium and Denmark as outliers, because it does not consider country-specific differences in the pass-through of international energy prices to domestic energy prices as exceptional factors in so far as these reflect structural differences in the energy markets of Member States. The determination of best performing Member States for the June 2024 Convergence Report is without prejudice to the preparation of future Convergence Reports.

The average rate of HICP inflation over the 12-month reference period from June 2023 to May 2024 is reviewed in the light of the country's economic performance over the last ten years in terms of price stability. This allows a more detailed examination of the sustainability of price developments in the country under review. In this connection, attention is paid to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of supply and demand conditions, focusing on factors such as unit labour costs and import prices. Finally, trends in other relevant price indices are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, institutional and structural aspects relevant to maintaining an environment conducive to price stability after adoption of the euro are discussed.

With regard to fiscal developments, the legal provisions and their application by the ECB, together with procedural issues, are outlined in Box 2.

Box 2
Fiscal developments

1. Treaty and other legal provisions

Article 140(1), second indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

"the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)".

Article 2 of Protocol (No 13) on the convergence criteria stipulates that:

"The criterion on the government budgetary position referred to in the second indent of Article 140(1) of the said Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists".

Article 126 sets out the excessive deficit procedure (EDP). In accordance with Article 126(2) and (3), the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

1. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the EDP as 3% of GDP), unless either:
   (a) the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
   (b) the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the EDP as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

In addition, the report prepared by the Commission must take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission's report. Finally, in accordance with Article 126(6), the EU Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and excluding the

Member State concerned, and following an overall assessment, whether an excessive deficit exists in a Member State.

The Treaty provisions under Article 126 are further clarified by Regulation (EC) No 1467/97[7] as amended by Regulations (EU) Nos 1177/2011[8] and 2024/1264[9], which, among other things:

- confirms the equal footing of the debt criterion with the deficit criterion by making the former operational;
- specifies the conditions under which a ratio of government debt to GDP which exceeds the reference value shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace in accordance with Article 126(2)(b) of the Treaty. The reformed EU fiscal framework modifies the conditions under which a ratio of government debt to GDP which exceeds the reference value shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace in accordance with Article 126(2)(b). Notably, Article 2(2) of the Regulation provides that the requirement shall be considered fulfilled if the Member State concerned respects its net expenditure path. The Commission shall prepare a report in accordance with Article 126(3) of the Treaty when the ratio of government debt to GDP exceeds the reference value, the budgetary position is not close to balance or in surplus and the deviations recorded in the control account of the Member State exceed either 0.3 percentage points of GDP annually or 0.6 percentage points of GDP cumulatively;
- details the relevant factors that the Commission shall take into account when preparing a report under Article 126(3) of the Treaty. Most importantly, it mentions a series of factors considered relevant in assessing developments in medium-term economic, budgetary and government debt positions (see Article 2(3) of the Regulation and, below, details on the ensuing ECB analysis).

2. Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 2014 to 2023, the outlook and the challenges for general government finances, focusing on the links between deficit and debt developments. Regarding the impact of the pandemic and Russia's war against Ukraine on general government finances, the ECB refers to the Stability and Growth Pact's general escape clause, which was activated from 20 March 2020 until 31 December 2023. In particular, before the reform of April 2024, for the preventive arm, Articles 5(1) and 9(1) of Regulation (EC) No 1466/97[10] stated that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term". For the corrective arm, Article 3(5) of Regulation (EC) No 1467/97 stipulated that "in

[7] Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997, p. 6).

[8] Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 306, 23.11.2011, p. 33).

[9] Council Regulation (EU) No 2024/1264 of 29 April 2024 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L, 2024/1264, 30.4.2024).

[10] Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p. 1).

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the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU provided that this does not endanger fiscal sustainability in the medium term", while Article 5(2) of Regulation (EC) No 1467/97 stipulated that "in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised notice under Article 126(9) TFEU, on condition that this does not endanger fiscal sustainability in the medium term". The ECB also provides an analysis with regard to the effectiveness of national budgetary frameworks, as was referred to in Article 2(3)(b) of Regulation (EC) No 1467/97 and in Directive 2011/85/EU[11]. With regard to Article 126, the ECB, in contrast to the Commission, has no formal role in the EDP. Therefore, the ECB report only states whether the country is subject to an EDP.

With regard to the Treaty provision that a debt ratio of above 60% of GDP should be "sufficiently diminishing and approaching the reference value at a satisfactory pace", the ECB examines past and future trends in the debt ratio. For Member States in which the debt ratio exceeds the reference value, the ECB provides the European Commission's latest assessment of compliance with the debt reduction benchmark that was laid down in Article 2(1a) of Regulation (EC) No 1467/97.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 2010 (ESA 2010) (see Chapter 6). Most of the figures presented in this report were provided by the Commission in April 2024 and include government financial positions from 2014 to 2023 as well as Commission forecasts for 2024-25.

With regard to the sustainability of public finances, the outcome in the reference year, 2023, is reviewed in the light of the performance of the country under review over the past ten years. First, the development of the deficit ratio is investigated. It is useful to bear in mind that the change in a country's annual deficit ratio is typically influenced by a variety of underlying forces. These influences can be divided into "cyclical effects" on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include temporary effects on the budgetary balance stemming from the impact of both policy measures and special factors.

As a further step, the development of the government debt ratio in this period is considered, as well as the factors underlying it. These factors are the difference between nominal GDP growth and interest rates, the primary balance and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. In addition, the structure of government debt is considered, focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By

[11] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41).

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comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates can be highlighted.

For the period 2020-23, the general escape clause of the EU's Stability and Growth Pact was activated. This allowed countries to undertake the necessary policy coordination measures in the context of the pandemic and Russia's invasion of Ukraine within the framework of the Pact. Specifically, it allowed a departure from the budgetary requirements that would have normally applied.

In April 2024 a reformed Stability and Growth Pact entered into force, changing the rules on the opening of a debt-based EDP. The reformed rules aim to safeguard the sustainability of government debt and the countercyclicality of fiscal policy, to adopt a more medium-term approach to budgetary policies and to achieve, inter alia, increased national ownership of the framework. The rules also consider that reforms, investment and fiscal sustainability can be mutually reinforcing and should therefore be fostered. Finally, the rules aim to ensure more effective enforcement.[12] While the rules on the opening of a deficit-based EDP remain basically unchanged, the rules on the opening of a debt-based EDP are changed as described in Box 2. However, in 2024 no debt-based EDPs have been opened on the basis of the 2023 outcomes, as national fiscal-structural plans – as part of the reformed EU fiscal framework – will be not be published until autumn 2024, covering fiscal strategies as of 2025.

Turning to a forward-looking perspective, recent forecasts by the European Commission for 2024-25 and the assessment of long-term challenges to debt sustainability are considered. This includes, in particular, the outlook for budget balances and debt ratios on the basis of current fiscal policies. In addition, long-term challenges to the sustainability of budgetary positions and broad areas for consolidation are emphasised, particularly those related to unfunded government pension systems in connection with demographic change and to contingent liabilities incurred by government. Unlike in previous reports, the assessment will not cover countries' medium-term budgetary plans as outlined in annual convergence programmes. This is because, under the new fiscal rules, countries will lay out their detailed medium-term budgetary plans as part of their national fiscal-structural plans, which will be due around 20 September 2024. These plans must present a net expenditure trajectory covering a period of at least four years and will outline government fiscal strategies as of 2025.

With regard to exchange rate developments, the legal provisions and their application by the ECB are outlined in Box 3.

[12] See Opinion of the European Central Bank of 5 July 2023 on a proposal for economic governance reform in the Union (CON/2023/20).

Box 3
Exchange rate developments

1. Treaty provisions

Article 140(1), third indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

"the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro".

Article 3 of Protocol (No 13) on the convergence criteria stipulates that:

"The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the said Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period".

2. Application of Treaty provisions

With regard to exchange rate stability, the ECB examines whether the country has participated in ERM II (which superseded the ERM as of January 1999) for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against the euro. In cases of shorter periods of participation, exchange rate developments are described over a two-year reference period.

The examination of exchange rate stability against the euro focuses on the exchange rate being close to the ERM II central rate, while also taking into account factors that may have led to an appreciation, which is in line with the approach taken in the past. In this respect, the width of the fluctuation band within ERM II does not prejudice the examination of the exchange rate stability criterion.

Moreover, the issue of the absence of "severe tensions" is generally addressed by: (i) examining the degree of deviation of exchange rates from the ERM II central rates against the euro; (ii) using indicators such as exchange rate volatility vis-à-vis the euro and its trend, as well as short-term interest rate differentials vis-à-vis the euro area and their development; (iii) considering the role played by foreign exchange interventions; and (iv) considering the role of international financial assistance programmes in stabilising the currency.

The reference period in this report is from 20 June 2022 to 19 June 2024. All bilateral exchange rates are official ECB reference rates (see Chapter 6).

In addition to ERM II participation and nominal exchange rate developments against the euro over the period under review, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real effective exchange rates and the current, capital and financial accounts of the balance of payments. The evolution of gross external debt and the net international investment position over longer periods is also examined. The section on exchange rate developments further considers measures of the degree of a country's integration with the euro area. This is assessed in terms of both external trade integration (exports and imports) and financial integration. Finally, the section on exchange rate developments reports, if applicable, whether the country under examination has during the two-year reference period benefited from central bank liquidity assistance or balance of payments support. Both actual and precautionary assistance are considered.

With regard to long-term interest rate developments, the legal provisions and their application by the ECB are outlined in Box 4.

Box 4
Long-term interest rate developments

1. Treaty provisions

Article 140(1), fourth indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

"the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels".

Article 4 of Protocol (No 13) on the convergence criteria stipulates that:

"The criterion on the convergence of interest rates referred to in the fourth indent of Article 140(1) of the said Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".

2. Application of Treaty provisions

In the context of this report, the ECB applies the Treaty provisions as outlined below.

First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is from June 2023 to May 2024, in line with the reference period for the price stability criterion.

Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three Member States included in the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of the three countries with the lowest inflation rate included in the calculation of the reference value for the price stability criterion were

2.6% (Denmark), 2.8% (Netherlands) and 3.1% (Belgium). As a result, the average rate is 2.8% and, adding 2 percentage points, the reference value is 4.8%.[13]

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from June 2023 to May 2024 are reviewed against the background of the path of long-term interest rates over the past ten years (or the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area. During the reference period, the average euro area long-term interest rate may have partly reflected high country-specific risk premia in several euro area countries. Therefore, the euro area AAA long-term government bond yield (i.e. the long-term yield of the euro area AAA yield curve, which includes the euro area countries with an AAA rating) is also used for comparison purposes. As background to this analysis, this report also provides information about the size and development of the financial market. This is based on three different indicators (the outstanding amount of debt securities issued by non-financial corporations, stock market capitalisation and MFI credit to the domestic non-financial private sector), which together provide a measure of the size of financial markets.

Finally, Article 140(1) of the Treaty requires this report to take account of several other relevant factors (see Box 5). In this respect, an enhanced economic governance framework in accordance with Article 121(6) of the Treaty entered into force on 13 December 2011 with the aim of ensuring a closer coordination of economic policies and the sustained convergence of EU Member States' economic performances. Box 5 below briefly outlines these legislative provisions and the way in which the above-mentioned additional factors are addressed in the assessment of convergence conducted by the ECB.

Box 5
Other relevant factors

1. Treaty and other legal provisions

Article 140(1) of the Treaty requires that "The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices".

In this respect, the ECB takes into account the legislative package on EU economic governance which entered into force on 13 December 2011. Building on the Treaty provisions under Article 121(6), the European Parliament and the EU Council adopted detailed rules for the multilateral surveillance procedure referred to in Article 121(3) and (4) of the Treaty. These rules were adopted "in

[13] Interest rates have been measured on the basis of available harmonised long-term interest rates, which were developed for the purpose of examining convergence (see Chapter 6).

order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States" (Article 121(3)) in view of the "need to draw lessons from the first decade of functioning of the economic and monetary union and, in particular, for improved economic governance in the Union built on stronger national ownership"[14]. The legislative package includes an enhanced surveillance framework (the macroeconomic imbalance procedure or MIP) aimed at preventing excessive macroeconomic and macro-financial imbalances by helping diverging EU Member States to establish corrective plans before divergence becomes entrenched.

2. Application of Treaty provisions

In line with past practice, the additional factors referred to in Article 140(1) of the Treaty are reviewed in Chapter 5 under the headings of the individual criteria described in Boxes 1 to 4. For completeness, in Chapter 3 the scoreboard indicators are presented for the countries covered in this report (including in relation to the alert thresholds), thereby ensuring the provision of all available information relevant to the detection of macroeconomic and macro-financial imbalances that may be hampering the achievement of a high degree of sustainable convergence as stipulated in Article 140(1) of the Treaty. Notably, EU Member States with a derogation that are subject to an excessive imbalance procedure can hardly be considered as having achieved a high degree of sustainable convergence as stipulated in Article 140(1) of the Treaty.

2.2 Compatibility of national legislation with the Treaties

2.2.1 Introduction

Article 140(1) of the Treaty requires the ECB (and the European Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports must include an examination of the compatibility of the national legislation of each Member State with a derogation, including the statutes of its NCB, with Articles 130 and 131 of the Treaty and the relevant Articles of the Statute. This Treaty obligation of Member States with a derogation is also referred to as 'legal convergence'.

When assessing legal convergence, the ECB is not limited to making a formal assessment of the letter of national legislation but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaties and the Statute. The ECB is particularly concerned about any signs of pressure being put on the decision-making bodies of any Member State's NCB which would be inconsistent with the spirit of the Treaty as regards central bank independence.

[14] See recital 2 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23/11/2011, p. 25).

The ECB also sees the need for the smooth and continuous functioning of the NCBs' decision-making bodies. In this respect, the relevant authorities of a Member State have, in particular, the duty to take the necessary measures to ensure the timely appointment of a successor if the position of a member of an NCB's decision-making body becomes vacant.[15]

The ECB will closely monitor any developments prior to making a positive final assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

Member States with a derogation and legal convergence

Bulgaria, the Czech Republic, Hungary, Poland, Romania and Sweden, whose national legislation is examined in this report, each have the status of a Member State with a derogation, i.e. they have not yet adopted the euro. Sweden was given the status of a Member State with a derogation by a decision of the Council in May 1998.[16] As far as the other Member States are concerned, Articles 4[17] and 5[18] of the Acts concerning the conditions of accession provide that each of these Member States shall participate in the Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 139 of the Treaty.

This report does not cover Denmark, which is a Member State with a special status and which has not yet adopted the euro. Protocol (No 16) on certain provisions relating to Denmark, annexed to the Treaties, provides that, in view of the notice given to the Council by the Danish Government on 3 November 1993, Denmark has an exemption and that the procedure for the abrogation of the derogation will only be initiated at the request of Denmark. As Article 130 of the Treaty applies to Denmark, Danmarks Nationalbank has to fulfil the requirements of central bank independence. The EMI's Convergence Report of 1998 concluded that this requirement had been fulfilled. There has been no assessment of Danish convergence since 1998 due to Denmark's special status. Until such time as Denmark notifies the Council that it intends to adopt the euro, Danmarks Nationalbank does not need to be legally integrated into the Eurosystem and no Danish legislation needs to be adapted.

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15 Opinions CON/2010/37 and CON/2010/91. All ECB opinions are available on EUR-Lex.

16 Council Decision 98/317/EC of 3 May 1998 in accordance with Article 109j(4) of the Treaty (OJ L 139, 11.5.1998, p. 30). Note: The title of Decision 98/317/EC refers to the Treaty establishing the European Community (prior to the renumbering of the Articles of this Treaty in accordance with Article 12 of the Treaty of Amsterdam); this provision has been repealed by the Treaty of Lisbon.

17 Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33).

18 For Bulgaria and Romania, see Article 5 of the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the Treaties on which the European Union is founded (OJ L 157, 21.6.2005, p. 203). For Croatia, see Article 5 of the Act concerning the conditions of accession of the Republic of Croatia and the adjustments to the Treaty on European Union, the Treaty on the Functioning of the European Union and the Treaty establishing the European Atomic Energy Community (OJ L 112, 24.4.2012, p. 21).

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The aim of assessing legal convergence is to facilitate the Council's decisions as to which Member States fulfil 'their obligations regarding the achievement of economic and monetary union' (Article 140(1) of the Treaty). In the legal domain, such conditions refer in particular to central bank independence and to the NCBs' legal integration into the Eurosystem.

Structure of the legal assessment

The legal assessment broadly follows the framework of the previous reports of the ECB and the EMI on legal convergence.[19]

The compatibility of national legislation is considered in the light of legislation enacted before 27 March 2024.

2.2.2 Scope of adaptation

Areas of adaptation

For the purpose of identifying those areas where national legislation needs to be adapted, the following issues are examined:

- compatibility with provisions on the independence of NCBs, members of NCBs' decision-making bodies and Governors in the Treaty (Article 130) and the Statute (Articles 7 and 14.2);
- compatibility with provisions on confidentiality (Article 37 of the Statute);
- compatibility with the prohibitions on monetary financing (Article 123 of the Treaty) and privileged access (Article 124 of the Treaty);
- compatibility with the single spelling of the euro required by EU law; and
- legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).

[19] In particular the ECB's Convergence Reports of June 2022 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2020 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), May 2018 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2016 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2014 (on Bulgaria, the Czech Republic, Croatia, Lithuania, Hungary, Poland, Romania and Sweden), June 2013 (on Latvia), May 2012 (on Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2010 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2008 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden), May 2007 (on Cyprus and Malta), December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), May 2006 (on Lithuania and Slovenia), October 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), May 2002 (on Sweden) and April 2000 (on Greece and Sweden), and the EMI's Convergence Report of March 1998.

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'Compatibility' versus 'harmonisation'

Article 131 of the Treaty requires national legislation to be 'compatible' with the Treaties and the Statute; any incompatibility must therefore be remedied. Neither the primacy of the Treaties and the Statute over national legislation nor the nature of the incompatibility affects the need to comply with this obligation.

The requirement for national legislation to be 'compatible' does not mean that the Treaty requires 'harmonisation' of the NCBs' statutes, either with each other or with the Statute. National particularities may continue to exist to the extent that they do not infringe the competence in monetary matters that is irrevocably conferred on the EU. Indeed, Article 14.4 of the Statute permits NCBs to perform functions other than those specified in the Statute, to the extent that they do not interfere with the objectives and tasks of the ESCB.[20] Provisions authorising such additional functions in NCBs' statutes are a clear example of circumstances in which differences may remain. Rather, the term 'compatible' indicates that national legislation and the NCBs' statutes need to be adjusted to eliminate inconsistencies with the Treaties and the Statute and to ensure the necessary degree of integration of the NCBs into the ESCB. In particular, any provisions that infringe an NCB's independence, as defined in the Treaty, and its role as an integral part of the ESCB, should be adjusted. It is therefore insufficient to rely solely on the primacy of EU law over national legislation to achieve this.

The obligation in Article 131 of the Treaty only covers incompatibility with the Treaties and the Statute. However, national legislation that is incompatible with secondary EU legislation relevant for the areas of adaptation examined in this Convergence Report should be brought into line with such secondary legislation. The primacy of EU law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 131 of the Treaty but also from the case law of the Court of Justice of the European Union.[21]

The Treaties and the Statute do not prescribe the manner in which national legislation should be adapted. Compatibility may therefore be achieved by removing any national legislation which is incompatible with EU law or by referring to the Treaties and the Statute, or, exceptionally, by incorporating provisions thereof and referring to their provenance, subject to the following qualifications:

As a rule, a reproduction of relevant provisions of Union law directly applicable in the legal order of the Member State using the same language is to be avoided[22]. A reproduction may create uncertainty both as to the legal nature and origin of the applicable provisions and as to the date of their entry into force. This would not align with the principle of uniform application and interpretation of Union law throughout the

[20] As regards tasks and powers that have been partially conferred upon the ECB, any national legislation must be without prejudice to the tasks and powers conferred upon the ECB. See Opinion CON/2020/15.

[21] See, amongst others, *Commission of the European Communities v French Republic*, C-265/95, EU:C:1997:595.

[22] See paragraph 12 of Opinion CON/2005/21, paragraph 2.4 of Opinion CON/2022/15, and paragraph 2.6 of Opinion CON/2023/27.

Union[23]. Moreover, if a national provision uses wording that is different from that used in the relevant Union provision, it creates regulatory content of its own. In accordance with Article 2(1) of the Treaty, the Union's exclusive competence in matters of monetary policy precludes Member States from adopting provisions which, in the light of their objective and content, establish legal rules governing the use of the euro as the single currency, unless Member States have been empowered to do so[24]. In this context, the concept of monetary policy is not limited to its operational implementation, which, under Article 127(2), first indent, of the Treaty is one of the basic tasks of the Eurosystem. It also has a regulatory dimension intended to guarantee the status of the euro as the single currency[25].

In exceptional circumstances, a reproduction of relevant provisions of Union law directly applicable in the legal order of the Member State using the same language may be used for the sake of coherence and in order to make them comprehensible to the persons to whom they apply. Where such exceptional circumstances allowing for a reproduction of directly applicable provisions of Union law exist, provisions should be reproduced precisely, and the wording should not be modified[26]. Furthermore, provisions should be reproduced only to the extent warranted by the exceptional circumstances. However, such exceptional circumstances do not exist where the directly applicable provisions of Union law are sufficiently coherent and comprehensive, making it unnecessary to repeat or reflect them in national law[27]. Where directly applicable provisions of Union law are merely relevant in the context of the areas covered by the national law, the national law does not need to reference these provisions. To the extent that national law necessarily reproduces directly applicable provisions of Union law for the abovementioned reasons, it should do so in an explicit manner and clarify that its provisions are either 'in accordance with' or 'in compliance with' the relevant provisions of Union law, where the latter are merely reproduced to put the national law in the larger context, or 'without prejudice to' the relevant provisions of Union law, where a national authority exercises residual competences that go beyond those exercised within the ESCB and the Eurosystem[28].

Furthermore, as a tool for achieving and maintaining the compatibility of national legislation with the Treaties and the Statute, the ECB must be consulted by the EU institutions and by the Member States on draft legislative provisions in its fields of

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23 Judgment of the Court of Justice of 7 February 1973, *Commission v Italy*, C-39/72, EU:C:1973:13, paragraphs 16 and 17; Judgment of the Court of Justice of 10 October 1973, *Variola*, C-34/73, EU:C:1973:101, paragraphs 9 to 11; Judgment of the Court of Justice of 2 February 1977, *Amsterdam Bulb*, C-50/76, EU:C:1977:13, paragraphs 5 to 8. See also paragraph 12 of Opinion CON/2005/21, paragraph 2.1 of Opinion CON/2006/10, paragraph 2.4 of Opinion CON/2006/29, paragraph 2.1 of Opinion CON/2007/1, paragraph 2.2 of Opinion CON/2007/43, paragraph 2.3 of Opinion CON/2022/15 and paragraph 2.3 of Opinion CON/2023/27.

24 E.g. under the relevant provisions of Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1) or other provisions of Union law.

25 Judgment of the Court of Justice of 26 January 2021, *Hessischer Rundfunk*, C-422/19 and C-423/19, EU:C:2021:63, paragraphs 38 and 39, Judgment of the Court of Justice of 20 April 2023, *Brink's Lithuania*, C-772/21, EU:C:2023:305, paragraphs 56 and 57.

26 See paragraph 2.2 (footnote 6) of Opinion CON/2007/43, paragraph 2.4 of Opinion CON/2022/15 and paragraph 2.6 of Opinion CON/2023/27.

27 See paragraph 13 of Opinion CON/2005/21, paragraphs 2.2 and 3.2 of Opinion CON/2006/10, paragraph 2.4 of Opinion CON/2022/15 and paragraph 2.6 of Opinion CON/2023/27.

28 See paragraph 2.6 of Opinion CON/2023/27.

competence, pursuant to Articles 127(4) and 282(5) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[29] expressly requires Member States to take the measures necessary to ensure compliance with this obligation.

2.2.3 Independence of NCBs

As far as central bank independence is concerned, national legislation in the Member States that joined the EU in 2004, 2007 or 2013 had to be adapted to comply with the relevant provisions of the Treaty and the Statute, and be in force on 1 May 2004, 1 January 2007 and 1 July 2013 respectively.[30] Sweden had to bring the necessary adaptations into force by the date of establishment of the ESCB on 1 June 1998.

Central bank independence

In November 1995, the EMI established a list of features of central bank independence (later described in detail in its 1998 Convergence Report) which were the basis for assessing the national legislation of the Member States at that time, in particular the NCBs' statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely: functional, institutional, personal, and financial independence. Over the past few years there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation and the Treaties and the Statute.

Functional independence

Central bank independence is not an end in itself but is instrumental in achieving an objective that should be clearly defined and should prevail over any other objective. Functional independence requires each NCB's primary objective to be stated in a clear and legally certain way and to be fully in line with the primary objective of price stability established by the Treaty. The pursuit of this objective is served by providing the NCBs with the necessary means and instruments for achieving this objective independently of any other authority. The Treaty's requirement of central bank independence reflects the generally held view that the primary objective of price stability is best served by a fully independent institution with a precise definition of its mandate. Central bank independence is fully compatible with holding NCBs accountable for their decisions, which is an important aspect of enhancing confidence in their independent status. This entails transparency and dialogue with third parties.

[29] OJ L 189, 3.7.1998, p. 42.

[30] This also applies to the ESCB's confidentiality regime; see Section 2.2.4 of this Convergence Report.

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As regards timing, the Treaty is not clear about when the NCBs of Member States with a derogation must comply with the primary objective of price stability set out in Articles 127(1) and 282(2) of the Treaty and Article 2 of the Statute. For those Member States that joined the EU after the date of the introduction of the euro in the EU, it is not clear whether this obligation should run from the date of accession or from the date of their adoption of the euro. While Article 127(1) of the Treaty does not apply to Member States with a derogation (see Article 139(2)(c) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 42.1 of the Statute). The ECB takes the view that the obligation of the NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden, and from 1 May 2004, 1 January 2007 and 1 July 2013 for the Member States that joined the EU on those dates. This is based on the fact that one of the guiding principles of the EU, namely price stability (Article 119 of the Treaty), also applies to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind the regular reports of the ECB and the European Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

The country assessments in this report are based on these conclusions as to the timing of the obligation of the NCBs of Member States with a derogation to have price stability as their primary objective.

Institutional independence

Institutional independence is reflected in Article 130 of the Treaty and Article 7 of the Statute. These two articles prohibit the NCBs and members of their decision-making bodies from seeking or taking instructions from EU institutions or bodies, from any government of a Member State or from any other body. In addition, they prohibit EU institutions, bodies, offices or agencies, and the governments of the Member States from seeking to influence those members of the NCBs' decision-making bodies whose decisions may affect the fulfilment of the NCBs' ESCB-related tasks. For national legislation to mirror Article 130 of the Treaty and Article 7 of the Statute, it should reflect both prohibitions and not narrow the scope of their application.[31] The recognition that central banks have such independence does not have the consequence of exempting them from every rule of law or of shielding them from any kind of legislation.[32]

Whether an NCB is organised as a state-owned body, a special public law body or simply a public limited company, there is a risk that influence may be exerted by the owner on its decision-making in relation to ESCB-related tasks by virtue of such

[31] Opinion CON/2011/104.

[32] See paragraph 2.3 of Opinion CON/2019/15 and *Commission v European Central Bank*, C-11/00, EU:C:2003:395, paragraphs 134 to 136.

ownership.[33] Such influence, whether exercised through shareholders' rights or otherwise, may affect an NCB's independence and should therefore be limited by law.

The legal framework for central banking needs to provide a stable and long-term basis for a central bank's functioning. Frequent changes to the institutional set-up of an NCB, affecting its organisational or governance stability, could adversely affect that NCB's institutional independence.[34]

Institutional independence should also be respected in cases of emergency. Only where the conditions under Article 347 of the Treaty are met, may national authorities be justified in exercising, on a temporary and exceptional basis, powers that fall within the exclusive competence of the ESCB. The critical time for this assessment is when the measure is adopted. Due to the exceptional nature of Article 347 of the Treaty, Member States should refrain from adopting preventive legislation in the absence of the conditions prescribed by Article 347 of the Treaty.[35]

Prohibition on giving instructions

Rights of third parties to give instructions to NCBs, their decision-making bodies or their members are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

Any involvement of an NCB in the application of measures to strengthen financial stability must be compatible with the Treaty, i.e. NCBs' functions must be performed in a manner that is fully compatible with their functional, institutional, and financial independence so as to safeguard the proper performance of their tasks under the Treaty and the Statute.[36] To the extent that national legislation provides for a role of an NCB that goes beyond advisory functions and requires it to assume additional tasks, it must be ensured that these tasks will not affect the NCB's ability to carry out its ESCB-related tasks from an operational and financial point of view.[37] Additionally, the inclusion of NCB representatives in collegiate decision-making supervisory bodies or other authorities would need to give due consideration to safeguards for the personal independence of the members of the NCB's decision-making bodies.[38]

Prohibition on approving, suspending, annulling or deferring decisions

Rights of third parties to approve, suspend, annul or defer an NCB's decisions are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.[39]

33 Opinion CON/2019/23.

34 See paragraph 2.2 of Opinion CON/2011/104 and paragraph 3.2.2 of Opinion CON/2017/34.

35 See paragraph 2.2. of Opinion CON/2021/35.

36 Opinion CON/2010/31.

37 Opinion CON/2009/93.

38 Opinion CON/2010/94.

39 Opinion CON/2016/33.

Prohibition on censoring decisions on legal grounds

A right for bodies other than independent courts to censor, on legal grounds, decisions relating to the performance of ESCB-related tasks is incompatible with the Treaty and the Statute, since the performance of these tasks may not be reassessed at the political level. A right of an NCB Governor to suspend the implementation of a decision adopted by the ESCB or by an NCB decision-making body on legal grounds and subsequently to submit it to a political body for a final decision would be equivalent to seeking instructions from third parties.

Prohibition on participation in decision-making bodies of an NCB with a right to vote

Participation by representatives of third parties in an NCB's decision-making body with a right to vote on matters concerning the performance by the NCB of ESCB-related tasks is incompatible with the Treaty and the Statute, even if such vote is not decisive.[40] Such participation even without the right to vote is incompatible with the Treaty and the Statute, if such participation interferes with the performance of ESCB-related tasks by that decision-making bodies or endangers compliance with the ESCB's confidentiality regime.[41]

Prohibition on ex ante consultation relating to an NCB's decision

An express statutory obligation for an NCB to consult third parties ex ante relating to an NCB's decision provides third parties with a formal mechanism to influence the final decision and is therefore incompatible with the Treaty and the Statute.

However, dialogue between an NCB and third parties, even when based on statutory obligations to provide information and exchange views, is compatible with central bank independence provided that:

- this does not result in interference with the independence of the members of the NCB's decision-making bodies;
- the special status of Governors in their capacity as members of the ECB's decision-making bodies is fully respected; and
- confidentiality requirements resulting from the Statute are observed.[42]

Discharge provided for the duties of members of the NCB's decision-making bodies

Statutory provisions regarding the discharge provided by third parties (e.g. governments) regarding the duties of members of the NCB's decision-making bodies (e.g. in relation to accounts) should contain adequate safeguards, so that such a

[40] Regarding voting in general, the secret character of voting may contribute to safeguarding the independence of an NCB's decision-making bodies. However, the possibility of open voting is not excluded by the principle of institutional independence, see paragraph 2.3 of Opinion CON/2022/10.

[41] Opinions CON/2014/25 and CON/2015/57.

[42] Opinion CON/2018/17.

power does not impinge on the capacity of the individual NCB member independently to adopt decisions in respect of ESCB-related tasks (or implement decisions adopted at ESCB level). Inclusion of an express provision to this effect in NCB statutes is recommended.

Personal independence

Article 130 of the Treaty and Articles 7 and 14.2 of the Statute further safeguard central bank independence in relation to Governors and members of NCBs' decision-making bodies. Governors are members of the General Council of the ECB and become members of the Governing Council upon adoption of the euro by their Member States. Governors cannot be regarded as representatives of a Member State when they perform their duties as members of the Governing Council or the General Council of the ECB.[43] Article 14.2 of the Statute provides that NCB statutes must, in particular, provide for a minimum term of office of five years for Governors. It also protects against Governors being arbitrarily relieved from their office by providing that they may only be relieved from office if they no longer fulfil the conditions required for performing their duties or if they have been found guilty of serious misconduct. In such cases, Article 14.2 of the Statute provides for the possibility of recourse to the Court of Justice of the European Union, which has the power to annul the national decision taken to relieve a Governor from office.[44] The suspension of a Governor may effectively amount to relieving a Governor from office for the purposes of Article 14.2 of the Statute.[45] NCB statutes must comply with this provision as set out below.

Article 130 of the Treaty prohibits national governments and any bodies from influencing the members of NCBs' decision-making bodies in the performance of their tasks. In particular, Member States may not seek to influence the members of the NCB's decision-making bodies by amending national legislation affecting their remuneration, which, as a matter of principle, should apply only for future appointments.[46]

Minimum term of office for Governors

In accordance with Article 14.2 of the Statute, NCB statutes must provide for a minimum term of office of five years for a Governor. This does not preclude longer terms of office, while an indefinite term of office does not require adaptation of the statutes provided the grounds for the relieving a Governor from office are in line with those of Article 14.2 of the Statute. Shorter periods cannot be justified even if only applied during a transitional period.[47] National legislation which provides for a

[43] See *LR Ģenerālprokuratūra*, C-3/20, ECLI:EU:C:2021:969, paragraph 43.

[44] See *Rimšēvičs and ECB v Latvia*, C-202/18 and C-238/18, EU:C:2019:139, paragraph 76.

[45] See *Rimšēvičs and ECB v Latvia*, C-202/18 and C-238/18, EU:C:2019:139, paragraph 52, and paragraph 3.7 of Opinion CON/2011/9.

[46] See, for example, Opinions CON/2010/56, CON/2010/80, CON/2011/104, CON/2011/106 and CON/2021/9.

[47] Opinion CON/2018/23.

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compulsory retirement age should ensure that the retirement age does not interrupt the minimum term of office provided by Article 14.2 of the Statute, which prevails over any compulsory retirement age, if applicable to a Governor.[48] When NCB statutes are amended, the amending law should safeguard the security of tenure of the Governor and of other members of decision-making bodies who are involved in the performance of ESCB-related tasks.[49]

Grounds for relieving Governors from office

NCB statutes must ensure that Governors may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute. The purpose of the requirement under that Article is to prevent the authorities involved in the appointment of Governors, particularly the relevant government or parliament, from arbitrarily dismissing a Governor. NCB statutes should delete any incompatibility with the grounds for relieving from office laid down in Article 14.2 of the Statute or omit any mention of grounds for relieving from office (since Article 14.2 is directly applicable).[50] Once elected or appointed, Governors may not be relieved from office under conditions other than those mentioned in Article 14.2 of the Statute even if they have not yet taken up their duties. As the conditions under which a Governor may be relieved from office are autonomous concepts of Union law, their application and interpretation do not depend on national contexts.[51] Ultimately, it is for the Court of Justice of the European Union, in accordance with the powers conferred on it by the second subparagraph of Article 14.2 of the Statute, to interpret these concepts.[52]

Security of tenure and grounds for relieving from office of members of NCBs' decision-making bodies, other than Governors, who are involved in the performance of ESCB-related tasks

Applying the same rules for the security of tenure and grounds for relieving of Governors from office to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks will also safeguard the personal independence of those persons.[53] Article 130 of the Treaty and Article 7 of the Statute refer to "members of the decision-making bodies" of NCBs, rather than to Governors specifically. This applies in particular where a Governor is "first among equals" with colleagues with equivalent voting rights or where such other members are involved in the performance of ESCB-related tasks.

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[48] Opinion CON/2012/89.

[49] Opinions CON/2018/17, CON/2019/19 and CON/2019/36.

[50] Opinion CON/2018/53.

[51] See Opinion CON/2019/36 and the Opinion of Advocate General Kokott in *Rimšēvičs and ECB v Latvia*, Joined Cases C-202/18 and C-238/18, EU:C:2018:1030, paragraph 77.

[52] See *Rimšēvičs and ECB v Latvia*, Joined Cases C-202/18 and C-238/18, EU:C:2019:139, paragraph 92: "[I]t is for the Court, in the context of the powers conferred on it by the second subparagraph of Article 14.2 of the Statute of the ESCB and of the ECB, to verify that a temporary prohibition on the governor concerned performing his duties is taken only if there are sufficient indications that he has engaged in serious misconduct capable of justifying such a measure."

[53] Opinions CON/2004/35, CON/2005/26, CON/2006/32, CON/2006/44, CON/2007/6, CON/2019/19 and CON/2019/24.

Right of judicial review

Governors as well as other members of the NCBs' decision-making bodies must have the right to submit any decision to relieve them from their office to an independent court of law, in order to limit the potential for political discretion in evaluating the grounds for such a decision.

Article 14.2 of the Statute stipulates that Governors who have been dismissed from office may refer such a decision to the Court of Justice of the European Union. The Court of Justice of the European Union has the power to annul the national measure of dismissal if it is found to be contrary to Union law.

On the basis of Article 130 of the Treaty and Article 7 of the Statute, national legislation should provide for a right of review by the national courts of a decision to dismiss members of NCBs' decision-making bodies (other than Governors) involved in the performance of ESCB-related tasks.[54] This right can either be a matter of general law or can it take the form of a specific provision. Even though this right may be available under the general law, for reasons of legal certainty it could be advisable to provide specifically for such a right of review.

Safeguards against conflicts of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of NCB decision-making bodies involved in the performance of ESCB-related tasks in relation to their respective NCBs (and of Governors also in relation to the ECB) and any other functions which such members of decision-making bodies may have and which may jeopardise their personal independence.[55] As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

Financial independence

The overall independence of an NCB would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate, i.e. to perform the ESCB-related tasks required of it under the Treaty and the Statute.[56]

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[54] Opinion CON/2022/45.

[55] In this regard, Member States are free to set the conditions required for the appointment of the members of the decision-making bodies of their NCBs, provided that they do not conflict with the features of central bank independence flowing from the Treaties. See Opinions CON/2018/23, CON/2020/19 and CON/2021/9.

[56] Opinions CON/2021/7 and CON/2023/17.

Member States may not put their NCBs in a position where they have insufficient financial resources and inadequate net equity[57] to carry out their ESCB or Eurosystem-related tasks, as applicable. This would be the case if, for example, an NCB was precluded from building up adequate financial resources in the form of reserves or buffers to offset losses, particularly those resulting from monetary policy operations, and the Member State concerned did not ensure in advance that the NCB had the necessary funds to bear the financial burden resulting from exercising a function outside the scope of the ESCB (such as the funds necessary to be able to pay the compensation resulting from the liability regime for that function), while retaining its ability to carry out its ESCB tasks effectively and independently.[58] It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of the ECB making further calls on the NCBs to contribute to the ECB's capital and to make further transfers of foreign reserves.[59] Moreover, Article 33.2 of the Statute provides[60] that, in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion to and up to the amounts allocated to the NCBs. The principle of financial independence means that compliance with these provisions requires an NCB to be able to perform its functions unimpaired.

For all the reasons mentioned above, financial independence also implies that an NCB should always be sufficiently capitalised. In particular, any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over.[61] Any such situation may negatively impact on the NCB's ability to perform its ESCB-related tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence. As concerns the ECB, the relevance of this issue has already been recognised by the Council by adopting Council Regulation (EC) No 1009/2000 of 8 May 2000 concerning capital increases of the European Central Bank.[62] It enabled the Governing Council of the ECB to decide on an actual increase of the ECB's capital to sustain the adequacy of the capital base to support the operations of the ECB;[63] NCBs should be financially able to respond to such ECB decision.

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[57] Opinions CON/2014/24, CON/2014/27, CON/2014/56 and CON/2017/17.

[58] Opinions CON/2023/17 and CON/2023/44. See also *Banka Slovenije*, Case C-45/21, ECLI:EU:C:2022:670, paragraph 105.

[59] Article 30.4 of the Statute only applies within the Eurosystem.

[60] Article 33.2 of the Statute only applies within the Eurosystem.

[61] Opinions CON/2018/17, CON/2020/13, CON/2022/37, CON/2023/17 and CON/2023/24.

[62] OJ L 115, 16.5.2000, p. 1.

[63] Decision ECB/2010/26 of 13 December 2010 on the increase of the ECB's capital (OJ L 11, 15.1.2011, p. 53).

The concept of financial independence should be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's ESCB-related tasks but also over its ability to fulfil its mandate financially in terms of appropriate financial resources. The aspects of financial independence set out below are particularly relevant in this respect.[64] These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

If a third party has the power to determine or influence an NCB's budget, this is incompatible with financial independence unless the law provides a safeguard clause so that such a power is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.[65]

The accounting rules

The accounts should be drawn up either in accordance with general accounting rules or in accordance with rules specified by an NCB's decision-making bodies. If, instead, such rules are specified by third parties, the rules must at least take into account what has been proposed by the NCB's decision-making bodies.

The annual accounts should be adopted by the NCB's decision-making bodies, assisted by independent accountants, and may be subject to ex post approval by third parties (e.g. the government or parliament). The NCB's decision-making bodies should be able to decide on the calculation of the profits independently and professionally.

Where an NCB's operations are subject to the control of a state audit office or similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework,[66] should be without prejudice to the activities of the NCB's independent external auditors[67] and further, in line with the principle of institutional independence, it should comply with the prohibition on giving instructions to an NCB and its decision-making bodies and should not interfere with the NCB's ESCB-related tasks.[68] The state audit should be done on a non-political, independent and purely professional basis.[69]

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how its profits are to be allocated. In the absence of such provisions, decisions on the allocation of profits

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[64] The main formative ECB opinions in this area are: Opinions CON/2002/16, CON/2003/22, CON/2003/27, CON/2004/1, CON/2006/38, CON/2006/47, CON/2007/8, CON/2008/13, CON/2008/68 and CON/2009/32.

[65] Opinion CON/2019/12.

[66] Opinion CON/2019/19.

[67] For the activities of the independent external auditors of the NCBs see Article 27.1 of the Statute.

[68] Opinions CON/2011/9, CON/2011/53, CON/2015/57 and CON/2018/17.

[69] Opinions CON/2015/8, CON/2015/57, CON/2016/24, CON/2016/59 and CON/2018/17.

should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.[70]

Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created.[71] Temporary or ad hoc legislative measures amounting to instructions to the NCBs in relation to the distribution of their profits are not permissible.[72] Similarly, a tax on an NCB's unrealised capital gains would also impair the principle of financial independence.[73]

A Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies, which must aim to ensure that it retains sufficient financial means to fulfil its mandate under Article 127(2) of the Treaty and the Statute as a member of the ESCB. For the same reason, any amendment to the profit distribution rules of an NCB should only be initiated and decided in close cooperation with the NCB, which is best placed to assess its required level of reserve capital.[74] As regards financial provisions or buffers, NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets. Member States may also not hamper NCBs from building up their reserve capital to a level which is necessary for a member of the ESCB to fulfil its tasks.[75]

Financial liability for supervisory authorities

Most Member States place their financial supervisory authorities within their NCB. This is unproblematic if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In such cases, national legislation should enable the NCB to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.[76]

Autonomy in staff matters

Member States may not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the Treaty and the Statute.[77] Also, an NCB may not be put into a position where it has

[70] Opinions CON/2017/17 and CON/2018/17.

[71] Opinions CON/2009/85, CON/2017/17, CON/2022/37 and CON/2023/24.

[72] Opinions CON/2009/26 and CON/2013/15.

[73] Opinions CON/2009/59 and CON/2009/63.

[74] Opinions CON/2009/53, CON/2009/83 and CON/2019/21.

[75] Opinions CON/2009/26, CON/2012/69 and CON/2020/13.

[76] Opinion CON/2021/7.

[77] Opinion CON/2019/19.

limited control or no control over its staff, or where the government of a Member State can influence its policy on staff matters.[78] Any amendment to the legislative provisions on the remuneration for members of an NCB's decision-making bodies and its employees should be decided in close and effective cooperation with the NCB,[79] taking due account of its views, to ensure the ongoing ability of the NCB to independently carry out its tasks.[80] Autonomy in staff matters extends to issues relating to staff pensions. Further, amendments that lead to reductions in the remuneration for an NCB's staff should not interfere with that NCB's powers to administer its own financial resources, including the funds resulting from any reduction in salaries that it pays.[81]

Ownership and property rights

Rights of third parties to intervene or to issue instructions to an NCB in relation to the property held by an NCB are incompatible with the principle of financial independence.

2.2.4 Confidentiality

The obligation of professional secrecy for ECB and NCB staff as well as for the members of the ECB and NCB governing bodies under Article 37 of the Statute may give rise to similar provisions in NCBs' statutes or in the Member States' legislation. The primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents should comply with relevant Union law provisions, including Article 37 of the Statute, and may not lead to infringements of the ESCB's confidentiality regime.[82] The access of a state audit office or similar body to an NCB's confidential information and documents must be limited to what is necessary for the performance of the statutory tasks of the body that receives the information and must be without prejudice to the ESCB's independence and the ESCB's confidentiality regime to which the members of NCBs' decision-making bodies and staff are subject.[83] NCBs should ensure that such bodies protect the confidentiality of information and documents disclosed at a level corresponding to that applied by the NCBs.

2.2.5 Prohibition on monetary financing and privileged access

On the monetary financing prohibition and the prohibition on privileged access, the national legislation of the Member States that joined the EU in 2004, 2007 or 2013 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and

[78] Opinions CON/2008/9, CON/2008/10, CON/2012/89 and CON/2023/37.

[79] Opinion CON/2019/19.

[80] Opinions CON/2010/42, CON/2010/51, CON/2010/56, CON/2010/69, CON/2010/80, CON/2011/104, CON/2011/106, CON/2012/6, CON/2012/86, CON/2014/7 and CON/2023/37.

[81] Opinion CON/2014/38.

[82] Opinion CON/2021/16.

[83] Opinions CON/2015/8 and CON/2015/57.

be in force on 1 May 2004, 1 January 2007 and 1 July 2013 respectively. Sweden had to bring the necessary adaptations into force by 1 January 1995.

Prohibition on monetary financing

Article 123(1) of the Treaty prohibits overdraft facilities or any other type of credit facility with the ECB or with the NCBs in favour of EU institutions, bodies, offices or agencies, central governments, regional, local, or other public authorities, other bodies governed by public law, or public undertakings of Member States.

It also prohibits the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from this monetary financing prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 123(2) of the Treaty). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty,[84] according to which the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition aims to encourage the Member States to follow a sound budgetary policy not allowing monetary financing of public deficits (or privileged access by public authorities to the financial markets) to lead to excessively high levels of debt or excessive Member State deficits.[85] Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to the limited exemptions contained in Article 123(2) of the Treaty and Regulation (EC) No 3603/93. Thus, even if Article 123(1) of the Treaty refers specifically to 'credit facilities', i.e. with the obligation to repay the funds, the prohibition applies a fortiori to other forms of funding, i.e. without the obligation to repay.

The ECB's general stance on the compatibility of national legislation with the prohibition has primarily been developed within the framework of consultations of the ECB by Member States on draft national legislation under Articles 127(4) and 282(5) of the Treaty.[86]

National legislation relating to the scope of application of the monetary financing prohibition

National legislation may not narrow the scope of application of the monetary financing prohibition or extend the exemptions available under EU law. For example, national

[84] OJ L 332, 31.12.1993, p. 1. Articles 104 and 104b(1) of the Treaty establishing the European Community are now Articles 123 and 125(1) of the Treaty on the Functioning of the European Union.

[85] *Peter Gauweiler and Others*, C-62/14, EU:C:2015:400, paragraph 100. Article 123 of the Treaty also serves the objective of maintaining price stability and reinforces central bank independence.

[86] See Convergence Report 2008, footnote 13, containing a list of formative EMI/ECB opinions in this area adopted between May 1995 and March 2008.

legislation providing for the financing by the NCB of a Member State's financial commitments to international financial institutions or to third countries is, in principle, incompatible with the monetary financing prohibition. As an exemption, Regulation (EC) No 3603/93 allows for the financing by the NCBs of obligations falling upon the public sector vis-à-vis the IMF provided that it results in foreign claims which have all the characteristics of reserve assets.[87] The relevant characteristics that determine the reserve asset quality of the claims concern their availability on demand to meet balance of payments financing needs and other related purposes, which implies that the credit quality and liquidity of the claims must be ensured.[88]

National legislation conferring tasks upon NCBs

National legislation assigning tasks to NCBs may not lead to any financing of the public sector's obligations vis-à vis third parties. In accordance with Article 14.4 of the Statute, NCBs may perform functions other than those specified in the Statute unless the Governing Council finds that these functions interfere with the objectives and tasks of the ESCB. Where a Member State assigns such a function to its NCB, that NCB is responsible and liable for the performance of that function. Nevertheless, when defining the responsibility and liability of an NCB in relation to that function, Member States are required to comply with their obligations deriving from Union law and, in particular, Article 123(1) of the Treaty.[89]

Article 1(1), point (b), of Council Regulation (EC) No 3603/93 defines the term 'other type of credit facility' for the purposes of Article 123 of the Treaty as, inter alia, any financing of the public sector's obligations vis-à-vis third parties. Accordingly, the NCB concerned must not assume obligations vis-a-vis third parties that could potentially be incumbent on the public sector. Consequently, the NCB concerned must not finance pre-existing obligations vis-à-vis third parties that are incumbent on other public authorities or bodies and the effective financing of the obligations vis-à-vis third parties by the NCB concerned must not result directly from the measures adopted or the policy choices made by other public authorities or bodies.[90]

Advanced distribution of central bank profits

National legislation may not require the distribution of central bank profits which have not been fully realised, accounted for and audited. To comply with the monetary financing prohibition, the amount distributed to the State budget pursuant to the applicable profit distribution rules cannot be paid, even partially, from the NCB's reserve capital. Therefore, profit distribution rules should leave unaffected the NCB's reserve capital. Moreover, when NCB assets are transferred to the State, they must be

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[87] Recital 14 and Article 7 of Regulation (EC) No 3603/93. See, for example, Opinions CON/2016/21, CON/2017/4, CON/2020/37 and CON/2021/23.

[88] See Opinion CON/2021/39.

[89] *Banka Slovenije*, C-45/21, EU:C:2022:670, paragraphs 53, 54, 57 and 97. See, for example, Opinions CON/2022/39, paragraph 2.2, CON/2023/17, paragraph 2.2.1, and CON/2023/44, paragraph 2.3.

[90] *Banka Slovenije*, C-45/21, EU:C:2022:670, paragraphs 67 to 75 and 84. See, for example, paragraph 3.1 of Opinion CON/2022/39, paragraph 2.2.2 of Opinion CON/2023/17, and paragraph 3.1.1 of Opinion CON/2023/44.

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remunerated at market value and the transfer should take place at the same time as the remuneration.[91]

Similarly, intervention in the performance of other Eurosystem tasks, such as the management of foreign reserves, by introducing taxation of theoretical and unrealised capital gains is not permitted since this would result in a form of central bank credit to the public sector through the advanced distribution of future and uncertain profits.[92]

Assumption of public sector liabilities

National legislation which requires an NCB to take over the liabilities of a previously independent public body, as a result of a national reorganisation of certain tasks and duties (for example, in the context of a transfer to the NCB of certain supervisory tasks previously carried out by the state or independent public authorities or bodies), without fully insulating the NCB from all financial obligations resulting from the prior activities of such a body, would be incompatible with the monetary financing prohibition.[93]

National legislation holding an NCB liable on account of the exercise of a task assigned to it under national law would entail the assumption of a pre-existing obligation vis-à-vis third parties and be incompatible with the monetary financing prohibition if the third parties who have suffered harm were not compensated as a result of the NCB's actions, i.e. the infringement by the NCB of the rules imposed on it in that context.[94] In addition, in case of tasks that require implementation of highly complex and urgent measures, such as those relating to the reorganisation or resolution of banks, national legislation holding an NCB liable on account of the exercise of such tasks would amount to the effective financing of the obligations vis-à-vis third parties if the NCB's liability was not limited to infringements of a serious nature of the rules imposed on it in that context.[95]

Financial support for credit and/or financial institutions

National legislation which provides for financing by an NCB, even if granted independently and at their full discretion, of insolvent credit and/or other financial institutions would be incompatible with the monetary financing prohibition.

The same would apply to the Eurosystem financing of a credit institution which has been recapitalised to restore its solvency by way of a direct placement of state-issued debt instruments where no alternative market-based funding sources exist (hereinafter "recapitalisation bonds"), and where such bonds are to be used as collateral. In such case of a state recapitalisation of a credit institution by way of direct placement of recapitalisation bonds, the subsequent use of the recapitalisation bonds as collateral in central bank liquidity operations raises monetary financing concerns.[96]

91 Opinions CON/2011/91 and CON/2011/99.

92 Opinions CON/2009/59 and CON/2009/63.

93 Opinion CON/2013/56.

94 *Banka Slovenije*, C-45/21, EU:C:2022:670, paragraph 71.

95 *Banka Slovenije*, C-45/21, EU:C:2022:670, paragraph 75. See, for example, paragraph 2.2.3 of Opinion CON/2023/17, and paragraphs 3.1.2. and 3.1.3 of Opinion CON/2023/44.

96 Opinions CON/2012/50, CON/2012/64, and CON/2012/71.

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Emergency liquidity assistance, granted by an NCB independently and at its full discretion to a solvent credit institution on the basis of collateral security in the form of a State guarantee, has to meet the following criteria: (i) it must be ensured that the credit provided by the NCB is as short term as possible; (ii) there must be systemic stability aspects at stake; (iii) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (iv) there must be no doubts as to the economic adequacy of the State guarantee, which should cover both principal and interest on the loans.[97]

Financial support for resolution funds or financial arrangements and deposit insurance or investor compensation schemes

The financing by an NCB of a resolution fund or a deposit guarantee fund that qualifies as a 'body governed by public law' within the meaning of Article 123(1) of the Treaty is not compatible with the monetary financing prohibition. A body is 'governed by public law' if it has all of the following characteristics: (a) it is established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character; (b) it has legal personality; and (c) it is closely dependent on the public sector entities referred to in Article 123(1) of the Treaty. A close dependence on those public sector entities is presumed when a body is financed, for the most part, by them; or is subject to management supervision by them; or has an administrative, managerial or supervisory board, more than half of whose members are appointed by them.[98]

Even if the financing is not provided to a 'body governed by public law', the financing of any resolution fund or financial arrangement is not in line with the monetary financing prohibition.[99] Where an NCB acts as resolution authority, it should not, under any circumstances, assume or finance any obligation of either a bridge institution or an asset management vehicle.[100] To this end, national legislation should clarify that the NCB will not assume or finance any of these entities' obligations.[101]

The Deposit Guarantee Schemes Directive[102] and the Investor Compensation Schemes Directive[103] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. With the exception of financing a 'body governed by public law', national legislation which provides for the financing by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary

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97 Opinion CON/2012/4, footnote 42 referring to further relevant Opinions in this field. See also Opinions CON/2016/55 and CON/2017/1.

98 Opinions CON/2020/24 and CON/2021/17.

99 Opinions CON/2015/22, CON/2016/28 and CON/2019/16.

100 Opinions CON/2011/103, CON/2012/99, CON/2015/3 and CON/2015/22.

101 Opinions CON/2015/33, CON/2015/35 and CON/2016/60.

102 Recital 27 of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (OJ L 173, 12.6.2014, p. 149).

103 Recital 23 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion.[104] In particular, central bank support for deposit guarantee schemes should not amount to a systematic pre-funding operation.[105]

Fiscal agency function

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to clarify that NCBs may continue to provide the fiscal agent service traditionally provided to governments and other public entities without infringing the monetary financing prohibition. In addition, Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows: (i) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;[106] (ii) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;[107] and (iii) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.[108]

National legislation on the fiscal agency function should be compatible with EU law in general, and with the monetary financing prohibition in particular.[109] Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services, which is a legitimate function traditionally performed by NCBs, the provision by central banks of fiscal agency services complies with the monetary financing prohibition, provided that such services remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations vis-à-vis third parties or central bank crediting of the public sector outside the narrowly defined exceptions specified in Regulation (EC) No 3603/93.[110] National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to

104 Opinions CON/2020/24 and CON/2021/17.

105 Opinion CON/2011/84.

106 Article 4 of Regulation (EC) No 3603/93 and Opinion CON/2013/2.

107 Article 5 of Regulation (EC) No 3603/93.

108 Article 6 of Regulation (EC) No 3603/93.

109 Opinion CON/2013/3.

110 Opinions CON/2009/23, CON/2009/67 and CON/2012/9.

enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine that objective. It is essential for any remuneration of an account to reflect market parameters and it is particularly important to correlate the remuneration rate of the deposits with their maturity.[111] Moreover, the provision without remuneration by an NCB of fiscal agent services does not raise monetary financing concerns, provided they are core fiscal agent services.[112]

Prohibition on privileged access

Article 124 of the Treaty provides that '[a]ny measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.' As with the monetary financing prohibition, the prohibition of privileged access aims to encourage the Member States to follow a sound budgetary policy, not allowing (monetary financing of public deficits or) privileged access by public authorities to the financial markets to lead to excessively high levels of debt or excessive Member State deficits.[113]

Under Article 1(1) of Council Regulation (EC) No 3604/93,[114] privileged access is understood as any law, regulation or other binding legal instrument adopted in the exercise of public authority which: (a) obliges financial institutions to acquire or to hold liabilities of EU institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of Member States, or (b) confers tax advantages that only benefit financial institutions or financial advantages that do not comply with the principles of a market economy, in order to encourage those institutions to acquire or hold such liabilities.

As public authorities, NCBs may not take measures granting privileged access to financial institutions by the public sector if such measures are not based on prudential considerations. Furthermore, the rules on the mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[115] Member States' legislation in this area may not establish such privileged access.

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[111] See, among others, Opinions CON/2010/54, CON/2010/55 and CON/2013/62.

[112] Opinion CON/2012/9.

[113] See, to that effect, *Smaranda Bara and Others v Casa Naţională de Asigurări de Sănătate and Others*, C-201/14, EU:C:2015:638, paragraph 22; and *Peter Gauweiler and Others*, C-62/14, EU:C:2015:400, paragraph 100.

[114] Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a of the Treaty [establishing the European Community] (OJ L 332, 31.12.1993, p. 4). Article 104a of the Treaty establishing the European Community is now Article 124 of the Treaty.

[115] Article 3(2) of and recital 10 of Regulation (EC) No 3604/93.

Article 2 of Regulation (EC) No 3604/93 defines 'prudential considerations' as those which underlie national laws, regulations or administrative actions based on, or consistent with, EU law and designed to promote the soundness of financial institutions so as to strengthen the stability of the financial system as a whole and the protection of the customers of those institutions. Prudential considerations seek to ensure that banks remain solvent with regard to their depositors.[116] In the area of prudential supervision, EU secondary legislation has established a number of requirements to ensure the soundness of credit institutions.[117] A 'credit institution' has been defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.[118] Additionally, credit institutions, commonly referred to as 'banks', require an authorisation by a competent Member State authority to provide services.[119]

Although minimum reserves might be seen as a part of prudential requirements, they are part of an NCB's operational framework and used as a monetary policy tool in most economies, including in the euro area.[120] In this respect, paragraph 2 of Annex I to Guideline ECB/2014/60[121] states that the Eurosystem's minimum reserve system primarily pursues the aims of stabilising the money market interest rates and creating (or enlarging) a structural liquidity shortage.[122] The ECB requires credit institutions established in the euro area to hold the required minimum reserves (in the form of deposits) on account with their NCB.[123]

This report focuses on the compatibility both of national legislation or rules adopted by NCBs and of the NCBs' statutes with the Treaty prohibition on privileged access. However, this report is without prejudice to an assessment of whether laws, regulations, rules or administrative acts in Member States are used under the cover of prudential considerations as a means of circumventing the prohibition on privileged access. Such an assessment is beyond the scope of this report.

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116 Opinion of Advocate General Elmer in *Société civile immobilière Parodi v Banque H. Albert de Bary et Cie.*, C-222/95, EU:C:1997:345, paragraph 24.

117 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.06.2013, p. 1) and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.06.2013, p. 338).

118 Article 4(1)(1) of Regulation (EU) No 575/2013.

119 Article 8 of Directive 2013/36/EU.

120 This is supported by Article 3(2) and recital 9 of Regulation (EC) No 3604/93.

121 Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (General Documentation Guideline) (ECB/2014/60) (OJ L 91, 2.4.2015, p. 3).

122 The higher the reserve requirement is set, the fewer funds banks will have to loan out, leading to lower money creation.

123 See: Article 19 of the Statute; Council Regulation (EC) No 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank (OJ L 318, 27.11.1998, p. 1); Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003 on the application of minimum reserves (ECB/2003/9) (OJ L 250, 2.10.2003, p. 10); and Regulation (EU) No 1071/2013 of the European Central Bank of 24 September 2013 concerning the balance sheet of the monetary financial institutions sector (ECB/2013/33) (OJ L 297, 7.11.2013, p. 1).

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2.2.6 Single spelling of the euro

Article 3(4) of the Treaty on European Union lays down that the 'Union shall establish an economic and monetary union whose currency is the euro'. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as 'euro'. In the Greek alphabet text, the euro is spelled 'ευρώ' and in the Cyrillic alphabet text the euro is spelled 'евро'.[124] Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro[125] makes it clear that the name of the single currency must be the same in all the official languages of the EU, taking into account the existence of different alphabets. The Treaties thus require a single spelling of the word 'euro' in the nominative singular case in all EU and national legislative provisions, taking into account the existence of different alphabets.

In view of the exclusive competence of the EU to determine the name of the single currency, any deviations from this rule are incompatible with the Treaties and should be eliminated.[126] While this principle applies to all national legislation, the assessment in the country chapters focuses on the NCBs' statutes and the euro changeover laws.

2.2.7 Legal integration of NCBs into the Eurosystem

Provisions in national legislation (in particular an NCB's statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with the ECB's decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 131 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004, 1 January 2007 and 1 July 2013 (as regards the Member States that joined the EU on these dates). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

The main areas examined in this report are those in which statutory provisions may hinder NCBs' compliance with the Eurosystem's requirements. These include provisions (a) that could prevent NCBs from taking part in implementing the single monetary policy, as defined by the ECB's decision-making bodies, or (b) that could

[124] The 'Declaration by the Republic of Latvia, the Republic of Hungary and the Republic of Malta on the spelling of the name of the single currency in the Treaties', annexed to the Treaties, states that: 'Without prejudice to the unified spelling of the name of the single currency of the European Union referred to in the Treaties as displayed on banknotes and on coins, Latvia, Hungary and Malta declare that the spelling of the name of the single currency, including its derivatives as applied throughout the Latvian, Hungarian and Maltese text of the Treaties, has no effect on the existing rules of the Latvian, Hungarian or Maltese languages'.

[125] OJ L 139, 11.5.1998, p. 1.

[126] Opinion CON/2012/87.

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hinder a Governor from fulfilling their duties as a member of the ECB's Governing Council, or (c) that do not respect the ECB's prerogatives, or (d) that do not recognise that the exclusive competence for ESCB-related tasks in Member States whose currency is the euro is irrevocably conferred on the Union,[127] or (e) pursuant to which NCBs in the performance of their ESCB-related tasks are bound by decisions of national authorities that conflict with legal acts of the ECB. Distinctions are made between economic policy objectives, tasks, financial provisions, exchange rate policy and international cooperation. Finally, other areas where NCBs' statutes may need to be adapted are mentioned.

Economic policy objectives

The full integration of an NCB into the Eurosystem requires its statutory objectives to be compatible with the ESCB's objectives, as laid down in Article 2 of the Statute. Among other things, this means that statutory objectives with a 'national flavour' – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted. Furthermore, an NCB's secondary objectives must be consistent and not interfere with its obligation to support the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU as laid down in Article 3 of the Treaty on European Union, which is itself an objective expressed to be without prejudice to maintaining price stability.[128]

Tasks

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB's statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[129] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitutes an impediment to carrying out ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the EU's monetary policy is to be carried out through the Eurosystem.[130] An NCB's statutes may contain provisions on monetary policy instruments. Such provisions should be comparable to those in the Treaty and the Statute, and any incompatibility must be removed in order to comply with Article 131 of the Treaty.

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[127] Opinion CON/2020/2.

[128] Opinions CON/2010/30 and CON/2010/48.

[129] See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 of the Statute.

[130] First indent of Article 127(2) of the Treaty.

Monitoring fiscal developments is a task that an NCB carries out on a regular basis to assess properly the stance to be taken in monetary policy. NCBs may also present their views on relevant fiscal developments on the basis of their monitoring activity and the independence of their advice, with a view to contributing to the proper functioning of the European Monetary Union. The monitoring of fiscal developments by an NCB for monetary policy purposes should be based on the full access to all relevant public finance data. Accordingly, the NCBs should be granted unconditional, timely and automatic access to all relevant public finance statistics. However, an NCB's role should not go beyond monitoring activities that result from or are linked – directly or indirectly – to the discharge of their monetary policy mandate.[131] A formal mandate for an NCB to assess forecasts and fiscal developments implies a function for the NCB in (and a corresponding responsibility for) fiscal policymaking which may risk undermining the discharge of the Eurosystem's monetary policy mandate and the NCB's independence.[132]

In the context of the national legislative initiatives to address the turmoil in the financial markets, the ECB has emphasised that any distortion in the national segments of the euro area money market should be avoided, as this may impair the implementation of the single monetary policy. In particular, this applies to the extension of State guarantees to cover interbank deposits.[133]

Member States must ensure that national legislative measures addressing liquidity problems of businesses or professionals, for example their debts to financial institutions, do not have a negative impact on market liquidity. In particular, such measures may not be inconsistent with the principle of an open market economy, as reflected in Article 3 of the Treaty on European Union, as this could hinder the flow of credit, materially influence the stability of financial institutions and markets and therefore affect the performance of Eurosystem tasks.[134]

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that, once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 128(1) of the Treaty and Article 16 of the Statute,[135] while the right to issue euro banknotes belongs to the ECB and the NCBs. Once the euro is adopted, national legislative provisions enabling the government to influence issues such as the denominations, production, volume or withdrawal of banknotes must also either be repealed or recognition must be given to the ECB's powers with regard to euro banknotes, as set out in the provisions of the Treaty and the Statute. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted. A Member State may not consider currency in

131 Opinions CON/2012/105, CON/2013/90 and CON/2013/91.

132 For example, national legislative provisions transposing Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L306, 23.11.2011, p. 41). See Opinions CON/2013/90 and CON/2013/91.

133 Opinions CON/2009/99, CON/2011/79 and CON/2017/1.

134 Opinion CON/2010/8.

135 Paragraph 3.1 of Opinion CON/2024/1.

circulation as its NCB's debt to the government of that Member State, as this would defeat the concept of a single currency and be incompatible with the requirements of Eurosystem legal integration.[136]

With regard to foreign reserve management,[137] any Member State that has adopted the euro and which does not transfer its official foreign reserves[138] to its NCB is in breach of the Treaty. In addition, any right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to the management of the official foreign reserves would be inconsistent with the third indent of Article 127(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

With regard to statistics, although regulations adopted under Article 34.1 of the Statute in the field of statistics do not confer any rights or impose any obligations on Member States that have not adopted the euro, Article 5 of the Statute, which concerns the collection of statistical information, applies to all Member States, regardless of whether they have adopted the euro. Accordingly, Member States whose currency is not the euro are under an obligation to design and implement, at national level, all measures they consider appropriate to collect the statistical information needed to fulfil the ECB's statistical reporting requirements[139] and to make timely preparations in the field of statistics in order for them to become Member States whose currency is the euro.[140] National legislation laying down the framework for cooperation between the NCBs and national statistical offices should guarantee the NCBs' independence in the performance of their tasks within the ESCB's statistical framework.[141]

Financial provisions

The financial provisions in the Statute comprise rules on financial accounts,[142] auditing,[143] capital subscription,[144] the transfer of foreign reserve assets[145] and the allocation of monetary income.[146] NCBs must be able to comply with their obligations

136 Opinion CON/2008/34.

137 Third indent of Article 127(2) of the Treaty.

138 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.

139 In this regard, national legislation should ensure consistency with the reporting requirements set out in Union legislation. See Opinion CON/2020/29.

140 Opinion CON/2013/88.

141 Opinions CON/2015/5 and CON/2015/24.

142 Article 26 of the Statute.

143 Article 27 of the Statute.

144 Article 28 of the Statute.

145 Article 30 of the Statute.

146 Article 32 of the Statute.

under these provisions and therefore any incompatible national provisions must be repealed.[147]

Exchange rate policy

A Member State with a derogation may retain national legislation which provides that the government is responsible for the exchange rate policy of that Member State, with a consultative and/or executive role being granted to the NCB. However, by the time that a Member State adopts the euro, such legislation must reflect the fact that responsibility for the euro area's exchange rate policy has been transferred to the EU level in accordance with Articles 138 and 219 of the Treaty.

International cooperation

For the adoption of the euro, national legislation must be compatible with Article 6.1 of the Statute, which provides that in the field of international cooperation involving the tasks entrusted to the Eurosystem, the ECB decides how the ESCB is represented. National legislation allowing an NCB to participate in international monetary institutions must make such participation subject to the ECB's approval (Article 6.2 of the Statute).

Miscellaneous

In addition to the above issues, for certain Member States there are other areas where national provisions need to be adapted (for example in the area of clearing and payment systems and the exchange of information).

[147] Paragraphs 2.1 and 3.2 to 3.4 of Opinion CON/2022/37; paragraphs 2.1, 2.2 and 3.1 to 3.5 of Opinion CON/2023/24.

3 The state of economic convergence

This chapter provides a horizontal overview. Some factors relevant for the overall assessment are not covered here, but in Chapters 4 and 5.

Reflecting challenging economic conditions, limited progress has been made as regards compliance with the convergence criteria since the ECB's 2022 Convergence Report. In all six countries examined in this report, HICP inflation is above the reference value, and well above it in five countries (Table 3.1). Since April 2022 the 12-month average of long-term interest rate differentials versus the euro area has increased in one country, declined in four countries and remained unchanged in one country. As in 2022, three countries are not compliant with the long-term interest rate criterion, with their rate being above the reference value. The currencies of some of the countries examined in this report have experienced sizeable fluctuations against the euro over the last few years. Public finances improved in most of the countries following the COVID-19 pandemic as their economies recovered and pandemic support measures were phased out. However, in most cases, public deficits and debt ratios remain above pre-pandemic levels, partly owing to the economic impact of Russia's war against Ukraine and the fiscal policy measures taken in response to the resulting high energy prices.

Table 3.1

Overview table of economic indicators of convergence

	Price stability	Government budgetary developments and projections			Exchange rate		
	HICP inflation[1]	Country in excessive deficit[2,3]	General government surplus (+)/ deficit (-)[4]	General government debt[4]	Currency participating in ERM II	Exchange rate vis-à-vis the euro[5]	Long-term interest rate[6]
Bulgaria							
2022	13.0	No	-2.9	22.6	Yes	0.0	1.5
2023	8.6	No	-1.9	23.1	Yes	0.0	3.8
2024	5.1	No	-2.8	24.8	Yes	0.0	4.0
Czech Republic							
2022	14.8	No	-3.2	44.2	No	4.2	4.3
2023	12.0	No	-3.7	44.0	No	2.3	4.4
2024	6.3	No	-2.4	45.2	No	-4.2	4.2
Hungary							
2022	15.3	No	-6.2	74.1	No	-9.1	7.6
2023	17.0	No	-6.7	73.5	No	2.4	7.5
2024	8.4	No	-5.4	74.3	No	-2.0	6.8
Poland							
2022	13.2	No	-3.4	49.2	No	-2.6	6.1
2023	10.9	No	-5.1	49.6	No	3.1	5.8
2024	6.1	No	-5.4	53.7	No	4.9	5.6
Romania							
2022	12.0	Yes	-6.3	47.5	No	-0.2	7.5
2023	9.7	Yes	-6.6	48.8	No	-0.3	6.7
2024	7.6	Yes	-6.9	50.9	No	-0.6	6.4
Sweden							
2022	8.1	No	1.2	33.2	No	-4.8	1.5
2023	5.9	No	-0.6	31.2	No	-8.0	2.5
2024	3.6	No	-1.4	32.0	No	0.7	2.5
Reference value[7]	**3.3**		**-3.0**	**60.0**			**4.8**

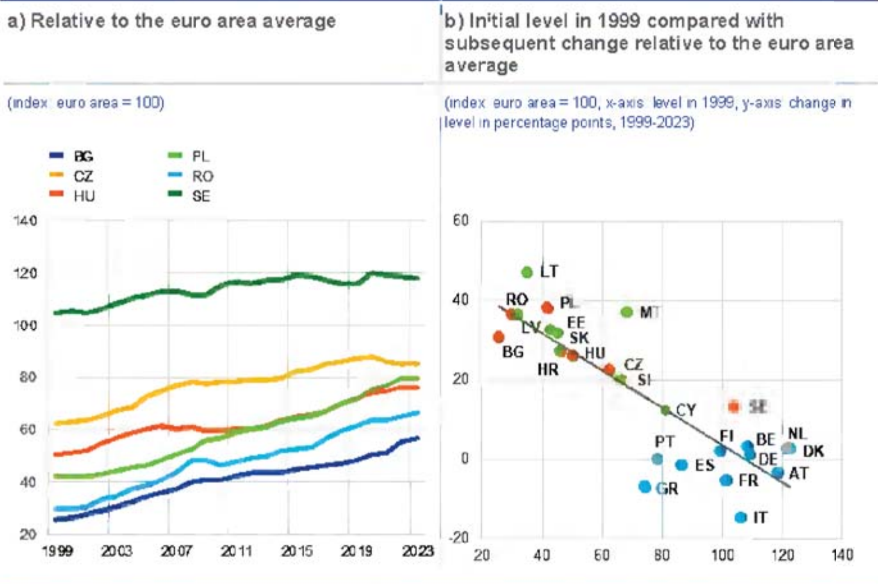
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs) and European System of Central Banks.
1) Average annual percentage change. Data for 2024 refer to the period from June 2023 to May 2024.
2) Refers to whether a country was subject to an EU Council decision on the existence of an excessive deficit for at least part of the year.
3) The information for 2024 refers to the period up to the cut-off date for statistics (19 June 2024).
4) As a percentage of GDP. Data for 2024 are taken from the European Commission's Spring 2024 Economic Forecast.
5) Annual percentage change. A positive (negative) number denotes appreciation (depreciation) vis-à-vis the euro. Data for 2024 refer to the period from 1 January 2024 to 19 June 2024.
6) Average annual interest rate. Data for 2024 refer to the period from June 2023 to May 2024.
7) The reference values for HICP inflation and long-term interest rates refer to the period from June 2023 to May 2024; for the general government balance and debt, the reference values referred to in Article 126(2) of the Treaty are specified in the related Protocol (No 12) on the excessive deficit procedure.

Over the past two years the EU has been hit by the economic fallout from Russia's invasion of Ukraine, which led to a significant weakening of economic activity and soaring inflation rates. Since early 2022 Russia's war against Ukraine has weighed on economic activity in the countries under review owing to the associated uncertainty, trade and supply chain disruptions, and deteriorating business and consumer confidence. At the same time, the surge in energy and commodity prices reduced demand and held back production. The central and eastern European countries under review have been particularly strongly affected by the economic impact of the war given their high energy intensity of production, their economic openness and integration in global supply chains, and their trade with and financial exposures to Russia (see also Section 3.1). In addition, the tightening of monetary policy, which in most of the countries under review started earlier than in the euro area, has weighed on economic activity. The Czech Republic, Hungary and Sweden were particularly strongly affected, with their economies contracting in 2023 as a whole. In the same year, weak growth was recorded in Poland, while the economies of Bulgaria and Romania remained somewhat more resilient, growing at rates of around 2%, supported by relatively strong domestic demand.

Economic activity is expected to strengthen in the near term in all the countries under review, but geopolitical tensions are clouding their economic prospects. The easing of price pressures and supply bottlenecks observed since the beginning of 2023, along with improved confidence and resilient labour markets, is expected to support the economic recovery of the countries under review in 2024. At the same time, economic activity will continue to be dampened by tight financing conditions and uncertainty. A key source of uncertainty is geopolitical tensions, which might exacerbate fragmentation trends, potentially further disrupting trade and investment flows and increasing risk perceptions. The economic outlook is also clouded by losses in price competitiveness over recent years in most of the countries under review and uncertainty surrounding the path of inflation.

Over recent decades the central and eastern European countries under review have made progress in terms of real convergence towards the euro area average. Since 1999 these countries have significantly narrowed their gaps to the euro area average in terms of real GDP per capita (Chart 3.1). However, since 2019 the catching-up process has stalled, or even reversed, in some countries, particularly the Czech Republic, which experienced substantial real exchange rate appreciation between the end of 2019 and spring 2023. At the same time, significant macroeconomic and financial vulnerabilities persist, albeit to differing degrees depending on the country. If not adequately addressed, such vulnerabilities are likely to expose countries to adverse external shocks and slow their convergence progress over the long term. Some of the key challenges related to the long-term real convergence of these countries include (i) a changing and uncertain geopolitical landscape, which might not only affect trade and investment flows in the near future but also shape long-term production trends; (ii) shifting industrial structures, which is typically a challenge for countries moving from middle to high income levels; (iii) persistent labour shortages and adverse demographic developments, particularly the outflow of highly skilled people; and (iv) limited progress on improving the quality of governance, institutional capacity and the business environment.

Chart 3.1
Real GDP per capita

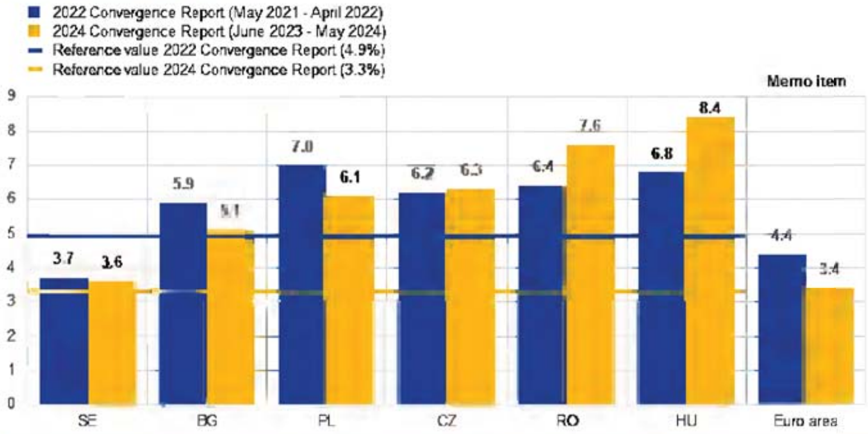


Sources: European Commission (Directorate-General for Economic and Financial Affairs) and ECB calculations.
Notes: Based on real GDP per capita in terms of purchasing power standard. In panel b), the red dots indicate the countries under review, the green dots indicate countries that joined the euro area from 2003 onwards, the light blue dots indicate countries that joined the euro area before 2003, the grey dot indicates Denmark. Ireland is excluded because of the exceptional GDP revision made for 2015, which did not reflect an actual increase in economic activity. Luxembourg is excluded because GDP per capita computations are distorted by the high number of cross-border workers.

Regarding the price stability criterion, the 12-month average inflation rate was above the reference value of 3.3% in all of the six countries examined in the report (Chart 3.2). Bulgaria, the Czech Republic, Hungary, Poland and Romania recorded inflation rates well above the reference value, while inflation was slightly above the reference rate in Sweden. In the 2022 Convergence Report, Bulgaria, the Czech Republic, Hungary, Poland and Romania also recorded inflation rates well above the reference value applicable at that time, which was 4.9%.

Chart 3.2
HICP inflation

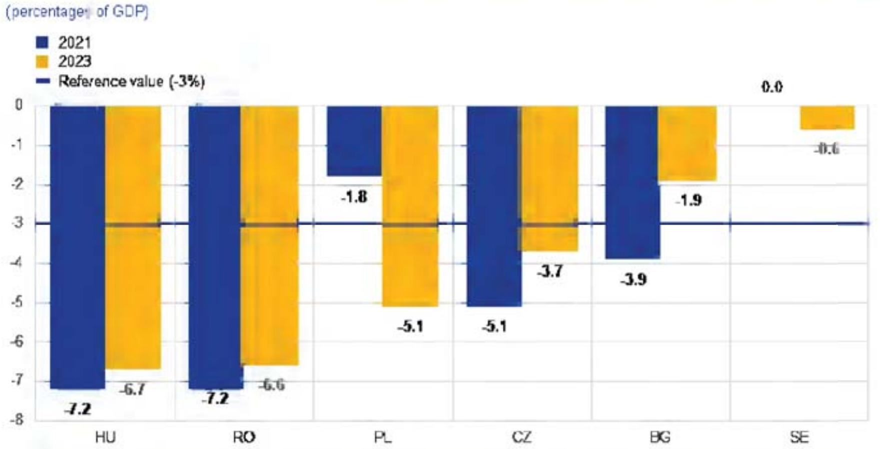
(average annual percentage changes)



Source: Eurostat

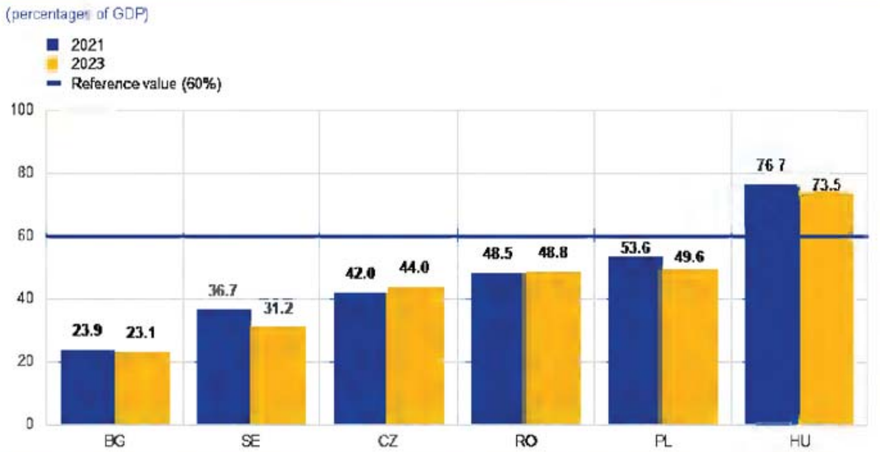
At the time of publication of this report, Romania is the subject of an EU Council decision on the existence of an excessive deficit. In addition, the European Commission found in June 2024 that Hungary and Poland did not fulfil the deficit criterion of the Stability and Growth Pact. After sharp increases during the pandemic, budget deficits mostly decreased but remained at elevated levels in all the countries except Sweden in 2023. Compared with the 2022 Convergence Report, the budget balance improved in four of the countries under review, while it deteriorated strongly in Poland and to a lesser extent in Sweden. In 2023 the budget deficit was above the reference value in four of the countries under review: in Hungary and Romania, it was significantly above the reference value, at 6.7% and 6.6% of GDP respectively, in Poland it was well above the reference value, at 5.1% of GDP, and in the Czech Republic, it was above the reference value, at 3.7% of GDP (Chart 3.3). In 2024 the deficit-to-GDP ratio is expected to deteriorate in four of the countries, according to the European Commission's Spring 2024 Economic Forecast, and it is expected to remain above the 3% reference value in Hungary, Poland and Romania. In 2025 the budget balance is expected to improve in four of the countries, but is expected to continue to exceed the reference value in Hungary, Poland and Romania. Regarding the debt criterion, in 2023 the debt ratio was well below the reference value in both Bulgaria and Sweden (Chart 3.4). In the Czech Republic, Poland and Romania it was below the reference value, between 40% and 50% of GDP. Hungary was the only country under review with a general government debt-to-GDP ratio above the 60% reference value in 2023. At the cut-off date for this report, Romania was still subject to a Council decision on the existence of an excessive deficit. An excessive deficit procedure was launched in April 2020, and in June 2024 the Commission found that Romania had not taken effective action to put an end to its excessive deficit situation. At the same time, the Commission also concluded that the government deficit criterion of the Stability and Growth Pact was not fulfilled either in Hungary or Poland, based on their outcomes in 2023 and planned deficits for 2024. Consequently, the Commission announced its intention to propose in July 2024 to the EU Council to adopt a decision under Article 126(6) of the Treaty establishing the existence of an excessive deficit situation in Hungary and Poland.

Chart 3.3
General government surplus (+) or deficit (-)



Source: Eurostat
Note: Data for 2021 have been revised slightly since the 2022 Convergence Report

Chart 3.4
General government gross debt

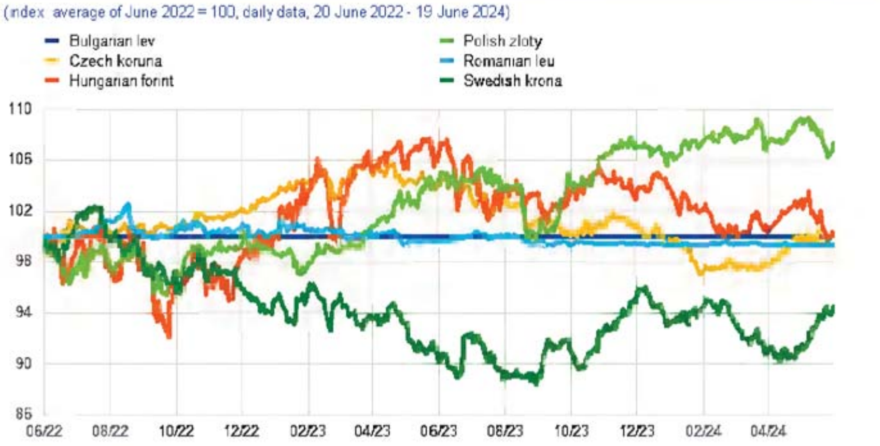


Source: Eurostat
Note: Data for 2021 have been revised slightly since the 2022 Convergence Report

As regards the exchange rate criterion, only the Bulgarian lev is participating in the exchange rate mechanism (ERM II) at the time of publication of this report. The Bulgarian lev was included in ERM II as of July 2020 at a central rate of 1.95583 levs per euro and is subject to the standard fluctuation band of ±15%. Bulgaria joined ERM II with its existing currency board in place as a unilateral commitment, placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments made by the Bulgarian authorities. Over the two-year reference period the Bulgarian lev did not exhibit any deviation from its central rate. With the exception of the Romanian leu, which showed low volatility, the other currencies not participating in ERM II exhibited relatively high volatility. The Czech koruna, the Romanian leu and the Swedish krona were weaker against the euro in June 2024 than in June 2022. At the same time, the Hungarian forint was trading at almost the same level, while the Polish zloty was stronger (Chart 3.5).[148]

Chart 3.5

Bilateral exchange rates vis-à-vis the euro

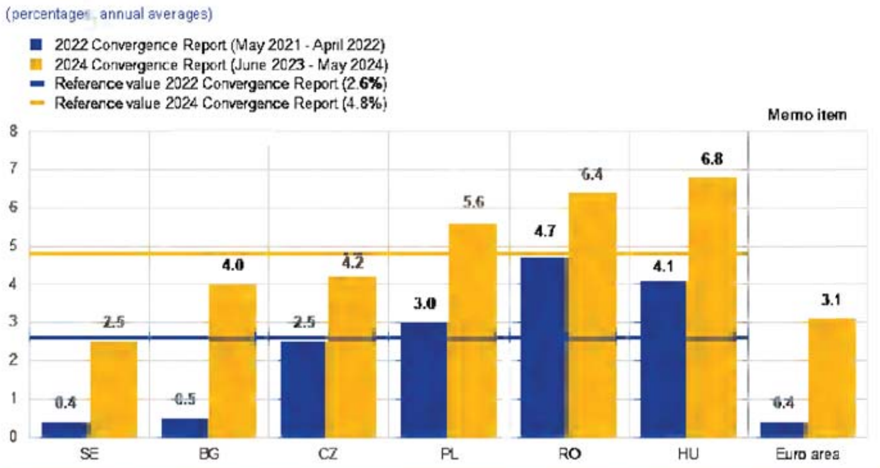


Source: ECB
Note: An upward (downward) movement indicates appreciation (depreciation) of the currency.

With regard to the convergence of long-term interest rates, three of the six countries under review recorded long-term interest rates above the reference value, which was 4.8% (Chart 3.6). Interest rates were above the reference value in Poland, Romania and Hungary. The lowest value was recorded in Sweden. In the 2022 Convergence Report, long-term interest rates in Poland and Hungary were above the reference value, which at that time was 2.6%, while in Romania they were well above that value.

[148] For the purpose of this report, exchange rates are quoted in units of national currency per euro. Thus a decrease in the exchange rate corresponds to an appreciation of the currency against the euro, and an increase in the exchange rate corresponds to a depreciation of the currency against the euro, while the percentage changes indicate the degree of appreciation or depreciation of the currency.

Chart 3.6
Long-term interest rates



Sources: Eurostat and ECB

When considering compliance with the convergence criteria, sustainability is essential. Convergence must be achieved on a lasting basis and not just at a given point in time. The first decade of Economic and Monetary Union (EMU) showed that weak fundamentals, an excessively loose macroeconomic stance, inadequate statistical capacity at the country level and overly optimistic expectations about convergence in real incomes pose risks not only to the countries concerned but also to the smooth functioning of the euro area as a whole. The second decade showed that economic convergence can be challenging and take a long time if initial macroeconomic imbalances are large, adjustment and reform processes are difficult, and/or resilience to adverse shocks is weak. Addressing these challenges is the responsibility of national authorities and is first and foremost in the country's own interest, but it is also important for the smooth functioning of the of the euro area in general and the transmission of monetary policy in particular. Compliance with the numerical convergence criteria at a single point in time is, by itself, not a guarantee of smooth and beneficial economic and financial developments as a member of the euro area in the future. Countries joining the euro area should therefore demonstrate the sustainability of their convergence processes and their capacity to live up to the ongoing commitments and challenges which euro adoption represents, taking into account that the monetary union is not a fiscal union and that risk-sharing mechanisms within EMU are thus very limited.

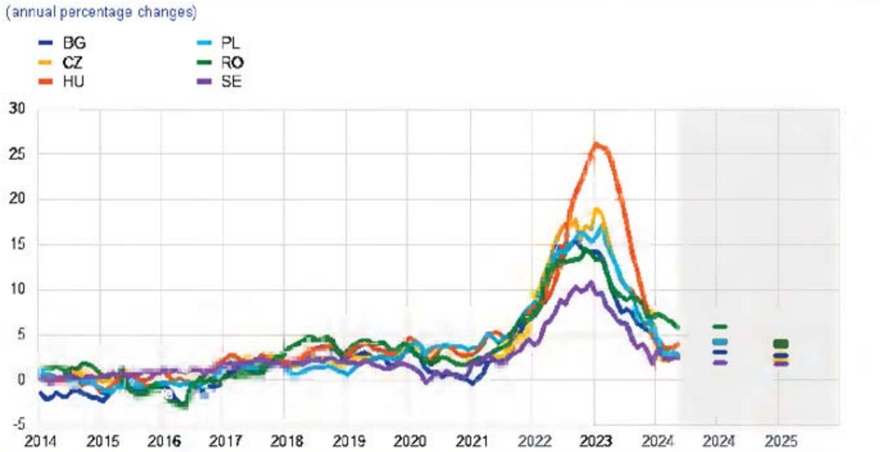
To achieve sustainable convergence, lasting policy adjustments are required in many of the countries under review. Prerequisites for sustainable convergence include macroeconomic stability, a supportive business environment with efficient economic structures and public institutions, and, in particular, a sound fiscal policy. A high degree of flexibility in product and labour markets is essential to cope with macroeconomic shocks. A stability culture needs to exist, with well-anchored inflation expectations helping to achieve an environment of price stability. The conditions of an open market economy with free competition are needed to ensure the efficient use of capital and labour in the economy, and to support productivity and long-run economic growth. A high degree of economic integration with the euro area is needed to achieve the synchronisation of business cycles. Moreover, appropriate macroprudential policies need to be in place to prevent the build-up of macroeconomic and financial imbalances, such as excessive asset price increases and socially costly boom-bust credit cycles. An appropriate framework for the supervision of financial institutions also needs to be in place. In the case of countries subject to in-depth reviews by the European Commission in the context of the macroeconomic imbalance procedure (MIP), it is essential that they address the identified imbalances in their economies. Finally, the strength of the institutional environment, including a country's ability to implement economic adjustment and sound structural policies, is a major factor in economic integration and convergence. The Next Generation EU (NGEU) package represents a unique opportunity to accelerate the process of convergence with the euro area, with efficient and effective implementation of investment plans and reforms being crucial for its success.

3.1 The price stability criterion

In May 2024 five of the six countries under review recorded a 12-month average inflation rate well above the reference value of 3.3% for the price stability criterion. Inflation rose sharply in 2021, largely driven by base effects, strong increases in energy prices, supply bottlenecks triggered by the pandemic, and a sharp rise in global demand for goods. Since early 2022 Russia's war against Ukraine has exacerbated inflationary pressures through higher energy and commodity prices and by adding strains to already stretched supply chains. Consequently, inflation increased further in all countries under review in 2022, albeit to differing degrees owing partly to domestic policies. Since the 2022 Convergence Report, inflation has followed a similar pattern in most of the countries under review; between June 2023 and May 2024 inflation moderated significantly in all countries, but was higher in Bulgaria, the Czech Republic, Hungary, Poland and Romania than in Sweden, mainly reflecting their greater vulnerability to recent adverse global shocks, as well as the tightness of their labour markets. Against this background, these five countries recorded inflation rates well above the reference value, while in Sweden the inflation rate was slightly above the reference value.

Longer-term price developments have mirrored the volatile macroeconomic environment, particularly over the past few years. Over the past ten years both the average rate and the volatility of inflation have varied significantly across the countries examined (Chart 3.7). During this period, average inflation was consistently higher than in the euro area in all the countries under review. Initially, from 2014 to 2016, inflation was subdued in all the countries, mainly reflecting developments in global commodity prices, low imported inflationary pressures and, in some countries, persistent spare capacity, reductions in administered prices and indirect taxes, and a strengthening of the nominal effective exchange rate. Against this backdrop, monetary policy conditions were loosened considerably. From 2017 inflation accelerated owing to the strengthening of economic activity, solid domestic demand, increasingly tight labour market conditions and rising energy and commodity prices, prompting a tightening of the monetary policy stance in some of the countries under review. The outbreak of the pandemic in 2020 resulted in a large drop in economic activity in that year. Inflation slowed in some countries, while it remained more persistent in others, reflecting higher food and services prices, as well as the tightness of the labour market. Inflation increased significantly in all the countries under review in 2021 and 2022, largely driven by sharp increases in energy prices, and by the supply-demand mismatches triggered by the pandemic and the macroeconomic policy responses. Since early 2022 Russia's war against Ukraine has added to the inflationary pressures. To combat this rise in inflation, most central banks started to strongly increase their main policy rates in 2021, while governments introduced discretionary fiscal support measures to alleviate the burden of high inflation on the economy. In the countries under review, these measures were concentrated in 2022 and 2023, and mainly took the form of increases in subsidies, largely in relation to energy products, and, to a lesser extent, reduced indirect taxes. After peaking around the end of 2022/beginning of 2023, inflation started to fall sharply, driven by previous monetary policy tightening, the fall in global energy prices and the easing of pipeline pressures and supply bottlenecks. Given the moderation in inflation dynamics, central banks in the Czech Republic, Hungary and Poland started to ease their monetary policy stance, while fiscal support measures have gradually been withdrawn in all the countries under review.

Chart 3.7
Long-term HICP inflation developments and outlook



Sources: Eurostat, European Commission (Directorate-General for Economic and Financial Affairs) and ECB.
Notes: Solid lines depict annual percentage changes in the monthly HICP. In the shaded area, projections of annual HICP inflation from the European Commission's Spring 2024 Economic Forecast are shown.

Most of the countries under review were particularly exposed to recent global shocks, largely owing to certain structural features of their economies. Countries in central and eastern Europe experienced significantly higher inflation rates than the euro area and Sweden, reflecting their vulnerability to the impact of the war in Ukraine and associated geopolitical changes. First, these countries typically display a higher energy intensity of production than the euro area, mainly owing to larger energy-intensive sectors (i.e. manufacturing and transport) and fewer energy-efficient appliances and buildings. Second, the share of energy and food in their consumption

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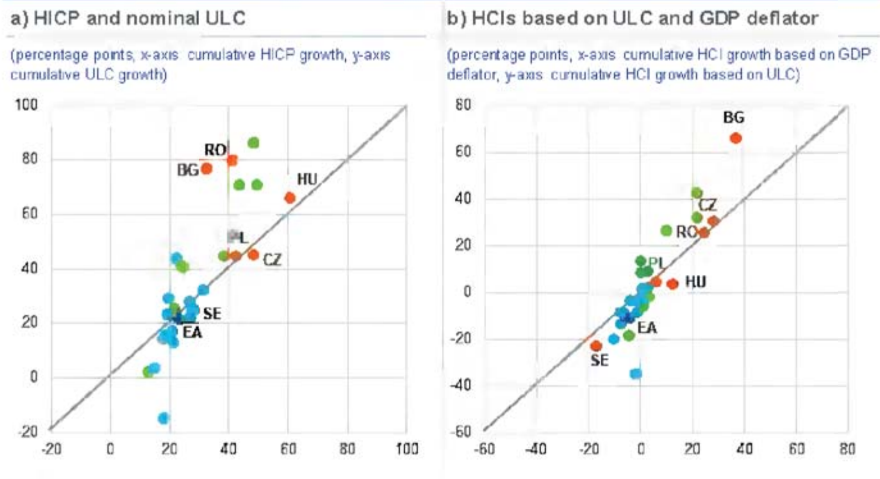
baskets is higher than in the euro area, which can often be seen in economies with lower average incomes. Third, most of these economies were heavily dependent on Russian energy prior to the outbreak of the war, making them more vulnerable to energy supply disruptions. Fourth, these countries are deeply integrated in global supply chains, implying a larger impact of global supply bottlenecks. While external shocks were an important driver of initial inflation differentials, domestic factors also played a prominent role. In particular, labour market conditions have remained tight in most of the countries under review, with historically low unemployment rates and persistent labour shortages resulting in robust wage growth (Chart 3.8, panel a) (see also Section 3.5).

Chart 3.8

Cumulative growth in the HICP, nominal unit labour costs (ULC) and harmonised competitiveness indicators (HCIs) between 2014 and 2023



Sources: Eurostat and ECB.
Notes: Panel a) shows cumulative ULC growth on the y-axis and cumulative HICP growth on the x-axis, panel b) shows cumulative growth of HCIs based on the GDP deflator on the x-axis and cumulative growth of HCIs based on total ULC on the y-axis. The solid lines in each panel represent the bisector. HICP growth is computed from monthly data aggregated to average annual data. HCIs based on the GDP deflator for individual countries are calculated relative to the 20 euro area countries and the EER-41 group of trading partners, HCIs based on total ULC for individual countries are calculated relative to the 20 euro area countries and the EER-18 group of trading partners. For the euro area, HCIs based on the GDP deflator and total ULC are calculated relative to the EER-41 and the EER-18 group of trading partners, respectively. The red dots indicate the countries under review (labelled), the green dots indicate countries that joined the euro area from 2003 onwards (unlabelled), the light blue dots indicate countries that joined the euro area before 2003 (unlabelled), the grey dot indicates Denmark, the dark blue dot indicates the euro area aggregate.

While inflationary pressures are expected to moderate further over the forecast horizon, over the longer term there are concerns about the sustainability of inflation convergence in most of the countries examined. According to the European Commission's Spring 2024 Economic Forecast, inflation is expected to decrease from 2023 levels in all the countries under review in 2024, owing to the ongoing easing of pipeline pressures and supply bottlenecks and to the past monetary policy tightening. However, inflation is expected to remain elevated in Hungary, Poland and Romania in 2024 and 2025, owing to a recovery in domestic demand and high labour cost growth, while in Sweden it is projected to already converge to the target in 2024. These forecasts are subject to considerable uncertainty given the current circumstances. The risks to the inflation outlook are tilted to the upside in almost all the countries under review, as renewed global supply bottlenecks and tensions in energy markets might result in stronger than expected inflation, which, given the tightness of the labour markets, could also exert further upward pressure on wages. Looking further ahead, since GDP per capita and price levels are still lower than in the euro area in all the central and eastern European countries under review, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless counteracted by an appreciation of nominal exchange rates.

An environment that is conducive to sustainable price stability in the countries covered in this report requires stability-oriented economic policies, structural reforms and measures to safeguard financial stability. Achieving or maintaining an environment supportive of price stability will crucially depend on the functioning of labour markets. Looking ahead, an important factor will be how wages react to high realised inflation and how they reflect labour productivity growth and take into account labour market conditions and developments in price and cost competitiveness relative to competitor countries (Chart 3.8). Continued reform efforts are needed to further improve the functioning of labour and product markets and to maintain favourable conditions for economic expansion and employment growth. To this end, measures to support stronger governance and further improvements in the quality of institutions are essential. Given the limited room for manoeuvre in monetary policy, especially for Bulgaria, which participates in ERM II, it is imperative that other policy areas support the capacity of these economies to maintain price stability, cope with country-specific shocks and avoid the build-up of macroeconomic imbalances.

3.2 The government budgetary position criterion

At the time of publication of this report, Romania remains the subject of an EU Council decision on the existence of an excessive deficit, while three other countries also exceeded the deficit reference value in 2023. The deficit in Romania exceeded the 3% of GDP reference value in 2019 and an excessive deficit procedure was opened in April 2020. The deadline for correction of the excessive deficit was later set to 2024. The fiscal deficit-to-GDP ratios of four of the countries under review exceeded the reference value in 2023. The deficits were above the reference value in the Czech Republic, at 3.7% of GDP, well above the reference value in Poland, at 5.1% of GDP, and significantly above the reference value in Romania, at 6.6% of GDP, and in Hungary, at 6.7% of GDP. In Bulgaria and Sweden the deficit remained well below the reference value, at 1.9% of GDP and 0.6% of GDP respectively.

The fiscal deficit in 2023 was below its 2021 level in four of the countries covered in this report on account of the economic recovery after the pandemic and the phasing-out of the fiscal policy measures taken in response to it. After having risen above the 3% reference value in all the countries under review except Sweden in 2020, as the pandemic led to a substantial deterioration in economic activity and fiscal measures were adopted to mitigate its impact, the deficit remained above the reference value in four of the countries in 2021. In 2022 the budget balance improved in most of the countries as their economies continued to recover and parts of the fiscal support measures were withdrawn. However, in 2023 this was partly counteracted by the ongoing economic impact of Russia's war against Ukraine, the fiscal policy measures taken in response to the resulting high energy prices and the weakening of economic activity, leading to a worsening of the budget balance in 2023 compared with 2022 in five of the countries, most notably in Poland, where the budget deficit in 2023 was 3.3 percentage points higher than in 2021.

For 2024 the European Commission forecasts that the deficit-to-GDP ratio will remain above the 3% reference value in Hungary, Poland and Romania. In 2024 the government balance is projected to deteriorate in four of the countries under review, and it is projected to remain well above the reference value in Hungary and Poland, and significantly above it in Romania. At the same time, it is expected to return to below the 3% reference value in the Czech Republic.

In 2023 the debt ratio was above 60% of GDP in Hungary, while in the other countries under review the debt levels were below or well below this threshold (Table 3.1 and Chart 3.4). The government debt-to-GDP ratio was below its 2021 level in four of the countries under review in 2023, mostly on account of the recovery after the pandemic. While the debt ratio increased notably, by 2.0 percentage points of GDP, in the Czech Republic and slightly, by 0.3 percentage points of GDP, in Romania, it fell by 5.5 percentage points of GDP in Sweden, 4.0 percentage points in Poland, 3.2 percentage points in Hungary and 0.8 percentage points in Bulgaria. Taking a longer perspective, between 2014 and 2023 the government debt-to-GDP ratio increased significantly in Romania (by 9.7 percentage points) and notably in the Czech Republic (by 2.1 percentage points), while it declined in the other countries.

For 2024 the European Commission projects an increase in debt-to-GDP ratios in all of the countries under review. The debt ratio is expected to increase notably in Poland and Romania and moderately in the other four countries. The Commission's projections indicate that the debt ratio will remain below or well below the 60% reference value in all the countries in 2024, with the exception of Hungary.

In June 2024 the European Commission found that Romania had not taken effective action to address its excessive deficit, and that Hungary and Poland did not fulfil the deficit criterion of the Stability and Growth Pact. On 19 June 2024 the Commission issued a report prepared in accordance with Article 126(3) of the Treaty based on data validated by Eurostat on 22 April 2024 for 12 Member States, including the Czech Republic, Hungary and Poland.[149] It found that in 2023 the budget deficit was above, and not close to, the 3% of GDP reference value in the Czech Republic, Hungary and Poland. Moreover, it found that Hungary and Poland were planning a deficit above, and not close to, the reference value in 2024. The excess over the reference value was not considered to be exceptional (as defined by the Treaty) in all three countries. It was not expected to be temporary in Hungary or Poland, whereas it was expected to be temporary in the Czech Republic, as its deficit was projected not to exceed the reference value in 2024 and 2025. Overall, it assessed that the deficit criterion was not fulfilled by either Hungary or Poland, while it was assessed as being fulfilled by the Czech Republic. On the basis of the report, the

[149] Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union (COM(2024) 598 final).

Commission announced its intention to propose in July 2024 to the EU Council to adopt a decision under Article 126(6) of the Treaty establishing the existence of an excessive deficit situation in Hungary and Poland. It is expected that the Commission will propose to the Council in autumn 2024 recommendations to put an end to the excessive deficit situation. Moreover, the Commission found that Romania had missed the deficit target of its ongoing excessive deficit procedure in 2023, and that the fiscal effort fell significantly short of what had been recommended by the Council. On that basis, the Commission issued a recommendation for a Council decision establishing that Romania had not taken effective action in response to the Article 126(7) recommendation to put an end to the excessive deficit situation by 2024 at the latest.

Looking ahead, it is essential for the countries examined in this report to achieve and/or maintain sound and sustainable fiscal positions. Romania, which is subject to an excessive deficit procedure and was found to be at high medium-term fiscal sustainability risk in the European Commission's Debt Sustainability Monitor 2023, should ensure compliance with the rules of the Stability and Growth Pact and correct its excessive deficit in line with the recommendation of the EU Council.[150] In all the countries under review except Sweden, the deficits in 2023 clearly exceeded those from before the pandemic. Those countries should return their budget balance to below the 3% reference value as soon as possible, or keep it below it, and they should build up the buffers needed to allow automatic stabilisers to work and raise resilience to adverse shocks. Moreover, Hungary, whose debt-to-GDP ratio exceeds the reference value, should ensure that its ratio is declining sufficiently to ensure that fiscal buffers are available for any future downturn. All countries need to ensure compliance with the revised Stability and Growth Pact, which will set recommendations for 2025 onwards. Generally, further consolidation would make it easier to deal with the budgetary challenges related to adverse demographic developments. Strong national fiscal frameworks that are fully in line with EU rules and implemented effectively should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Overall, fiscal strategies should be consistent with reprioritising government investment as well as comprehensive structural reforms to increase potential growth and employment. The NGEU programme needs to be implemented efficiently and effectively in order to support economic development and adjust to the structural changes that are under way.

3.3 The exchange rate criterion

At the time of publication of this report, the Bulgarian lev is the only currency participating in ERM II. The currencies of the other Member States under review operate under different exchange rate regimes.

[150] European Commission, Debt Sustainability Monitor 2023, European Economy Institutional Paper, No 271, March 2024.

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Bulgarian lev in ERM II and it therefore participated in ERM II for the two-year reference period from 20 June 2022 to 19 June 2024. The Bulgarian lev was included in ERM II at a central rate of 1.95583 levs per euro with a standard fluctuation band of ±15%. Bulgaria joined ERM II with its existing currency board in place as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments made by the Bulgarian authorities (some of which had already fulfilled by the time of the inclusion of the lev in ERM II) with the aim of achieving a high degree of sustainable economic convergence by the time of euro adoption. The ECB and the European Commission have been monitoring the effective implementation of Bulgaria's post-entry commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. In its role as the supervisory authority, and given its shared responsibility for macroprudential policy, the ECB is closely monitoring the implementation of the commitments related to the financial sector, i.e. the insolvency framework and the anti-money laundering framework, owing to their potential impact on prudential aspects. Bulgaria is currently working towards completing these commitments and is encouraged to accelerate its efforts to fulfil the elements of the Action Plan as adopted by the Financial Action Task Force following the grey-listing of Bulgaria in October 2023. Over the reference period the lev did not exhibit any deviation from the central rate.

The currencies not participating in ERM II traded under flexible or managed floating exchange rate regimes, in most cases amid relatively high exchange rate volatility. The Romanian leu, which traded under a managed floating exchange rate regime, exhibited a low degree of volatility. The other currencies not participating in ERM II traded under flexible exchange rate regimes and were subject to a relatively strong degree of volatility. The Czech koruna, the Romanian leu and the Swedish krona were weaker against the euro in June 2024 than in June 2022. At the same time, the Hungarian forint was trading at almost the same level, while the Polish zloty was stronger.

3.4 The long-term interest rate criterion

Over the reference period, three of the six countries under review recorded average long-term interest rates that were above the 4.8% reference value. The countries with the lowest average long-term interest rates were Sweden and Bulgaria at 2.5% and 4.0% respectively. The Czech Republic also recorded an average long-term interest rate below the reference value at 4.2%, while Poland and Romania remained above at 5.6% and 6.4% respectively. The highest average long-term interest rate was recorded in Hungary at 6.8%. In 2022 12-month averages of long-term interest rates continued to rise owing to mounting inflationary pressures following the initial shock related to the impact of Russia's invasion of Ukraine. Since the beginning of 2023 long-term interest rates in all the countries appear to have stabilised, or even declined somewhat, albeit still remaining at high levels in almost all of them.

Since the 2022 Convergence Report, long-term interest rate spreads vis-à-vis the euro area average have declined in all of the countries under review except Bulgaria. Nonetheless, a significant degree of heterogeneity persists in long-term interest rate differentials across the countries under review, reflecting differences both in the countries' cyclical positions and in financial markets' assessments of their external and internal vulnerabilities, including developments in budgetary performance and the prospects for sustainable convergence. In May 2024 Bulgaria's long-term interest rate was 60 basis points above the euro area level, representing a 0.9 percentage point increase in the differential compared with its level at the beginning of the review period in May 2022. These developments are presumably linked to country risk arising from political instability, as Bulgaria's banking system is predominantly owned by euro area-based banks and the central bank operates a currency board which de facto imports euro area monetary conditions. Hungary, Poland, the Czech Republic and Romania experienced the largest declines in the interest rate differential over the review period, by between 1.8 percentage points and 2.9 percentage points. Sweden's interest rate differential declined the least (by 0.8 percentage points).

3.5 Other relevant factors

According to the European Commission, concerns related to cost competitiveness pressures have increased significantly. In its Alert Mechanism Report 2024 the Commission refers in particular to the significant increase in nominal unit labour costs in the central and eastern European countries under review, amidst large cumulated inflation differentials and tight labour markets. The Commission concluded that in-depth reviews were warranted for Hungary, Romania and Sweden. As regards Hungary, the Commission found that there are still concerns related to strong price and cost pressures, government and external financing needs, and house prices. For Romania, it found that concerns related to cost competitiveness, external sustainability and the government deficit remain substantial. In the case of Sweden, the Commission found that concerns related to house prices, high household debt and corporate debt remain. Although the Commission classified the other countries under review in this report as having no imbalances, those countries also face various challenges. In its 2024 European Semester Spring Package, the Commission confirmed that Hungary and Sweden continue to experience imbalances, while Romania was found to be experiencing excessive imbalances after experiencing imbalances until 2023, as vulnerabilities related to external accounts, mainly linked to large and increasing government deficits, remain, while significant price and cost pressures have increased and policy action has been weak.

The external positions of most of the countries under review have deteriorated in recent years. The MIP scoreboard shows that three-year average current account balances moved further into negative territory in most of the countries under review in 2023 (Table 3.2). Widened deficits reflected surging commodity prices, resulting in worsening terms of trade, together with resilient domestic demand and weak import demand in major trading partners. In 2023 the three-year average current account deficit was beyond the lower band of the indicative threshold of -4.0% of GDP in

Romania and at -4.0% in Hungary. It was above the upper band of the indicative threshold of 6.0% in Sweden.

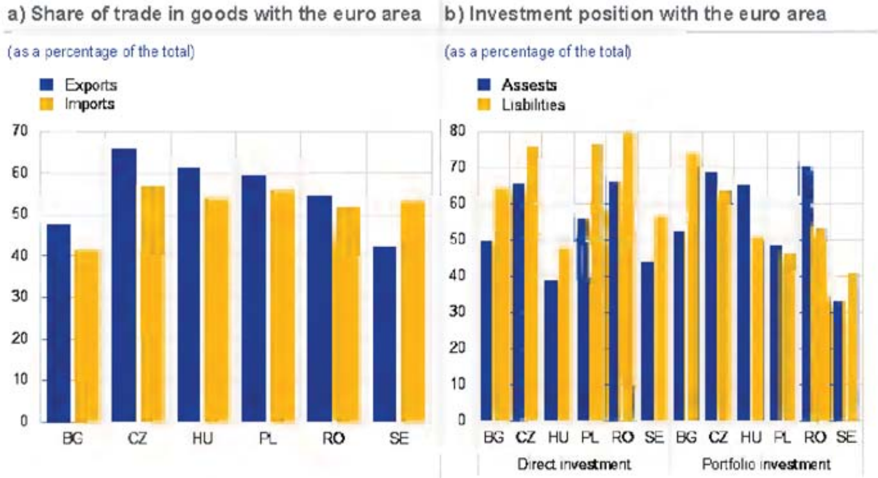
In most of the countries under review, negative net international investment positions as a share of GDP have diminished but remain at high levels. The net foreign liabilities of the central and eastern European countries are mainly in foreign direct investment, which is considered a more stable form of financing. In 2023 the net international investment position was beyond the indicative threshold of -35% of GDP in Hungary and Romania. Net foreign liabilities were lower in Poland (31.5% of GDP), the Czech Republic (13.2% of GDP) and Bulgaria (7.6% of GDP), while Sweden recorded a positive net international investment position (33.2% of GDP).

In terms of price and cost competitiveness, between 2021 and 2023 HICP-deflated real effective exchange rates appreciated to different degrees in many of the countries examined, with Sweden being an exception. The three-year growth rate of unit labour costs, stood at very high levels in almost all the countries under review. It exceeded the indicative threshold of 12% in all the countries except Sweden in 2023. In Bulgaria, Hungary and Romania, unit labour costs increased by more than twice the threshold. Despite the deterioration in price and cost competitiveness, export market shares improved somewhat in all countries in 2023 and also over a multi-year horizon (owing to, for example, the expansion of export production capacities).

The economies of the countries under review remain well integrated with the euro area through trade and financial linkages. The euro area is the main trading and financial partner of all the countries under review (Chart 3.9). In 2023 exports of goods to the euro area ranged from around 40.7% of total exports in Sweden to 62.4% in the Czech Republic. In the same year, imports from the euro area varied between 41.8% of total imports in Bulgaria and 55.8% in Poland. As regards financial investment, the share of the euro area in the stock of inward direct investment exceeded 70% in the Czech Republic, Romania and Poland, while the share of the euro area in the stock of portfolio investment liabilities was above that threshold in Bulgaria. For both direct investment and portfolio investment, the share of the stock of foreign assets invested in the euro area was highest in Romania, followed by the Czech Republic. In addition, banks owned by financial institutions domiciled in the euro area play an important role in the banking systems of the central and eastern European countries under review, especially in Bulgaria, the Czech Republic and Romania. Overall, the business cycles of all the countries under review continue to be highly synchronised with that of the euro area.

Chart 3.9

Trade and financial linkages with the euro area



Sources: Eurostat and ECB
Note: Data refer to 2023

Since 2022 house price growth has decelerated in all the countries under review. In the period 2021-22 house prices increased at rates not seen since before the global financial crisis in most of the countries under review. Since 2022 the steep increase in borrowing costs, coupled with deteriorating consumer confidence, has had a dampening impact on mortgage lending and residential property prices, albeit to different degrees across the countries (Chart 3.10, panel a). In Bulgaria and Poland, the correction in the housing market was relatively mild, while house prices contracted sharply in Sweden, where risks remain high owing to elevated levels of household indebtedness and the large exposure of the banking sector to real estate. Higher interest rates increased debt service costs, particularly in countries where the share of variable rate mortgages has historically been high, such as Poland, Romania and Sweden (Chart 3.10, panel b). Looking ahead, the debt servicing capacity of households might be eroded further should energy prices soar again, interest rates remain higher for longer or labour market conditions deteriorate significantly.

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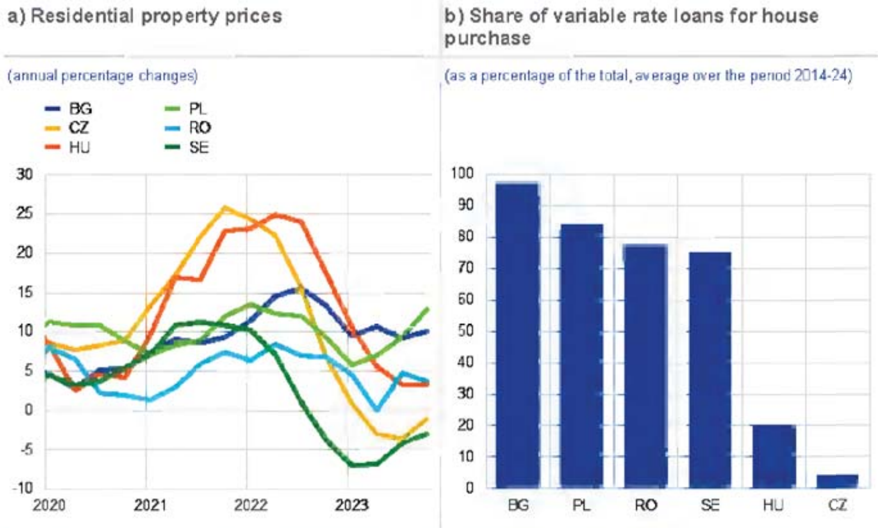
Chart 3.10

House prices and share of variable rate mortgage loans

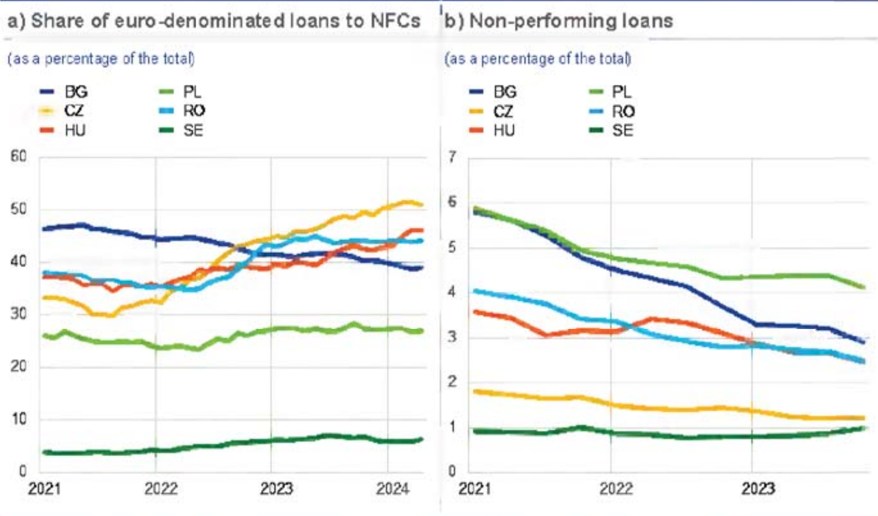


Sources: Eurostat, ECB, and ECB calculations.
Notes: Panel a): residential property prices in nominal terms; panel b): share of new loans to households for house purchase with a floating rate or an initial rate fixation period of up to one year in total new loans to households for house purchase. Average over the period from January 2014 to April 2024.

Exposures to foreign exchange risk increased in most of the countries under review, while the banking sector has remained resilient overall. Since 2022 the share of loans to firms denominated in euro has increased significantly (Chart 3.11, panel a), especially in the Czech Republic, Hungary and Romania, reflecting the widening of interest rate differentials vis-à-vis the euro area. By contrast, euro-denominated loans to households have remained at relatively low levels in all of the countries under review. Besides potentially reducing the effectiveness of domestic monetary policy, high euroisation increases the vulnerability of the financial system to exchange rate swings, as it could lead to currency mismatches on private sector balance sheets. Financial stability risks associated with higher foreign exchange exposures, higher interest rates and the ongoing correction in housing markets are mitigated by the resilience of the banking sectors, which have continued to display sound capital positions and liquidity buffers, stable access to funding and adequate profitability in all of the countries under review. In addition, non-performing loan ratios have declined further, reaching or remaining close to historical lows in 2023 (Chart 3.11, panel b), albeit remaining above the euro area level in most of the countries under review.

Chart 3.11

Euro-denominated and non-performing loans

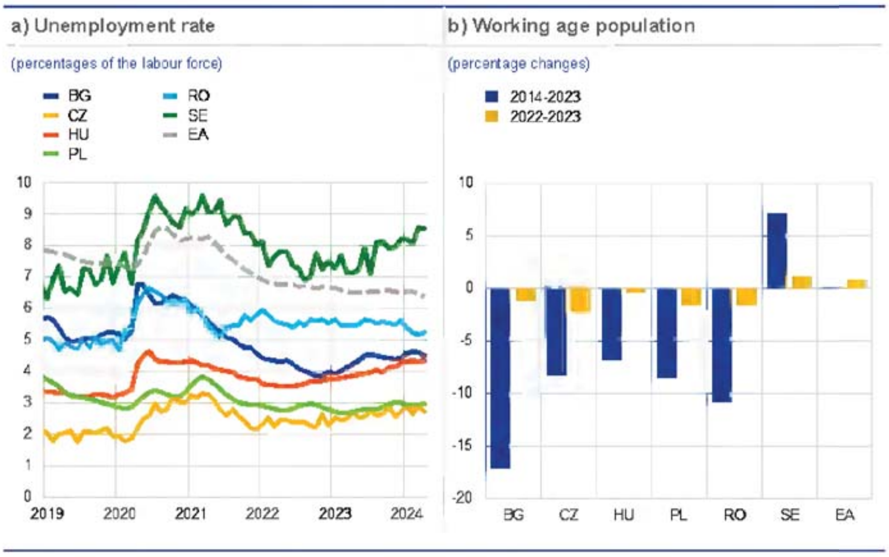


Sources: ECB and ECB calculations.
Note: Panel a): based on outstanding amounts.

Financial sector policies in the countries under review should be aimed at ensuring that the financial sector makes a sound contribution to sustainable economic growth and price stability, and supervisory policies should be geared towards ensuring a financially healthy and resilient banking system, which is a precondition for joining the Single Supervisory Mechanism (SSM). In order to further support confidence in the financial system, the national competent authorities should continue to improve their supervisory practices by, among other things, following the applicable recommendations of the relevant international and European bodies and by collaborating closely with national supervisors of other EU Member States within the supervisory colleges. Since the entry into force of the close cooperation framework with Българска народна банка (Bulgarian National Bank) in 2020, the ECB has assumed responsibility for (i) the direct supervision of significant institutions in Bulgaria, (ii) common procedures for all supervised entities, and (iii) the oversight of less significant institutions, which continue to be supervised by the national supervisor. Since establishing close cooperation, the ECB has worked closely with Българска народна банка (Bulgarian National Bank) to ensure its smooth integration into the SSM.

Labour market conditions have remained tight in most of the countries under review. Since the publication of the 2022 Convergence Report, the unemployment rate has increased somewhat in most countries under review, but it has remained close to historical lows and below the euro area level (Chart 3.12, panel a). Most of the countries continued to face labour shortages in certain segments of the labour market, which added to strong wage pressures. Shortages in labour supply are apparent from less favourable developments in the labour force and working age population in the central and eastern European countries under review compared with the euro area (Chart 3.12, panel b). These trends are due to migration outflows of highly skilled young people and rapid population ageing. Other structural challenges in the labour markets of some of the countries under review include low labour market participation (especially for women) and significant skill mismatches. Although the tightness of the labour market represents an upward risk for the wage and inflation outlook in the near term, risks of a wage-price spiral seem to be contained, owing to broadly anchored longer-term inflation expectations, which reflect the markets' belief in the commitment of central banks to price stability. In the medium term, adverse demographics and structural issues in labour markets represent a major challenge for the central and eastern European countries in trying to further catch up with the euro area. Risks are particularly pronounced in Bulgaria and Romania, whose populations are expected to continue shrinking at a fast pace over the coming decade.

Chart 3.12
Labour market indicators



Sources: Eurostat and ECB calculations.
Note: Panel b): percentage changes between the first quarter of 2014 and the fourth quarter of 2023 (blue bars), percentage changes between the first quarter of 2022 and the fourth quarter of 2023 (yellow bars).

The strength of the institutional environment is another important factor in the analysis of the sustainability of economic integration and convergence. Low quality of institutions and weak governance may be associated with, for example, weaknesses in the business environment, an inefficient public administration, tax evasion, corruption, a lack of social inclusion, a lack of transparency, a lack of judicial independence and/or poor access to online services. In most of the countries under review, enhancing institutional quality would contribute to removing existing rigidities and impediments to the efficient allocation and use of production factors, thereby strengthening long-term growth capacity. By hampering potential output growth, a weak institutional environment may also undermine a country's debt servicing ability and make economic adjustment more difficult. It may also affect a country's ability to implement necessary policy measures.

The quality of institutions and governance is relatively weak in all the central and eastern European countries under review – especially in Bulgaria, Romania and Hungary. This can pose risks for economic resilience and the sustainability of

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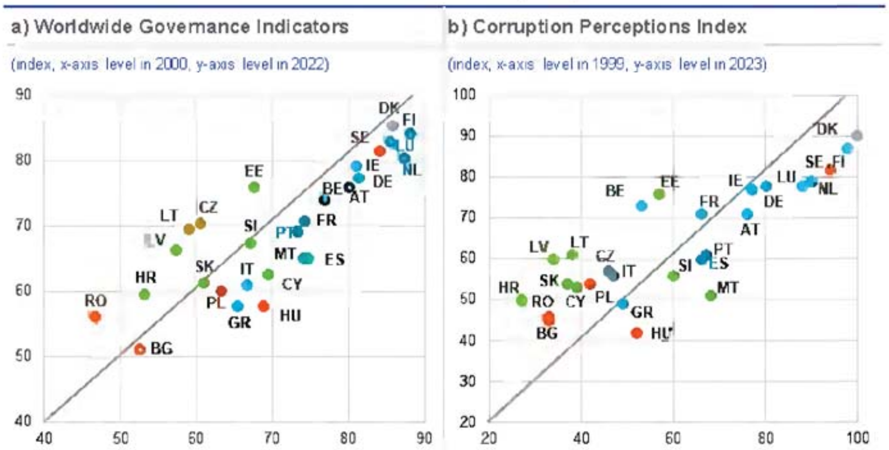
convergence. Specific institutional indicators broadly confirm an overall picture of poor-quality institutions and poor governance in most of the countries, although some of them have experienced an improvement over recent decades (Chart 3.13).[151] In this respect, Bulgaria, Romania and Hungary are among the countries facing the greatest challenges within the EU. The implementation of the reforms set out in their respective Recovery and Resilience Plans would help strengthen the rule of law and governance in these countries.

Chart 3.13

Overview of EU countries in terms of institutional quality



Sources: Worldwide Governance Indicators 2023 (World Bank), Transparency International and ECB calculations.
Notes: Panel a): The index is computed as the average of the percentile scores (relative to the scale) of the following World Governance Indicators: voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption. Panel b): The Corruption Perceptions Index ranks countries by their perceived levels of public sector corruption on a scale of 0 (highly corrupt) to 100 (very clean). For the Corruption Perceptions Index, the reference years for Cyprus and Malta are 2003 and 2004 respectively. The red dots indicate the countries under review, the green dots indicate countries that joined the euro area from 2003 onwards, the light blue dots indicate countries that joined the euro area before 2003, the grey dot indicates Denmark.

Wide-ranging structural reforms are required in most of the countries under review to improve economic growth and competitiveness. Improving local institutions, governance and the business environment, along with further progress on the reform and privatisation of state-owned enterprises and the efficient absorption of EU funds, would help speed up productivity growth. This would in turn contribute to

[151] Measuring institutional quality is challenging and inevitably involves a degree of judgement. On the one hand, perception-based indicators can have some merit when compared with other indicators. One advantage of perception-based surveys resides in their catch-all nature, whereas more specific measures may provide highly distorted information. Also, while the absolute value of perception-based indicators may be questionable, they are useful for cross-country comparisons, unless it is clear that there is a systematic bias against one or more specific countries. Moreover, indicators that are based solely on the content of laws, but not on detailed knowledge of their actual implementation, can be misleading. Furthermore, as no institutional model may be presumed to be preferable ex ante, perception-based surveys may prevent the emergence of measurement biases when gauging the various dimensions of economic governance directly. On the other hand, perception-based surveys also produce distortions. For instance, they may be heavily influenced by a recent episode or poorly designed questions. Moreover, as regards EU countries, the institutional focus has only gained analytical and policy prominence in recent years. There is thus, generally speaking, still ample scope for measurement improvements. Finally, cross-country approaches to an issue as complex as institutional quality or good governance are necessarily somewhat insufficient and clearly need to be complemented with more country-specific and longer-term assessments. At the same time, measurement difficulties should not lead to a down-playing of these crucially important determinants of long-term prosperity, social fairness and well-being.

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increasing competition in key regulated sectors (e.g. energy and transport), lowering barriers to entry and encouraging much-needed private investment.

Table 3.2
Scoreboard for the surveillance of macroeconomic imbalances

Table 3.2a – External imbalances and competitiveness indicators

	Current account balance[1]	Net international investment position[2]	Real effective exchange rate, HICP-deflated[3]	Export market share[4]	Nominal unit labour costs[5]
Bulgaria					
2020	1 0	-25 6	7 0	15 4	19 9
2021	0 1	-18 6	3 7	10 9	16 4
2022	-1 0	-12 9	5 6	14 7	23 6
2023	-1 1	-7 6	8 6	15 9	27 4
Czech Republic					
2020	0 9	-16 3	5 5	7 8	18 7
2021	-0 1	-14 5	5 0	-2 0	13 9
2022	-1 9	-18 7	13 3	-7 5	14 8
2023	-2 4	-13 2	24 1	0 6	15 8
Hungary					
2020	-0 5	-52 5	-5 1	7 1	13 6
2021	-2 0	-53 6	-4 2	-3 0	12 5
2022	-4 5	-52 1	-8 9	-5 2	24 0
2023	-4 0	-46 6	10 3	4 4	34 0
Poland					
2020	0 1	-43 9	0 8	33 3	14 0
2021	0 3	-39 8	-0 7	23 3	12 1
2022	-0 4	-33 3	-0 5	15 8	15 7
2023	-0 7	-31 4	9 3	23 0	22 0
Romania					
2020	-4 8	-47 6	3 4	19 5	20 7
2021	-5 7	-47 0	1 1	9 2	14 7
2022	-7 1	-40 8	2 5	6 0	16 9
2023	-7 8	-39 8	6 7	10 6	26 7
Sweden					
2020	4 6	7 4	-4 8	2 8	8 1
2021	6 1	19 1	2 2	0 6	4 5
2022	6 2	31 6	-1 6	-3 2	7 8
2023	6 5	33 7	-7 3	3 7	11 1
Threshold	-4.0/+6.0	-35.0	+/-11.0	-6.0	+12.0

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Table 3.2b – Internal imbalances and unemployment indicators

	Internal imbalances						Unemployment indicators		
	House prices, consumption-deflated[6]	Private sector credit flow, consolidated[2]	Private sector debt, consolidated[2]	Financial sector liabilities[6]	General government debt[2]	Unemployment rate[7]	Activity rate[8]	Long-term unemployment[8]	Youth unemployment[8]
Bulgaria									
2020	5.2	4.2	92.1	10.5	24.6	5.8	0.9	-1.2	1.3
2021	2.5	4.9	84.0	10.4	23.9	5.5	0.6	-1.0	-0.1
2022	-2.1	5.9	74.6	11.8	22.6	5.2	0.6	-0.7	-1.5
2023	2.7				23.1	4.6	1.8	-0.4	-5.3
Czech Republic									
2020	5.4	0.6	81.7	4.8	37.7	2.3	0.5	-0.4	0.1
2021	16.4	2.9	78.8	8.2	42.0	2.5	0.0	0.1	1.5
2022	1.6	4.5	76.0	3.2	44.2	2.5	0.5	0.0	1.2
2023	-10.0				44.0	2.5	0.7	0.2	0.3
Hungary									
2020	1.5	8.2	76.9	54.9	79.3	3.7	2.0	-0.5	2.0
2021	9.6	12.9	80.9	16.9	76.7	3.8	2.1	-0.1	3.6
2022	5.2	9.2	79.0	8.7	74.1	3.9	2.5	0.1	-0.6
2023	-7.7				73.5	3.9	2.9	0.3	0.3
Poland									
2020	6.7	1.7	76.0	11.7	57.2	3.5	1.5	-0.9	-4.1
2021	3.5	3.7	71.2	12.9	53.6	3.3	3.5	-0.1	0.1
2022	-1.9	3.0	63.4	3.0	49.2	3.2	3.5	0.2	1.1
2023	-1.9	0.9	57.0	10.9	49.6	3.0	4.3	0.2	0.6
Romania									
2020	2.3	1.3	48.1	13.4	46.7	5.4	2.3	-0.6	-1.4
2021	-0.2	3.8	47.9	14.3	48.5	5.5	3.2	-0.2	0.5
2022	-6.4	3.3	43.7	8.2	47.5	5.8	3.5	0.2	1.8
2023	-5.9	2.0	40.4	16.7	48.8	5.6	2.7	0.4	0.2
Sweden									
2020	3.3	14.5	212.7	10.4	40.2	7.3	-0.1	-0.1	6.5
2021	8.1	16.2	213.5	11.2	36.7	8.1	0.1	0.9	7.9
2022	-3.0	10.4	208.0	3.0	33.2	8.3	0.7	1.1	2.4
2023	-10.9				31.2	8.0	1.9	0.6	-1.5
Threshold	**+6.0**	**+14.0**	**+133.0**	**+16.5**	**+60.0**	**+10.0**	**-0.2**	**0.5**	**2.0**

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs) and European System of Central Banks.
Notes: This table includes data available as at 19 June 2024, i.e. the cut-off date for this report, and therefore differs from the scoreboard published in the Alert Mechanism Report 2024, which was published in November 2023.
1) As a percentage of GDP, three-year average.
2) As a percentage of GDP.
3) Three-year percentage change relative to 41 other industrial countries. A positive value indicates a loss of competitiveness.
4) Five-year percentage change.
5) Three-year percentage change.
6) Year-on-year percentage change.
7) Three-year average.
8) Three-year percentage point change.

4 Country summaries

4.1 Bulgaria

In May 2024 the 12-month average rate of HICP inflation in Bulgaria was 5.1%, i.e. well above the reference value of 3.3% for the criterion on price stability. This rate is expected to decrease gradually over the coming months, as pipeline pressures and supply bottlenecks continue to ease. Core inflation is expected to remain persistently high, mainly reflecting strong wage pressures amid tight labour markets. Unit labour costs grew by 27.4% over the period from 2020 to 2023, which is well above the euro area rate of 9.5%. There are concerns about the sustainability of inflation convergence in Bulgaria over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area.

Bulgaria is currently not subject to a Council Decision on the existence of an excessive deficit. Bulgaria's general government budget deficit was 1.9% of GDP in 2023, i.e. well below the 3% reference value, and its debt-to-GDP ratio was 23.1%, i.e. well below the 60% reference value.

The Bulgarian lev participated in ERM II in the two-year reference period from 20 June 2022 to 19 June 2024. Over the reference period the lev did not exhibit any deviation from the central rate. The agreement on participation in ERM II was based on a number of policy commitments by the Bulgarian authorities. Bulgaria is currently working towards completing these post-entry commitments and is encouraged to accelerate its efforts to fulfil the elements of the action plan that was adopted by the Financial Action Task Force (FATF) after Bulgaria was placed on the FATF's "grey list" of jurisdictions under increased monitoring in October 2023.

Over the reference period from June 2023 to May 2024, long-term interest rates in Bulgaria stood at 4.0% on average and were thus below the 4.8% reference value for the interest rate convergence criterion. The differential between long-term interest rates in Bulgaria and the euro area (GDP-weighted) interest rate declined slightly, standing at 0.9 percentage points at the end of the reference period. Capital markets in Bulgaria remain smaller and much less developed than those in the euro area.

Bulgarian law is compatible with the Treaties and the Statute of the ESCB as required under Article 131 of the Treaty, subject to the conditions and interpretations set out in Section 7.1.

4.2 Czech Republic

In May 2024 the 12-month average rate of HICP inflation in the Czech Republic was 6.3%, i.e. well above the reference value of 3.3% for the criterion on price

stability. This rate is expected to decrease gradually over the coming months, driven by the past monetary policy tightening and the ongoing easing of pipeline pressures and supply bottlenecks. At the same time, the very tight labour market will continue to exert upward pressure on inflation. There are some concerns about the sustainability of inflation convergence in the Czech Republic over the longer term. Unless counteracted by an appreciation of the nominal exchange rate, the catching-up process may result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still relatively lower in Czech Republic than in the euro area.

The Czech Republic is currently not subject to a Council Decision on the existence of an excessive deficit. The Czech Republic's general government budget deficit was 3.7% of GDP in 2023, i.e. above the 3% reference value, while its debt-to-GDP ratio was 44.0%, i.e. below the 60% reference value. In June 2024, the European Commission assessed the excess deficit as being temporary since the deficits in 2024 and 2025 were projected not to exceed the reference value. After considering the relevant factors, it assessed the deficit criterion of the Stability and Growth Pact as being fulfilled.

In the two-year reference period from 20 June 2022 to 19 June 2024, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Czech koruna against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 19 June 2024 the exchange rate stood at 24.9100 korunas per euro, i.e. the koruna was 0.8% weaker than its average level in June 2022.

Over the reference period from June 2023 to May 2024, long-term interest rates in the Czech Republic stood at 4.2% on average and were thus below the 4.8% reference value for the interest rate convergence criterion. The differential between long-term interest rates in the Czech Republic and the euro area (GDP-weighted) interest rate declined slightly, standing at 1.1 percentage points at the end of the reference period. Capital markets in the Czech Republic are smaller and much less developed than those in the euro area.

Czech law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. The Czech Republic is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.3 Hungary

In May 2024 the 12-month average rate of HICP inflation in Hungary was 8.4%, i.e. considerably above the reference value of 3.3% for the criterion on price stability. This rate is expected to decrease gradually over the coming months, driven by the past monetary policy tightening and the ongoing easing of pipeline pressures and supply bottlenecks. At the same time, the tight labour market and strong repricing in the services sector will continue to exert upward pressure on inflation. Unit labour costs grew by 34.0% over the period from 2020 to 2023, which is well above the euro area rate of 9.5%. There are concerns about the sustainability of inflation convergence in Hungary over the longer term. Unless counteracted by an appreciation of the nominal exchange rate, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Hungary than in the euro area.

The European Commission found, in June 2024, that Hungary did not fulfil the deficit criterion of the Stability and Growth Pact. Hungary's general government budget deficit was 6.7% of GDP in 2023, i.e. significantly above the 3% reference value, and its debt-to-GDP ratio was 73.5%, i.e. above the 60% reference value. In June 2024, the Commission found that Hungary did not fulfil the deficit criterion of the Stability and Growth Pact and announced its intention to propose to the Council, in July, that a decision be adopted under Article 126(6) establishing the existence of an excessive deficit situation in Hungary.

In the two-year reference period from 20 June 2022 to 19 June 2024, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Hungarian forint against the euro exhibited, on average, a very high degree of volatility over the reference period. On 19 June 2024 the exchange rate stood at 396.3400 forints per euro, i.e. the forint was trading almost at the same level (0.1%) as its average level in June 2022.The Magyar Nemzeti Bank entered a repo line arrangement with the ECB in June 2020, under which it could borrow up to €4 billion against high-quality euro-denominated collateral to provide euro liquidity to Hungarian financial institutions. This agreement remained in place over the reference period as it was extended again in January 2024.

Over the reference period from June 2023 to May 2024, long-term interest rates in Hungary stood at 6.8 % on average and were thus above the 4.8% reference value for the interest rate convergence criterion. The differential between long-term interest rates in Hungary and the euro area (GDP-weighted) interest rate declined sizeably, standing at 3.7 percentage points at the end of the reference period. Capital markets in Hungary are smaller and much less developed than those in the euro area.

Hungarian law does not comply with all the requirements for central bank independence, the prohibition of monetary financing, the requirements for the single spelling of the euro and legal integration into the Eurosystem. Hungary is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.4 Poland

In May 2024 the 12-month average rate of HICP inflation in Poland was 6.1%, i.e. well above the reference value of 3.3% for the criterion on price stability. This rate is expected to decrease gradually over the coming months, driven by the past monetary policy tightening and the ongoing easing of pipeline pressures and supply bottlenecks. At the same time, the tight labour market will continue to exert upward pressure on inflation. Unit labour costs grew by 22.0% over the period from 2020 to 2023, which is well above the euro area rate of 9.5%. There are concerns about the sustainability of inflation convergence in Poland over the longer term. Unless counteracted by an appreciation of the nominal exchange rate, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Poland than in the euro area.

The European Commission found, in June 2024, that Poland did not fulfil the deficit criterion of the Stability and Growth Pact. Poland's general government budget deficit was 5.1% of GDP in 2023, i.e. well above the 3% reference value, while its debt-to-GDP ratio was 49.6%, i.e. below the 60% reference value. In June 2024, the Commission found that Poland did not fulfil the deficit criterion of the Stability and Growth Pact and announced its intention to propose to the Council, in July, that a decision be adopted under Article 126(6) establishing the existence of an excessive deficit situation in Poland.

In the two-year reference period from 20 June 2022 to 19 June 2024, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 19 June 2024 the exchange rate stood at 4.3300 zlotys per euro, i.e. the zloty was 6.8% stronger than its average level in June 2022. Between March 2022 and mid-January 2024 Narodowy Bank Polski had a swap line arrangement with the ECB, under which it could borrow up to €10 billion against zlotys in order to address potential euro liquidity needs in the Polish financial system.

Over the reference period from June 2023 to May 2024, long-term interest rates in Poland stood at 5.6% on average and were thus above the reference value of 4.8% for the interest rate convergence criterion. The differential between long-term interest rates in Poland and the euro area (GDP-weighted) interest rate declined slightly, standing at 2.6 percentage points at the end of the reference period. Capital markets in Poland are smaller and much less developed than those in the euro area.

Polish law does not comply with all the requirements for central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. Poland is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.5 Romania

In May 2024 the 12-month average rate of HICP inflation in Romania was 7.6%, i.e. considerably above the reference value of 3.3% for the criterion on price stability. This rate is expected to decrease gradually over the coming months, driven by past monetary policy tightening and the ongoing easing of pipeline pressures and supply bottlenecks. At the same time, core inflation is expected to remain sticky, fuelled by strong wage developments in the context of a tight labour market. Unit labour costs grew by 26.7% over the period from 2020 to 2023, which is well above the euro area rate of 9.5%. There are concerns about the sustainability of inflation convergence in Romania over the longer term. Unless counteracted by an appreciation of the nominal exchange rate, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Romania than in the euro area.

Romania is currently subject to an excessive deficit procedure and the European Commission found, in June 2024, that it had not taken effective action. Romania's general government budget deficit was 6.6% in 2023, i.e. significantly above the 3% reference value, while its debt-to-GDP ratio was 48.8%, i.e. below the 60% reference value. Since April 2020, Romania has been subject to an excessive deficit procedure, as its fiscal position exceeded the 3% reference value in 2019. Its headline deficit in 2023 was much higher than the recommended target. In June 2024, the European Commission assessed that Romania's response had been insufficient and recommended a Council Decision establishing that Romania had not taken effective action to address its excessive deficit.

Over the reference period from 20 June 2022 to 19 June 2024, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime involving a managed floating of the currency's exchange rate. The exchange rate of the Romanian leu against the euro exhibited, on average, a low degree of volatility over the reference period. On 19 June 2024 it stood at 4.9768 lei per euro, i.e. the leu was 0.7% weaker than its average level in June 2022. Between June 2020 and mid-January 2024 Banca Naţională a României had a repo line arrangement with the ECB, under which it could borrow up to €4.5 billion against high-quality euro-denominated collateral to provide euro liquidity to Romanian financial institutions.

Over the reference period from June 2023 to May 2024, long-term interest rates in Romania stood at 6.4% on average and were thus above the 4.8% reference value for the interest rate convergence criterion. The differential between long-term interest rates in Romania and the euro area (GDP-weighted) interest rate increased slightly, standing at 3.2 percentage points at the end of the reference period. Capital markets in Romania are much smaller than those in the euro area and are still underdeveloped.

Romanian law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Romania is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.6 Sweden

In May 2024 the 12-month average rate of HICP inflation in Sweden was 3.6%, i.e. above the reference value of 3.3% for the criterion on price stability. This rate is expected to decrease gradually over the coming months, driven by a restrictive monetary policy stance, a fall in energy prices and the ongoing easing of pipeline pressures. Consumer price inflation is expected to converge to Sveriges Riksbank's 2% target in 2024 and remain close to it in 2025. Looking ahead, Sweden's monetary policy and its stability-oriented institutional framework should continue to support the achievement of price stability.

Sweden is currently not subject to a Council Decision on the existence of an excessive deficit. Sweden's general government budget deficit was 0.6% of GDP in 2023, i.e. well below the 3% reference value, and its debt-to-GDP ratio was 31.2%, i.e. well below the 60% reference value. Sweden has never been subject to an excessive deficit procedure.

In the two-year reference period from 20 June 2022 to 19 June 2024, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Swedish krona against the euro exhibited, on average, a high degree of volatility over the two-year period. On 19 June 2024 it stood at 11.2140 kronor per euro, i.e. the krona was 5.8% weaker than its average level in June 2022. Over the reference period Sveriges Riksbank maintained a swap agreement with the ECB for borrowing up to €10 billion in exchange for Swedish kronor, which has been in place since 20 December 2007.

Over the reference period from June 2023 to May 2024, long-term interest rates in Sweden stood at 2.5% on average and thus remained well below the 4.8% reference value for the interest rate convergence criterion. The differential between long-term interest rates in Sweden and the euro area (GDP-weighted) interest rate declined slightly, standing at -0.7 percentage points at the end of reference period. Capital markets in Sweden are highly developed compared with those in the euro area.

Swedish law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. Pursuant to the Treaty, Sweden has been under the obligation to adopt national legislation with a view to integration into the Eurosystem since 1 June 1998. As yet no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

5 Examination of economic convergence in individual countries

5.1 Bulgaria

5.1.1 Price developments

In May 2024 the 12-month average rate of HICP inflation in Bulgaria was 5.1%, i.e. well above the reference value of 3.3% for the criterion on price stability (Chart 5.1.1). This rate is expected to decrease gradually over the coming months, as pipeline pressures and supply bottlenecks continue to ease.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a very wide range, from -1.7% to 14.1%. After a prolonged period in negative territory, inflation turned positive again in 2017. Robust economic growth and falling unemployment, together with a longer-term decline in the working age population, as well as administrative and policy factors, led to a sharp rise in nominal wages and unit labour costs. In 2018 and 2019 the annual average rate of HICP inflation rose further, to around 2.5%, owing to upward pressure from both buoyant domestic demand on the back of strong wage growth and hikes in food and services prices. Thereafter, the contraction of the Bulgarian economy as a result of the COVID-19 pandemic and declines in oil and energy prices kept HICP inflation at low levels, averaging 1.2% in 2020 (Table 5.1.1). Rising global energy and food prices, changes in administered prices and the rebound in economic activity and private consumption pushed up prices in the first half of 2021. From September that year the rate of inflation accelerated markedly, owing to high electricity, fuel and gas prices, and the associated direct and indirect effects. Russia's invasion of Ukraine in late February 2022 exacerbated the increase in global commodity prices and supply bottlenecks, leading to a sharp rise in HICP inflation, which peaked at 15.6% in September 2022 before starting to decrease. As with the other central and eastern European countries under review, Bulgaria has been particularly vulnerable to recent global shocks, owing mainly to certain structural features of its economy and its exposure to Russia (see Chapter 3). By December 2023 annual HICP inflation had slowed to 5% on account of lower commodity prices, easing supply bottlenecks and government measures to mitigate the impact of the energy price rises. These were mainly in the form of transfers to households and firms, and to a lesser extent changes in indirect taxes. The strongest contribution to this decline in HICP inflation came from energy and food prices, the same components that fuelled inflation in the period 2021-22.

In May 2024 the annual rate of HICP inflation reached 2.7%. This is the lowest it has been since the third quarter of 2021 after the 2.5% inflation rate recorded in April 2024. The decline in inflation over the first five months of 2024 can be attributed to lower commodity prices and the easing of supply bottlenecks. Core inflation, defined

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as HICP inflation excluding energy and food, remains above headline inflation, owing to persistent wage pressures amid tight labour markets, strong domestic demand and limited spillover effects of monetary policy tightening in the euro area in the context of ample liquidity and competition in the banking sector.

The orientation of monetary policy towards price stability has played an important role in shaping inflation dynamics in Bulgaria over the past decade. On 1 July 1997 Българска народна банка (Bulgarian National Bank) introduced a currency board arrangement. The Bulgarian lev was initially pegged at par to the Deutsche Mark and since 1 January 1999 it has been pegged to the euro at a rate of 1.95583 levs per euro. Prudent fiscal policy has supported the stability of the currency board since 1997. Given the limited spillover effects of monetary policy tightening in the euro area, in 2023 Българска народна банка (Bulgarian National Bank) raised banks' minimum reserve requirements to withdraw some of the excess liquidity from the banking system.

Inflation is expected to continue to decline in the coming months, but over the longer term there are concerns about the sustainability of inflation convergence in Bulgaria. According to the European Commission's Spring 2024 Economic Forecast, HICP inflation will fall to 3.1% in 2024 and 2.6% in 2025. Over the forecast horizon, falling import prices are set to put downward pressure on the energy, food and non-energy industrial goods components in 2024. Core inflation is also projected to decelerate, driven by indirect effects from lower input prices and an expected moderation in wage growth. However, these forecasts are subject to considerable uncertainty about the evolution of energy prices and the geopolitical situation. Risks to the inflation outlook are tilted to the upside, as labour shortages and related wage pressures are expected to continue in the medium term, and an escalation of geopolitical tensions could disrupt trade and cause volatility in energy prices, adding further to inflation. Looking further ahead, there are concerns about the sustainability of inflation convergence in Bulgaria over the longer term, also taking into account the marked increase in unit labour costs and the tightness of labour markets. Unit labour costs grew by 27.4% over the period from 2020 to 2023 – well above the euro area rate of 9.5% – challenging the competitiveness of the Bulgarian economy (Table 3.2). The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies. In particular, while hourly labour costs in Bulgaria are still the lowest in the EU, growth in wages needs to be consistent with that in productivity, among other things, in order to safeguard price competitiveness and the country's attractiveness to foreign investors. Moreover, as Bulgaria has been participating in the exchange rate mechanism (ERM II) since July 2020 with its existing currency board arrangement in place, it is important to contain inflationary pressures with appropriate policies, not least to enhance productivity growth, especially in the non-traded goods sector.

Achieving an environment that is conducive to sustainable convergence in Bulgaria requires stability-oriented economic policies and wide-ranging

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structural reforms. Given monetary policy's limited room for manoeuvre under the currency board, other policy areas (fiscal, macroprudential) should provide the economy with the means to cope with potential country-specific shocks and macroeconomic imbalances. This is also of utmost importance for a smooth participation in ERM II, as reflected in a number of Bulgaria's ERM II post-entry commitments, which are discussed in more detail in Section 5.1.3. In addition, structural reforms to enhance the business and institutional environment are crucial in order to attract foreign direct investment and boost potential growth. These include Bulgaria's commitment to further reduce corruption, ensure an independent and effective judicial system, and improve the education system. A continued reduction in the declining – but still elevated – corporate debt burden would support corporate profitability and investment. It is also essential to strengthen national policies aimed at enhancing competition in product markets, to proceed with the liberalisation of regulated sectors and to manage a smooth transition to a digital and greener economy. In this context, sustained efforts are needed to build up administrative capacity and to further increase the absorption of EU funds. With long-term unemployment accounting for a large percentage of total unemployment, active labour market policy measures are required to enhance the employability and strengthen the skill level of the workforce, and to promote the economic inclusion of the most vulnerable segments of the population. With regard to macroeconomic imbalances, the European Commission did not select Bulgaria for an in-depth review in its Alert Mechanism Report 2024.

The convergence in banking supervision achieved under the close cooperation framework ensures the application of uniform supervisory standards and thus contributes to safeguarding financial stability. Following the inclusion of the Bulgarian lev in ERM II, the ECB and Българска народна банка (Bulgarian National Bank) have been working together under the close cooperation framework since 1 October 2020. The ECB is responsible for the direct supervision of four significant institutions and the common procedures for all supervised entities, as well as the oversight of 13 less significant institutions. Българска народна банка (Bulgarian National Bank) has been integrated into the Single Supervisory Mechanism and is participating in its structures and networks. With regard to the oversight of less significant institutions, which have a domestic market share of roughly 30%, the ECB is working closely with national supervisors to further harmonise implementation of the rules governing banking supervision, while also ensuring that joint supervisory standards are applied consistently across the system. Given the limited spillover effects of monetary policy tightening in the euro area, lending activity has remained elevated, particularly in the loans to households segment. The stepwise increase in the countercyclical capital buffer rate since 2022 to strengthen the resilience of the banking sector seems appropriate.

5.1.2 Fiscal developments

Bulgaria's general government budget deficit was well below the 3% reference value in 2023 and its debt level was well below the 60% reference value. In the reference year 2023, the general government budget recorded a deficit of 1.9% of

GDP, thus standing well below the 3% deficit reference value. The general government gross debt-to-GDP ratio was 23.1%, well below the 60% reference value (Table 5.1.2). Compared with the previous year, the general government deficit declined by 1.0 percentage points and the debt ratio increased slightly by 0.5 percentage point. With regard to other fiscal factors, the deficit ratio was below the ratio of public investment to GDP in 2023. The budget deficits in 2022 and 2023 were affected by the economic impact of Russia's war against Ukraine and the discretionary fiscal policy measures taken in response to the related high energy prices.

Bulgaria is currently not subject to a Council Decision on the existence of an excessive deficit. Bulgaria has been subject to the preventive arm of the Stability and Growth Pact since 2012. During the period in which the general escape clause under the Stability and Growth Pact applied (due to the COVID-19 pandemic and the invasion of Ukraine by Russia), the European Commission found, in May 2022, that the general government deficit-to-GDP ratio in 2021 had been above and not close to the reference value of 3%, and in May 2023, that the planned deficit in 2024 was also above and not close to the reference value. In both cases, the Commission's analysis suggested that the deficit criterion had not been fulfilled. However, given the high uncertainty surrounding the macroeconomic outlook, the Commission considered that at that juncture a decision on whether to place Member States under the excessive deficit procedure should not be taken. Bulgaria was once subject to an excessive deficit procedure between 2010 and 2012, while the general government debt has been below the 60% of GDP reference value since 2004.

The budget balance improved over the period 2021-23, but the deficit remains significantly above its level prior to the pandemic. Prior to the pandemic, prudent fiscal policy had allowed Bulgaria to record improving structural balances, turning the deficit of 5.4% of GDP in 2014 into a surplus of 2.1% of GDP in 2019. As a consequence of the pandemic and the government's fiscal support to buffer its impact, the structural balance deteriorated strongly, reaching a deficit of 3.9% of GDP in 2021. In addition, cyclical factors reflecting the deterioration in the economic situation contributed to the overall increase in the budget deficit by 6 percentage points between 2019 and 2021. The improvement in the budget balance since the pandemic by 2.0% of GDP between 2021 and 2023 was mostly related to an increase in the structural balance by 1.7 percentage points as a result of lower current expenditure. The budget balance in 2023 was 4.0% of GDP lower than in 2019, i.e. the year before the outbreak of the pandemic, which was entirely attributable to a deterioration in the structural balance by 4.0% of GDP.

The government debt-to-GDP ratio has remained well below the 60% reference value over the past two decades. Prior to the pandemic, the debt ratio had declined between 2014 and 2019 by 7.0 percentage points to 20% of GDP, mostly owing to high primary surpluses and, to a lesser extent, favourable interest-growth differentials. After increasing by 4.6% of GDP in 2020 at the start of the pandemic, the debt ratio then fell between 2020 and 2023 slightly by 1.5% of GDP thanks to favourable interest-growth differentials, which compensated somewhat for the debt-increasing impact arising from primary deficits. The debt ratio in 2023 was 3.1 percentage points higher than in 2019.

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In the presence of a long-standing currency board, the level and structure of public debt allow Bulgaria to manage its debt effectively. The share of government debt with a short-term maturity has generally been negligible. Taking into account the low share of debt with a variable interest rate and the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt is high (74.8% in 2023). It is almost entirely denominated in euro – the anchor currency of Bulgaria's currency board framework. Fiscal balances are thus insensitive to changes in exchange rates other than the euro/lev exchange rate, which is fixed under the currency board.

The European Commission's Spring 2024 Economic Forecast predicts an increase in the budget deficit and a moderate increase in the public debt ratio. According to the European Commission's Spring 2024 Economic Forecast, the headline balance deficit is expected to increase to 2.8% of GDP in 2024 and thus remain below the 3% deficit reference value. The budget balance is projected to deteriorate slightly in 2025 and reach a deficit of 2.9% of GDP. The debt ratio is projected to increase moderately to stand at 24.8% of GDP in 2024 and 24.6% of GDP in 2025.

Bulgaria's fiscal framework has helped it to maintain a low debt ratio, but there is still scope for further improvement. Bulgaria has a large number of fiscal rules at the general government and subnational levels, which comprise budget balance, debt and expenditure rules. While those rules mitigate the risk of increasing debt, in practice they are difficult to implement and therefore need to be streamlined and simplified in order to strengthen their credibility in terms of ensuring continued sound public finances over the longer run. The Public Finance Act was last amended in 2020 as a response to the pandemic. Those amendments were aimed at increasing the flexibility of the fiscal rules in the case of economic downturns, by allowing deviations from the 3% general government deficit ceiling and the expenditure rule in the case of extraordinary circumstances outside the control of the government which seriously impact the fiscal position. Moreover, the ceiling for the cash-based budget deficit was increased from 2% to 3% and the maximum amount of expenditure under the consolidated fiscal programme was effectively increased, as EU funds and national co-financing were exempted from the scope of expenditure, while the maximum amount of 40% of GDP remained. While those revisions lowered the stringency of the two rules, they do not compromise fiscal sustainability if the rules are adhered to. The Fiscal Council was introduced in 2016 in line with EU requirements, and its mandate and the quality of its work have been strengthened over time; further improvements in the areas of its technical and administrative capacities could help to increase transparency. While progress has been made in increasing tax collection and improving tax compliance, further progress is still desirable.

Bulgaria faces medium risks to fiscal sustainability over the medium and long term. The European Commission's 2023 Debt Sustainability Monitor found that

Bulgaria faces medium fiscal sustainability risks over the medium term.[152] This assessment has remained unchanged as compared with the 2021 results. While Bulgaria was found to have available fiscal consolidation space, it was considered to be at medium risk owing to the very high uncertainty about the debt dynamics over the next five years, based on historical volatility. Over the long term, Bulgaria was found to face medium risks, which were mainly driven by a projected increase in ageing-related costs, as well as an unfavourable initial budgetary position. According to the baseline from the 2024 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,[153] age-related public expenditure is projected to increase moderately by 0.6 percentage points of GDP over the period 2022-70, from a level of 18.2% of GDP in 2022. Under the AWG's risk scenario, the increase in costs was significantly higher and amounted to 3.9 percentage points of GDP, mainly owing to a larger rise in healthcare and in long-term care spending (by 2.1 percentage points of GDP by comparison with the baseline scenario). These projections signalled a need for further reforms in order to enhance the long-term sustainability of public finances.

Looking ahead, Bulgaria needs to continue to pursue its prudent fiscal policies in order to ensure compliance with the requirements of the Stability and Growth Pact. A consistent and prudent fiscal policy will ensure that Bulgaria continues to comply with the Stability and Growth Pact and maintains its buffers to alleviate adverse shocks. In addition, the Next Generation EU programme needs to be implemented efficiently and effectively in order to support the potential for growth and to adjust to the structural changes that are under way. Moreover, the quality and efficiency of capital spending should be enhanced by improved public investment management, including a long-term investment strategy. Further reducing tax collection gaps and the informal economy, improving the performance of state-owned enterprises as well as increasing spending efficiency are all essential measures for preserving medium-term fiscal sustainability.

5.1.3 Exchange rate developments

The Bulgarian lev participated in ERM II in the two-year reference period from 20 June 2022 to 19 June 2024. Over the reference period the lev did not exhibit any deviation from the central rate. As implied by the currency board framework, Българска народна банка (Bulgarian National Bank) has continued to exchange on demand domestic currency against the anchor currency (the euro) and vice versa at the fixed rate. Short-term interest rate differentials against the three-month EURIBOR stood at a very low level throughout the reference period. The Bulgarian lev was included in ERM II at a central rate of 1.95583 levs per euro with a standard fluctuation band of ±15% in July 2020. Bulgaria joined the exchange rate mechanism with its

[152] This assessment was confirmed by the updated debt sustainability analysis that was published as part of the European Commission's Country Report for Bulgaria on 19 June 2024.

[153] European Commission and Economic Policy Committee, "The 2024 Ageing Report. Economic and Budgetary Projections for the EU Member States (2022-2070)", *European Economy Institutional Paper*, No 279, European Commission, 2024.

existing currency board in place, as a unilateral commitment, thus placing no additional obligations on the ECB.

The agreement on participation in ERM II was based on a number of policy commitments by the Bulgarian authorities, with the aim of achieving a high degree of sustainable economic convergence by the time of the adoption of the euro. These commitments relate to implementing specific policy measures pertaining to the non-bank financial sector, state-owned enterprises, the insolvency framework and the anti-money laundering (AML) framework. The ECB and the European Commission have been monitoring the effective implementation of Bulgaria's post-entry commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. In its role as the supervisory authority and given its shared responsibility for macroprudential policy, the ECB is monitoring the implementation of the commitments related to the financial sector, i.e. the insolvency and AML frameworks, owing to their importance for the functioning of the financial system. Bulgaria is currently working towards completing these commitments and is encouraged to accelerate its efforts to fulfil the elements of the action plan that was adopted by the Financial Action Task Force (FATF) after Bulgaria was placed on the FATF's "grey list" of jurisdictions under increased monitoring in October 2023.

The HICP-based real effective exchange rate of the Bulgarian lev has appreciated over the past ten years (Chart 5.1.4). This appreciation reflected developments in the nominal effective exchange rate. However, the relatively high level of inflation following the sharp rise in energy prices in 2021, which was exacerbated in the wake of Russia's invasion of Ukraine in February 2022, put upward pressure on the real effective exchange rate. However, this indicator should be interpreted with caution, as Bulgaria is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

Bulgaria's combined current and capital account balance has mostly remained in surplus over the past ten years and the country's net foreign liabilities have declined markedly (Table 5.1.3). From 2014 to 2019 the combined current and capital account balance increased, primarily reflecting a substantial reduction in the goods deficit as a result of the export-led recovery. However, a deficit was recorded in 2021 and 2022 – two years characterised by high volatility owing to the pandemic and Russia's war against Ukraine. Over the period 2019-23 the substantial adjustment in the balance of payments was associated with a significant contraction in net direct investment inflows – which fell from double-digit levels before the global financial crisis to an average of -2.8% of GDP, while the balance on other investment was slightly negative. Gross external debt decreased further, falling from 61.3% of GDP in 2019 to 48.3% in 2023. At the same time, the country's net international investment position, largely consisting of foreign direct investment, continued to improve, rising from -30.2% of GDP in 2019 to -7.6% of GDP in 2023, on account of a further accumulation of reserve assets. Nevertheless, fiscal and structural policies continue to be important for supporting external sustainability and the competitiveness of the economy, especially in a more volatile environment characterised by geopolitical and commodity price shocks.

The Bulgarian economy is well integrated with the euro area through trade and investment linkages. In 2023 exports of goods and services to the euro area constituted 45.2% of total exports, with the corresponding figure for imports standing at 41.8%. In the same year the share of the euro area in Bulgaria's stock of inward direct investment stood at 64.3% and its share in the country's stock of portfolio investment liabilities was 73.9%. The share of Bulgaria's stock of foreign assets invested in the euro area amounted to 49.9% in the case of direct investment and 52.4% for portfolio investment in 2023.

5.1.4 Long-term interest rate developments

Over the reference period from June 2023 to May 2024, long-term interest rates in Bulgaria increased and stood at 4.0% on average, below the 4.8% reference value for the interest rate convergence criterion (Chart 5.1.5).

Long-term interest rates in Bulgaria increased slightly from 3.5% in January 2014 to 3.9% in May 2024. During the first half of the past decade, long-term interest rates declined almost continuously, converging to euro area levels in 2018. The decline occurred as the diminishing impact of the global financial crisis led to a reduction in macro-financial risk and to a significant improvement in the outlook for the public budget. Domestic and global cyclical factors also contributed to the declining trend in long-term interest rates in the first part of the decade. These included spillovers from low interest rates in the euro area, Bulgarian banks' continued demand for government debt securities in the context of scarce opportunities for lending to the private sector, a high private savings rate, and the effect of global trade tensions on growth expectations and, consequently, interest rates. In the period 2020-21 the negative impact of the pandemic on global and domestic economic activity and inflation drove long-term interest rates in Bulgaria down to a historically low level of 0.1 % from March to August 2021. Since 2022, in a context of mounting domestic and global inflationary pressures, long-term interest rates have increased significantly in line with global monetary policy and financial market developments. Renewed political uncertainty between the end of 2022 and the spring of 2023 – which resulted in two general elections being held in October 2022 and April 2023 – also contributed to a sharp increase of around 200 basis points in long-term interest rates over this period. Long-term interest rates in Bulgaria have stabilised since April 2023 and stood at 3.9% in May 2024, up from 1.6% in May 2022, the beginning of the review period (Chart 5.1.5). However, developments in long-term interest rates in Bulgaria must be interpreted with caution, as the bond used to derive the relevant interest rate was not traded between 20 March and 12 December 2023.The renewed domestic political uncertainty at the end of 2022 caused a sudden spike in the default risk on long-term Bulgarian debt, as measured by ten-year credit default swap spreads. These stood at more than 230 basis points in October 2022, up from 90 basis points in February 2022, when Russia launched its invasion of Ukraine. The spreads then gradually declined to around 115 basis points in May 2024, thus returning to the levels seen at the beginning of the review period in May 2022. Bulgaria's government debt is rated investment grade by all three main rating agencies (Moody's: Baa1; S&P: BBB; Fitch: BBB).

The long-term interest rate differential of Bulgarian government bonds vis-à-vis the euro area average stood at 0.9 percentage points in May 2024. Since 2014 Bulgarian long-term interest rates have gradually and almost continuously converged towards the euro area average rate of corresponding maturity (Chart 5.1.6). Initially, the stable and relatively high rates in Bulgaria combined with a decline in the average long-term interest rate in the euro area resulted in some widening of the differential, which peaked at 1.9 percentage points in November 2014 and oscillated between 0.7 and 1.8 percentage points from 2015 until late 2016. The differential then steadily declined and remained quite low – also spending some time in negative territory – until March 2023, when it turned significantly positive. In May 2024 it stood at 0.9 percentage points (1.2 percentage points vis-à-vis the euro area AAA yield).

Capital markets in Bulgaria are smaller and much less developed than those in the euro area (Table 5.1.4). In the past few years there have been only a few indications of a deepening of capital markets compared with early 2014. In recent years stock market capitalisation, as a percentage of GDP, has declined from an average of 15.4% over the period 2014-18 to 9.3% in 2023. Market-based debt financing of domestic monetary financial institutions (MFIs) has increased since 2014 to stand at 1.8% of GDP. Over the same period, the access of non-financial corporations in Bulgaria to the corporate debt market seems to have declined, as outstanding debt securities issued by this sector accounted for 1.7% of GDP in 2023, 1.5 percentage points lower than in the period 2014-18. In 2023 the reliance of the Bulgarian banking system on euro area banks for its funding needs increased significantly in comparison with the average over the period 2014-18. Euro area banks' claims on Bulgarian banks increased to 5.7% of the latter's total liabilities in 2023, up from an average level of 4.4% over the period 2014-18. The degree of financial intermediation remains quite low in Bulgaria compared with the euro area average, although it is comparable to that of peer countries in the region. MFI credit to non-government residents stood at 50.0% of GDP in 2023, 5 percentage points below its average for the period 2014-18. At the end of 2022 foreign-owned banks continued to play a major role in the banking system in Bulgaria, accounting for around 72% of total banking assets. The banking system is largely funded by resident private non-financial sector deposits. The banking system's assets vis-à-vis the non-financial private sector were dominated by loans, 76% of which were denominated in local currency.

5.1.5 Statistical tables and charts

Bulgaria

5.2 Czech Republic

5.2.1 Price developments

In May 2024 the 12-month average rate of HICP inflation in the Czech Republic was 6.3%, i.e. well above the reference value of 3.3% for the criterion on price stability (Chart 5.2.1). This rate is expected to decrease gradually over the coming months, driven by the past monetary policy tightening and the ongoing easing of pipeline pressures and supply bottlenecks.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a very wide range, from 0.2% to 16.8%. In 2014 and 2015 HICP inflation was close to zero as a result of utility price cuts, relatively muted wage growth and subdued external price pressures. Import price growth accelerated in 2014, owing partly to the exchange rate floor of 27 korunas per euro set by Česká národní banka. In the second half of the decade the Czech economy returned to a path of solid economic growth, which led to a notable appreciation of the koruna against the euro in real effective terms. The outbreak of the COVID-19 pandemic in 2020 resulted in a marked contraction of real GDP and a gradual decline in HICP inflation that year. To counteract the economic impact of the pandemic, Česká národní banka reduced its main policy rate significantly, bringing it down to 0.25%. In 2021 large increases in energy and commodity prices, coupled with global supply bottlenecks, put significant upward pressure on inflation, which was fuelled further by government support measures aimed at stabilising employment and providing emergency liquidity. In 2022, after Russia's invasion of Ukraine in late February, inflation continued to rise (Table 5.2.1), largely as a result of soaring energy, food and commodity prices. As with the other central and eastern European countries under review, the Czech Republic has been particularly vulnerable to recent global shocks, owing mainly to certain structural features of its economy and its exposure to Russia (see Chapter 3). To counter the rise in inflation, which reached an average of 14.8% in 2022, Česká národní banka had started a monetary policy tightening cycle in June 2021. This resulted in a cumulative 675 basis point hike in its main policy rate, up to 7% in June 2022. The central bank also intervened on foreign exchange markets in 2022 to avert a longer-term weakening of the koruna. After peaking at 19% in January 2023, the annual rate of inflation slowed gradually to 12% for the year as whole. This was due to the tighter monetary policy, government measures to mitigate the impact of the domestic energy price rises (mainly in the form of transfers to households and firms), the fall in global energy prices and the unwinding of supply bottlenecks. Česká národní banka responded to this decline with a rate cut of 25 basis points in December that year.

In May 2024 the annual rate of HICP inflation reached 2.8%. The downward trend in inflation that had begun in 2023 continued in the first quarter of 2024, with inflation approaching the central bank's 2% target. This trend reflected the waning impact of global shocks, subdued domestic demand pressures amid persistently weak economic growth and the tight monetary policy stance, and the base effect of the phasing-out of the government's energy savings tariff. Against this background, Česká

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národní banka lowered its key policy rate again on three occasions by a total of 150 basis points, down to 5.25% in May 2024.

The orientation of monetary policy towards price stability has played an important role in shaping inflation dynamics in the Czech Republic over the past decade. Since 2001 the inflation target has been defined in terms of consumer price inflation, originally as a continuously declining band and since 2006 as a flat point target. The target was set at 3% (±1 percentage point) in 2006 and reduced to 2% (±1 percentage point) in 2010. In November 2013, in order to fulfil its mandate to maintain price stability, Česká národní banka intervened to weaken the domestic currency and set the aforementioned exchange rate floor. When the central bank abandoned its commitment to a minimum exchange rate vis-à-vis the euro in 2017, the related policy shift was smooth, with a gradual appreciation of the koruna. The exit from the exchange rate floor was the first step towards normalising domestic monetary conditions and was followed by several interest rate adjustments in both directions in order to maintain price stability.

Inflation in the Czech Republic is expected to remain close to the 2% target over the forecast horizon. According to the European Commission's Spring 2024 Economic Forecast, HICP inflation is expected to average 2.5% in 2024 and to moderate to 2.2% in 2025. This outlook is based on the expectation that energy prices will moderate, with the past monetary policy tightening and the planned fiscal consolidation package also contributing to disinflationary pressures. However, these forecasts are subject to considerable uncertainty about the evolution of energy prices and the geopolitical situation. Risks to the inflation outlook are tilted to the upside. Given the high degree of openness and high energy intensity of the Czech economy, an escalation of geopolitical tensions could disrupt trade and cause volatility in energy prices, which may result in stronger than expected inflationary pressures in the coming years. These may also be exacerbated by robust wage growth in the context of a very tight labour market. Looking further ahead, unless counteracted by an appreciation of the nominal exchange rate, the catching-up process may result in positive inflation differentials vis-à-vis the euro area. GDP per capita and price levels are still lower than the euro area average in the Czech Republic, despite being relatively high compared with those in the other central and eastern European countries under review. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in the Czech Republic requires targeted economic policies, including structural reforms, that are geared to ensuring macroeconomic stability. The Czech Republic is facing the challenge of boosting its economic growth potential by enhancing productivity. Persisting inefficiencies in the business environment and growing labour shortages are weighing on potential growth. Additional efforts are needed to remove unnecessary restrictions on conducting business and firms' market entry, and to support research and development, and innovation. Moreover, skill mismatches in the labour market need to be addressed by improving vocational education and training, and by removing impediments to flexible working arrangements. Owing to adverse demographic trends, employment creation will also require larger labour market participation of under-represented groups, especially young people, which is lagging significantly behind the EU average. Against this background, it will be important to ensure an efficient and effective absorption of the EU funds allocated to the country. With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2024.

Financial sector policies should be aimed at safeguarding financial stability and ensuring that the financial sector can contribute to sustainable economic growth. The Czech Republic's banking sector remains broadly resilient to adverse shocks given the relatively large capital and liquidity buffers held by banks. Moreover, banks have remained profitable and levels of non-performing loans contained. Risks in the financial sector relate mainly to exchange rate risk stemming from the higher degree of euroisation in the corporate lending market on the back of the recent widening of interest rate differentials vis-à-vis the euro area. The potential impact of such risks depends largely on firms' degree of hedging against exchange rate movements. Risks in the housing market have declined, as households' average gross disposable income has recovered, meaning that they are in a better position to absorb any repricing of mortgages. However, given the high level of interest rates, liquidity-constrained households may still face a greater risk of default on mortgages even for average-priced property. In order to bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices by, among other things, following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.2.2 Fiscal developments

The Czech Republic's general government budget deficit was above the 3% reference value in 2023, while its debt remained below the 60% reference value. In the reference year 2023, the general government budget balance recorded a deficit of 3.7% of GDP, thus above the 3% deficit reference value. The general government gross debt-to-GDP ratio was 44%, i.e. below the 60% reference value (Table 5.2.2). Compared with the previous year, the government deficit-to-GDP ratio increased by 0.5 percentage points, while the debt-to-GDP ratio decreased moderately by 0.2 percentage points. With regard to other fiscal factors, the deficit ratio was below the ratio of public investment to GDP in 2023. The budget deficits in 2022 and 2023 were also affected by the economic impact of Russia's war against Ukraine and the discretionary fiscal policy measures taken in response to the related high energy prices.

The Czech Republic is currently not subject to a Council Decision on the existence of an excessive deficit. The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. On 19 June 2024, the European Commission published a report prepared in accordance with Article 126(3) of the Treaty for 12 Member States, including the Czech Republic, which found that the Czech Republic had exceeded the deficit reference value in 2023. This deficit level was above, and not close to, the reference value and the excess was not assessed to be exceptional. However, the deficit in excess of the reference value was assessed to be temporary, as the European Commission had not projected the deficit to exceed 3% of GDP in 2024 and 2025. Overall, taking into account mitigating relevant factors, the Commission concluded that the Czech Republic fulfilled the deficit criterion of the Stability and Growth Pact. During the period in which the general escape clause under the Stability and Growth Pact applied (due to the pandemic and the invasion of Ukraine by Russia), the European Commission found, in June 2021, May 2022 and May 2023, that the general government deficits in 2020, 2021 and 2022, respectively, had been above and not close to the reference value of 3% of GDP. In all three cases, the Commission's analysis suggested that the deficit criterion had not been fulfilled. However, given the high uncertainty surrounding the macroeconomic outlook, the Commission considered that at that juncture a decision on whether to place Member States under the excessive deficit procedure should not be taken. Previously, the Czech Republic had been subject to an excessive deficit procedure between December 2009 and June 2014. However, in the subsequent period to 2019, the Czech Republic comfortably met its medium-term objective of a structural deficit of no more than 1% of GDP.

Following the pandemic, the structural deficit has remained large, historically speaking, and cyclical factors are still contributing negatively to the government balance. Prior to the pandemic, the budget balance had improved, from a deficit of 2.1% of GDP in 2014 to a surplus of 0.3% of GDP in 2019 (Chart 5.2.2). With the pandemic shock, the deficit widened to 5.8% of GDP on account of both fiscal measures in response to the pandemic and cyclical factors reflecting the deterioration in the general economic situation. The budget balance improved in the period 2020-22 by 2.6 percentage points as a result of cyclical factors reflecting the economic recovery in 2021 and consolidation efforts implemented in 2022. The deterioration in public finances in 2023 was partly attributable to the large increase in pension spending due to the automatic indexation to inflation and a further deterioration in the economic situation, which led to a deficit in 2023 of 3.7% of GDP, 4 percentage points higher than the level seen in 2019, the year before the outbreak of the pandemic.

The debt-to-GDP ratio decreased slightly in 2023 and remained below the 60% reference value. Prior to the pandemic, the debt ratio had decreased by 11.9 percentage points, from 41.9% of GDP in 2014 to 30.0% of GDP in 2019. This reduction was mostly driven by primary surpluses and favourable interest-growth differentials. Between 2019 and 2021, the pandemic triggered an increase in the debt ratio by almost the same magnitude as the decrease prior to the pandemic, i.e. 12 percentage points. This was mainly on account of large primary deficits, as expenditure increased strongly to finance measures to mitigate the adverse impact of external shocks on households and firms. Since 2021, the debt ratio continued to increase, reaching a new peak of 44.2% of GDP in 2022 before decreasing slightly to 44% of GDP in 2023, 14 percentage points higher than the debt-to-GDP ratio recorded in 2019.

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The level and structure of government debt protect the Czech Republic from any sudden changes in market conditions, with the bulk of debt at long-term maturities and most of the debt denominated in local currency. The share of government debt with a short-term maturity is low (2.3% in 2023 – Table 5.2.2). Taking into account also the share of debt with a variable interest rate and the overall level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated government debt is low (7% in 2023) and since 2019, it has remained below the 2014-18 average (16.3%); it is predominantly denominated in euro (96% of foreign-denominated debt). Considering the size of the debt ratio, fiscal balances are also relatively insensitive to changes in exchange rates.

The European Commission's Spring 2024 Economic Forecast predicts an improvement in the budget balance but still a slight increase in the public debt ratio. According to the European Commission's Spring 2024 Economic Forecast, the headline balance is expected to improve, with a deficit of 2.4% of GDP in 2024, and therefore fall below the 3% deficit reference value. The foreseen improvement in the general government balance stems from the phasing-out of energy-related measures and the implementation of a consolidation package. This consolidation package is based mainly on cuts in subsidies, coupled with cuts in operational spending and public wages, increases in tax rates and the streamlining of the VAT structure. The budget balance is projected to improve further in 2025 and reach a deficit of 1.9% of GDP supported by growing momentum in economic activity, while the fiscal stance is expected to remain neutral. The debt ratio is projected to increase slightly to 45.2% of GDP in 2024 and 45.5% of GDP in 2025.

The Czech Republic's fiscal governance framework is applied effectively, but further progress remains warranted. The national legislation implementing the EU Directive on requirements for budgetary frameworks was adopted in 2017. Since then, the Fiscal Council has become operational and issued reports on long-term sustainability and on compliance with the budgetary rules. Nevertheless, coordination among the various levels of general government remains low and should be further enhanced. Tax compliance has improved over recent years, but there is still room for improvement. For instance, the VAT gap (at 7% in 2021) remains above the EU average. The streamlining of the VAT structure planned for 2024 is a step in the right direction, as opposed to the abolition of the electronic registration of sales, which was only introduced in 2016 but discontinued in 2023.

The Czech Republic faces medium risks to fiscal sustainability over the medium term and long term. The European Commission's 2023 Debt Sustainability Monitor shows that the Czech Republic faces medium fiscal sustainability risks over the medium term, mainly on account of rising ageing costs.[154] With regard to long-term risks, the Czech Republic was found to face medium fiscal sustainability risks mainly on account of projected increases in ageing costs that will only partially be mitigated by a favourable initial budgetary position. Budgetary pressures stemming

[154] This assessment was confirmed by the updated debt sustainability analysis that was published as part of the European Commission's Country Report for the Czech Republic on 19 June 2024.

from population ageing remain elevated. According to the 2024 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,[155] the Czech Republic would record a notable rise in age-related public expenditure (3.7 percentage points of GDP by 2070) under the baseline, from a level of 20.6% of GDP in 2022. Under the AWG's risk scenario, the increase was projected to be 6.2 percentage points of GDP. In spite of the favourable budgetary impact of the legislated reform to improve accessibility to healthcare services, which reduced healthcare spending compared with the 2021 Ageing Report, the increase in total age-related expenditure remains significantly above the EU average. This suggests that reforms to the pension, health and long-term care systems are necessary to improve the long-term sustainability of public finances.

Looking ahead, a prudent fiscal policy will be needed to safeguard the sustainability of public finances and compliance with the requirements of the Stability and Growth Pact. Notwithstanding the current low level of the debt-to-GDP ratio, a consistent and prudent fiscal policy is required to build a sufficient fiscal buffer to alleviate adverse shocks while ensuring compliance with the reformed EU governance framework. The envisaged consolidation plans fall short of reducing the structural deficit beyond 2024. The revenue-to-GDP ratio remains below the EU average, also on account of the 2021 tax reforms which led to a permanent deterioration in the structural balance. Moreover, the Next Generation EU programme needs to be implemented efficiently and effectively in order to support potential growth and to adjust to the structural changes that are under way.

5.2.3 Exchange rate developments

In the two-year reference period from 20 June 2022 to 19 June 2024, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. Česká národní banka intervened in foreign exchange markets from May to October 2022 to prevent a longer-term weakening of the koruna in an episode of high inflation. Over the reference period the Czech currency was mostly stronger – but often close to – its June 2022 average exchange rate against the euro of 24.7194 korunas per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (Chart 5.2.3). The maximum upward deviation from this benchmark was 5.9%, whereas the maximum downward deviation amounted to 3.0%. On 19 June 2024 the exchange rate stood at 24.9100 korunas per euro, i.e. the koruna was 0.8% weaker than its average level in June 2022. Over the past ten years the Czech koruna has appreciated by 9.3% against the euro.

The Czech koruna exhibited, on average, a relatively high degree of volatility against the euro over the two-year reference period. From June 2022 to April 2023 the koruna steadily strengthened against the euro, reflecting action by Česká národní banka, including interventions in foreign exchange markets that ended in October

[155] European Commission and Economic Policy Committee, "The 2024 Ageing Report: Economic and Budgetary Projections for the EU Member States (2022-2070)", *European Economy Institutional Paper*, No 279, European Commission, 2024.