ARMENIA

Highlights

- **Armenia's "Velvet Revolution" resulted in a peaceful transition of power.** The new government of Armenia took early steps to deliver on its declared commitment of fighting corruption, alleviating tax evasion, reducing the shadow economy and tackling monopolisation.
- **Strong GDP growth has been largely unaffected by political developments.** Following a growth stagnation in 2016, economic growth rebounded to 7.5 per cent in 2017 and then to 8.3 per cent in the first half of 2018.
- **The fiscal framework has been refined to strike a better balance between stimulation of growth and public debt reduction.** The new fiscal rule has been introduced with the aim of providing more flexibility for growth-enhancing capital expenditure while keeping current spending in check.

Key priorities for 2019

- **Fostering transparency and demonopolisation are top priorities.** The anti-corruption drive should be pursued vigorously, tax and customs reforms need to focus on transparency, fairness and compliance, while informal barriers to entrepreneurship should be dismantled.
- **More fiscal space is necessary to finance critical public infrastructure upgrades.** To put the public debt-to-GDP ratio on a downward sloping trajectory, Armenia needs to implement the new fiscal rule and boost the tax revenue intake.
- **Armenia needs to develop and implement a comprehensive programme of vertical reforms.** Initial steps taken by the authorities to combat corruption and economic crimes are welcome and should be followed up by sector-specific economic reform plans and prompt execution.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.6	3.2	0.2	7.5	5.5
Inflation (average)	3.0	3.7	-1.4	1.0	3.0
Government balance/GDP	-1.9	-4.8	-5.5	-4.8	-2.7
Current account balance/GDP	-7.6	-2.6	-2.3	-2.4	-3.8
Net FDI/GDP [neg. sign = inflows]	-3.3	-1.5	-2.6	-2.0	-2.5
External debt/GDP	73.6	84.5	94.4	91.2	n.a.
Gross reserves/GDP	12.8	16.8	20.9	20.1	n.a.
Credit to private sector/GDP	48.8	45.6	52.2	52.9	n.a.

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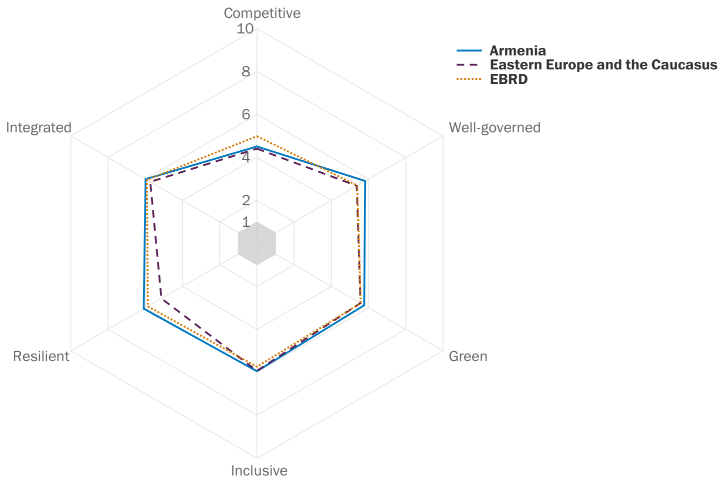
Macroeconomic performance

Armenia's economy is growing at a robust pace despite political uncertainty. GDP growth rebounded from a near-standstill in 2016 to 7.5 per cent in 2017, driven by a combination of strong demand from major trading partners and a recovery in internal consumption and investment. The volume of exports from Armenia increased by approximately 40.8 per cent in 2016-17 in cumulative terms, with the European Union (EU) and Russia accounting for approximately 28 and 24 per cent of goods, respectively, exported from Armenia in 2017. Following two consecutive years of decline, household consumption increased by 8.8 per cent in 2017, supported by a recovery in remittances. In 2017 capital investment recorded growth of 7.7 per cent after eight years of decline (with the exception of 2015 when it grew by 2.5 per cent). From a sectoral perspective, GDP growth in 2017 was broad-based, although agricultural output declined for the second consecutive year. The economic impact of political turmoil and the peaceful revolution was limited in the first half of 2018. GDP growth is estimated at 8.3 per cent year-on-year in this period. Capital investment and exports expanded by 14.7 per cent and 9.7 per cent, respectively, in the first half of 2018.

The macroeconomic environment remains generally sound. The current account deficit-to-GDP ratio averaged approximately 2.4 per cent in 2015-17. This is significantly lower than the 9.8 per cent averaged in the period 2010-14. Money transfers to Armenia increased by approximately 14.6 per cent in 2017 and by 4.9 per cent year-on-year in the first eight months of 2018. The dram remained stable against the US dollar in the first nine months of 2018. Gross international reserves stood at US$ 2.1 billion in September 2018, providing approximately four months of imports coverage. Inflation is gradually picking up although, at 2.6 per cent in the first nine months of 2018, it remains below the central bank's target of 4.0 per cent. Monetary policy remains relatively loose with the central bank's policy rate at the lowest level since the beginning of 2010. The budget deficit widened to 5.5 per cent of GDP in 2016 before declining to 4.8 per cent of GDP in 2017 (including a large one-off military loan of approximately 1.5 per cent of GDP). The public debt-to-GDP ratio increased to approximately 59 per cent in 2017. To put it on a declining path, the Armenian authorities have attempted fiscal consolidation with a plan to bring down the budget deficit to around 3 per cent of GDP in 2018.

The economy is set to maintain strong growth momentum. Real GDP is forecast to grow by 5.5 per cent in 2018 and by 5.0 per cent in 2019. The near-term economic outlook is shaped by a relatively benign external environment and the expected positive growth effects of ongoing governance reforms. At the same time, downside risks come from the exposure of the economy to fluctuations in commodity prices, both directly through copper exports, and indirectly through the impact on major economic partners.

Assessment of transition qualities (1-10)



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Major structural reform developments

The new government is tackling deep-seated governance problems. The government has pledged to root out corruption, decrease the size of the shadow economy, boost tax revenues (at 22.9 per cent of GDP, one of the lowest ratios in the region) and tackle monopolies. A series of high-profile corruption and tax evasion inquiries as well as arrests have been made against former public officials and politically connected business representatives. A number of customs brokerage firms have been prosecuted for tax evasion and fraud as part of the efforts to tackle informal monopolies on imports and customs corruption. According to the authorities, more than US$ 42 million of unpaid taxes was recovered from 73 companies by mid-July, which is approximately 1.6 per cent of tax revenue in 2017.

The authorities have adopted a new fiscal rule. The new rule, effective from January 2018, is designed to curb current spending while leaving more flexibility for the implementation of growth-enhancing investment projects in case public debt levels exceed the preset threshold. Under the new rule, if the government debt-to-GDP ratio exceeds 40 per cent, the government will be allowed to run a fiscal deficit exclusively for financing of capital expenditures. If the ratio rises above 50 per cent, the government will be further required to cap current spending and develop a medium-term plan to lower the debt burden. In addition, if public debt surpasses 60 per cent of GDP the government will need to link current expenditures to tax revenues and submit a remedial action plan to the parliament. Escape clauses were introduced for extreme cases (such as natural disasters, wars or economic shocks). New budget allocation rules that incentivise competitive procurement through the new e-procurement system will foster spending efficiency.

A mandatory funded pension system has come into effect for all workers. The new system is in place for private sector workers from July 2018, having become compulsory for public sector employees in 2014. Implementation for private sector workers had been kept optional until July 2018 due to a strong public outcry when first introduced. At this initial stage, employee contributions into an individual savings account will amount to 2.5 per cent of their salary and will be matched by a 7.5 per cent contribution from the state. Retirement savings are to be placed into one of two approved asset management providers and invested into both local and foreign financial assets.

Armenia has completed its inaugural renewable energy auction. The winner of the international tender for construction of a solar plant in Armenia was announced in March 2018 and the agreement signed in July 2018. This is the first instance of attracting private sector participation in renewable energy development through a competitive international auction in eastern Europe and the Caucasus (EEC). Once installed and operational, the solar power plant will contribute towards the diversification of Armenia’s energy sources.

A Comprehensive and Enhanced Partnership Agreement (CEPA) with the European Union has been provisionally applied from 1 June 2018. The Armenian parliament had previously ratified the CEPA in April 2018. Priority areas of cooperation include: strengthening institutions and good governance; economic development and market opportunities; connectivity, energy efficiency, environment and climate action; and mobility and people-to-people contacts.

AZERBAIJAN

Highlights

- **Azerbaijan's economy escaped recession in 2017.** GDP grew by 0.1 per cent in 2017 following a 3.1 per cent contraction in 2016. In the first nine months of 2018, output has continued to rise slowly, supported by growth in the non-oil sector.
- **Strategic energy projects reached important milestones.** The first commercial gas deliveries were made from the new Shah Deniz 2 gas field to Turkey. Azerbaijan has extended the Production Sharing Agreement with a consortium of international energy companies for the management of the country's largest oil field.
- **New public agencies were set up to support the non-oil private sector, although their effectiveness is yet to be tested.** The newly established agencies aim to promote food safety standards, improve regulation of the energy sector and support the development of small and medium-sized enterprises, including by lowering their borrowing cost through unfunded risk participation.

Key priorities for 2019

- **Investment climate reforms should build on recent positive changes.** Tax administration reform should be one of the reform priorities, with an emphasis on enhancing predictability of taxation and shrinking the size of the shadow economy through improving taxpayer compliance, expanding the tax base and reducing tax exemptions.
- **Decisive steps are needed to finalise banking sector restructuring.** Privatisation of the International Bank of Azerbaijan is one of the key priorities for lowering risk in the banking system and should be pursued without delay. The large stock of non-performing loans (NPLs) needs to be resolved, capital deficiencies in some banks addressed, and the independence and operations of the financial regulator (FIMSA) strengthened.
- **To fulfil their mandate, the newly established state agencies need to develop stronger institutional capacity.** Recently established public agencies are generally understaffed and lack both expertise and a sound operational framework. The authorities should take the necessary steps to ensure transparency and effectiveness of their operations.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.8	1.1	-3.1	0.1	1.5
Inflation (average)	1.4	4.0	12.4	12.9	3.5
Government balance[1]/GDP	2.7	-4.8	-1.2	-1.7	4.8
Current account balance/GDP	13.9	-0.4	-3.6	4.1	6.6
Net FDI/GDP [neg. sign = inflows]	-2.9	-1.5	-5.1	-0.7	-3.5
External debt[2]/GDP	14.5	18.5	20.4	n.a.	n.a.
Gross reserves[3]/GDP	18.3	9.5	10.5	13.1	n.a.
Credit to private sector/GDP	31.4	40.0	27.2	16.8	n.a.

[1] Includes central government and main extrabudgetary funds, including operations of the oil fund and the social protection fund. Figures for 2016 and 2017 are a projection.
[2] Public and publicly guaranteed external debt outstanding.
[3] Excluding assets of the State Oil Fund (SOFAZ).

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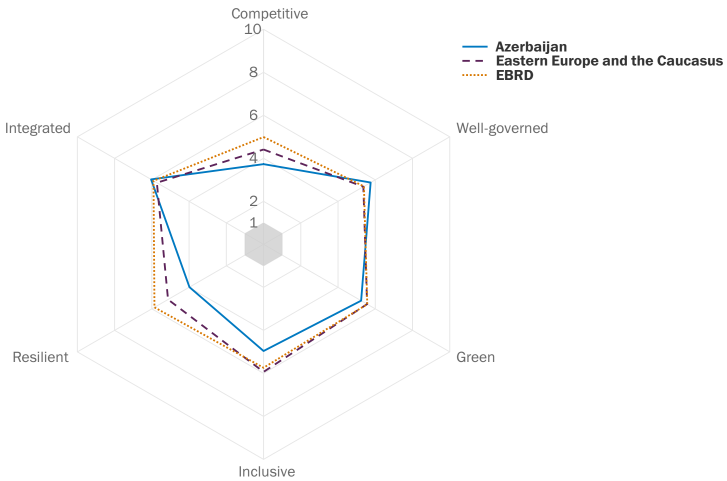
Macroeconomic performance

The economy has started growing slowly. After the GDP decline in 2016, economic growth was nearly flat at 0.1 per cent in 2017. The stabilisation of the economy was driven by a recovery in non-oil GDP, which grew by 2.7 per cent. In the first nine months of 2018, the economy expanded by 0.8 per cent year-on-year, although non-oil GDP growth slowed to 1.0 per cent year-on-year. Overall capital investment is in the fifth consecutive year of decline, although in the non-oil sector investment in fixed assets has posted growth in the first nine months of 2018. Inflation fell from an average of 12.9 per cent in 2017 to 2.6 per cent year-on-year in the first nine months of 2018, paving the way for looser monetary policy. The Central Bank of Azerbaijan (CBA) lowered the refinancing rate four times from 15 per cent in February 2018 to 9.75 per cent in October 2018.

The higher oil price is driving stronger external balances. Since April 2017, the manat-US dollar exchange rate has been maintained within a very narrow fluctuation band despite the recovery in the oil price. The current account switched from a deficit in 2016 to a surplus of 4.1 per cent of GDP in 2017 on the back of higher hydrocarbon revenues. In the first half of 2018, the current account surplus surged by growing more than fourfold compared with the first half of 2017. External trade trends were also positive outside of the oil and gas sector, supported by competitiveness-enhancing real devaluation of the manat in recent years. Exports of non-oil goods and services increased by 15.6 per cent in 2017 and by 19.5 per cent year-on-year in the first half of 2018, both in nominal US dollar terms, but their overall volume remains low compared with exports of hydrocarbons. Official foreign exchange reserves of the CBA are slowly recovering from US$ 4 billion in December 2016 to US$ 5.5 billion as of September 2018, covering 3.8 months of imports. Assets of the State Oil Fund of Azerbaijan (SOFAZ) increased from US$ 33.1 billion in 2016 to US$ 39.0 billion in the third quarter of 2018, providing a significant liquidity buffer.

Economic recovery is expected to continue in the absence of further commodity price shocks. Real GDP is forecast to grow by 1.5 per cent in 2018 and by 3.5 per cent in 2019. Near-term growth prospects are supported by a relatively stable oil price trend and ongoing expansion of gas production and export capacity. Recent moderate diversification gains augur well for medium-term economic growth but much more needs to be done to bolster the role of the non-oil economy.

Assessment of transition qualities (1-10)



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Major structural reform developments

New agencies have been established to enhance delivery of public services and render assistance to small and medium-sized enterprises (SMEs). In December 2017, the authorities established the Agency for Development of Small and Medium-Sized Enterprises to enhance and better coordinate the provision of public services to SMEs. The agency is planning to expand its geographical coverage by setting up outposts in the regions of Azerbaijan and offer a range of financial and non-financial services, as well as provide information on all other public resources available to SMEs. A Food Safety Agency was set up in the first quarter of 2018. It is aiming to help uphold quality standards and thus improve Azerbaijan's agricultural exports potential. Meanwhile, the state agency for public services (ASAN) has broadened the range of offered services. As of February 2018, ASAN has been issuing energy-related permits. In March 2018 the agency was mandated to implement and regulate state policy on e-government. The institutional capacities of these agencies remain to be tested and are likely to need strengthening over time.

Initiatives to promote the credit flow to the economy have been rolled out but their effectiveness is still uncertain. The credit to GDP ratio declined from approximately 40.0 per cent in 2015 to 16.8 per cent in 2017 due to the contraction in credit activity and IBA balance sheet restructuring. The decline in credit activity levelled off in the first half of 2018, but loan portfolio growth remains subdued. The authorities have taken a number of remedial steps. A credit guarantee fund was established and made operational in the second half of 2017. Entrepreneurs in the non-oil and gas sector are able to apply to the fund for state guarantees and interest rate subsidisation on loans provided by the authorised commercial banks. In December 2017, the Financial Market Supervision Authority (FIMSA) started discussing a new mechanism to encourage restructuring of NPLs. In the first quarter of 2018, the IBA together with seven other banks set up the first private credit bureau. Compared with the existing state-managed credit bureau, the private bureau is expected to cover a larger number of borrowers and to provide more exhaustive information. In March 2018, the state collateral registry for movable assets established by the FIMSA started operating online.

Meaningful progress has been made in strategically important energy projects. The Shah Deniz 2 gas field and South Caucasus Pipeline Expansion (SCPX) were officially inaugurated in May 2018. The second stage of the Shah Deniz gas field development is part of the South Gas Corridor (SGC) project which is set to almost triple Azerbaijan's annual gas production capacity. Another part of the SGC project, the Trans-Anatolian Pipeline (TANAP) which will carry gas from Azerbaijan to Europe, became operational in June 2018. In September 2017 Azerbaijan signed an amended and restated Production Sharing Agreement (PSA) for continued development of its largest oil field Azeri-Chirag-Deepwater Gunashli (ACG), extending the PSA tenure until 2049 and increasing the share of the State Oil Company of Azerbaijan Republic (SOCAR) in the project to 25 per cent. The agreement was ratified by Azerbaijan's parliament in October 2017.

A new energy regulator has been established. In December 2017 the Azerbaijan Energy Regulatory Agency (AERA) was created, in line with the government's Strategic Roadmap on the development of utilities. AERA's goal is to propose and calculate utility tariffs and oversee their implementation. Other objectives include the development of regulator law, currently under preparation, and other measures to promote legislative approximation with EU benchmarks. The regulator is also tasked with enhancing transparency and competition in the utility markets.

BELARUS

Highlights

- **The economic recovery has accelerated.** The economy grew by 2.4 per cent in 2017, following two years of recession, and has picked up speed in the first half of 2018.
- **Inflation has been brought down to its lowest level.** Consumer price inflation averaged 6.0 per cent in 2017 and decreased further to 4.8 per cent in the first nine months of 2018 on the back of prudent monetary, fiscal and credit policies.
- **Work is under way to improve governance and management in the state enterprise sector.** The authorities have rolled out pilot projects on commercialisation of the state road construction holding company and on strengthening the state's ownership function.

Key priorities for 2019

- **Further progress should be made in the modernisation of the financial sector.** The ongoing institutional building and pre-privatisation work in some of the state banks is paving the way for attracting good-quality equity participation by private investors. State lending programmes need to be decreased and, in the near future, fully phased out.
- **The authorities need to undertake benchmark-setting privatisation in the real sector.** A successful entry of a credible international investor in a state-owned company (SOE) would set a precedent that could be replicated by other SOEs, thus enhancing productivity and the role of the private sector.
- **Initial steps to commercialise the state sector need to be scaled up.** Replication of the model state holding company by other SOEs and wider application of OECD corporate governance principles will be necessary to improve the quality of management in the state sector.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.7	-3.8	-2.6	2.4	3.0
Inflation (average)	18.1	13.5	11.8	6.0	5.5
Government balance[1]/GDP	0.1	-3.0	-1.7	-0.3	-2.4
Current account balance/GDP	-6.6	-3.2	-3.3	-1.6	-2.5
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.7	-2.4	-2.2	-2.1
External debt/GDP	50.7	67.5	78.6	73.4	n.a.
Gross reserves/GDP	6.4	7.4	10.3	13.4	n.a.
Credit to private sector/GDP	21.1	23.1	21.2	22.0	n.a.

[1] Includes central government, local government and social security funds.

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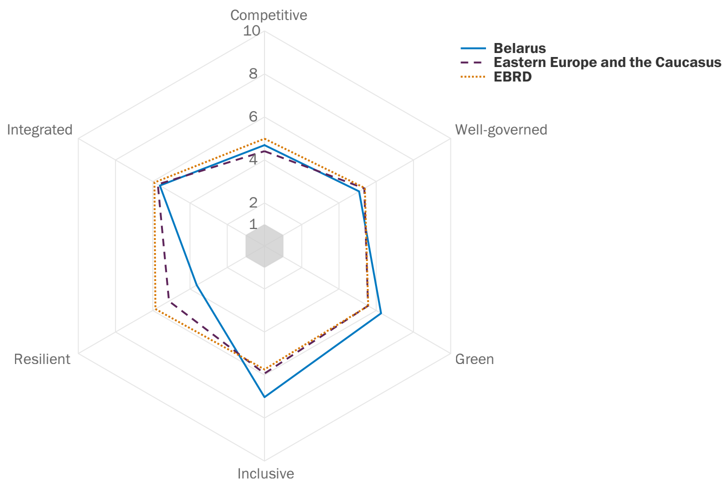
Macroeconomic performance

GDP growth has rebounded after two years of recession. In 2017, GDP expanded by 2.4 per cent, driven mainly by external demand and a recovery in household consumption. Growth of exports in volume terms accelerated from 2.6 per cent in 2016 to 7.3 per cent in 2017. Gross value added (GVA) of manufacturing, the economy's largest sector accounting for over one-fifth of the entire GDP, grew by 6.1 per cent in 2017. Following two years of contraction, household consumption grew by 4.6 per cent supported by a 7.5 per cent increase in real wages in 2017. The low comparison base resulting from the 2015-16 recession also helped boost the 2017 output growth rate. GDP growth is estimated to have gained pace to 3.7 per cent year-on-year in the first nine months of 2018. All main sectors except agriculture recorded positive growth rates in this period.

Low inflation and a stable exchange rate attest to well-calibrated macroeconomic policies. Near-term balance of payments pressures have abated as the authorities resolved the energy dispute with Russia in the first half of 2017 and repeatedly tapped the international capital markets, including the most recent Eurobond issuance in February 2018 for the total principal amount of US$ 0.6 billion. International reserve assets increased to US$ 7.2 billion in the beginning of September 2018, covering approximately 2.2 months of imports, still relatively low compared with external financing needs. The current account deficit shrank from 3.3 per cent of GDP in 2016 to 1.6 per cent of GDP in 2017 on the back of strong export receipts and increased money transfers from abroad. The exchange rate has remained relatively stable since the beginning of 2016. At 6.0 per cent on average in 2017, consumer price inflation was at its lowest level before declining further to 4.8 per cent year-on-year in the first nine months of 2018. The refinancing rate was lowered from 11 per cent at the end of 2017 to 10 per cent in June 2018.

Positive near-term growth prospects are balanced against structural weaknesses. Current forecasts are for economic growth at 3.0 per cent in 2018 and 2.5 per cent in 2019, supported by continued macroeconomic stability and improved external economic conditions. But the longer-term prospects for growth and prosperity depend on the willingness and ability of the authorities to enhance the private sector's role in the economy.

Assessment of transition qualities (1-10)



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Major structural reform developments

The authorities have been focusing on improving governance and quality of management in SOEs. In September 2017, the state-owned road-management holding company Belavtodor was chosen for the implementation of a pilot commercialisation project. It implies the establishment of a model state holding company based on the OECD principles via a corporate governance action plan. Work is under way to enhance the capacity of the state property fund in order to create a commercially sound holding structure for state assets.

A set of measures was adopted to promote the development of the IT sector. A presidential decree on digital economy development was adopted in December 2017. The decree prolongs the special taxation and regulation regime of the High-Technology Park (HTP) until 2049. It expands the range of eligible activities that are subject to preferential treatment, including marketing, advertising and other services related to developed software products. The new decree has introduced a liberal legal framework for Blockchain technologies and legalised so-called smart contracts in Belarus. Financial and legal tools have been introduced to stimulate venture capital transactions. Procedures for recruitment of foreign specialists by HTP residents have been simplified. The residents of the park have been allowed to sponsor and provide vocational training programmes. Established in 2005, the HTP hosted close to 200 resident companies as of September 2018, more than half of which were foreign-owned or joint ventures. In 2017, production and sales revenues of HTP resident-companies increased by 21 per cent and amounted to approximately US$ 1.1 billion, with an export share of approximately 92 per cent. The ICT sector accounted for approximately 5.0 per cent of GDP in 2017.

Monetary policy and banking supervision frameworks have been improved. The policy of the National Bank of the Republic of Belarus (NBRB) to move from targeting exchange rate stability to a fully fledged inflation targeting regime is on track. The monetary authorities have started to focus on managing the overnight interbank market interest rate instead of the rouble monetary base. The transparency and effectiveness of the public communications by the NBRB have also improved. Monetary policy objectives and their implementation are clearly communicated on the recently upgraded NBRB website. From January 2018, Belarusian banks are required to maintain capital ratios compliant with Basel III framework. In January 2018, the NBRB also published the list of systemically important banks which are required to maintain additional capital buffers.

Measures were taken to promote de-dollarisation and gradually liberalise foreign exchange regulations. In January 2018 the NBRB increased the reserve requirements for deposits in foreign currency from 15 per cent to 17 per cent. This was the third consecutive increase since the beginning of 2017, when the ratio stood at 7.5 per cent. To discourage foreign currency lending to unhedged borrowers, a higher reserve requirement was introduced for such loans. To incentivise lower interest rates on local currency loans, higher reserve requirements were imposed on rouble loans with an interest rate above the specified threshold, which is linked in turn to the NBRB overnight rate. The requirement for the mandatory sale of foreign currency proceeds was lowered from 20 per cent to 10 per cent in October 2017, and then abolished in August 2018.

GEORGIA

Highlights

- **Strong foreign direct investment (FDI) and a favourable external economic environment are fuelling growth.** GDP grew by 5 per cent in 2017 and at a similar pace in the first nine months of 2018, while FDI inflows amounted to a sizeable 12 per cent of Georgia's GDP in 2017.
- **The authorities introduced mandatory retirement savings as part of the pension reform.** Contributions by an employee and an employer will be matched by the state, with each contributing party providing 2 per cent of gross salary into the pension fund.
- **Taxation of small businesses was further simplified.** The rate of turnover tax was lowered and the turnover ceiling was raised to broaden the pool of eligible enterprises. The system of advance tax payments was abandoned in favour of monthly tax declarations and payments.

Key priorities for 2019

- **The justice administration system requires further reform.** Enhancing the transparency and efficiency of law enforcement, and ensuring the independence and competence of courts, including commercial chambers, would further increase public trust in the system.
- **The development of multimodal infrastructure should be stepped up.** To enhance Georgia's role as a regional hub economy for sectors such as tourism, trade and logistics, the country needs to make further progress in developing connectivity-enhancing infrastructure.
- **The new public-private partnership (PPP) framework should be put into operation promptly.** This can help mobilise private sector participation in various priority infrastructure schemes in a financially sustainable manner.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.6	2.9	2.8	5.0	4.5
Inflation (average)	3.1	4.0	2.1	6.0	2.8
Government balance[1]/GDP	-3.2	-3.7	-4.0	-3.9	-3.3
Current account balance/GDP	-10.8	-12.6	-13.1	-8.8	-10.5
Net FDI/GDP [neg. sign = inflows]	-8.5	-9.6	-8.1	-10.7	-8.7
External debt/GDP	84.6	109.0	110.4	113.8	n.a.
Gross reserves/GDP	16.4	18.0	19.2	20.0	n.a.
Credit to private sector/GDP	44.5	50.4	55.6	58.6	n.a.

[1] According to the definition by the Ministry of Finance.

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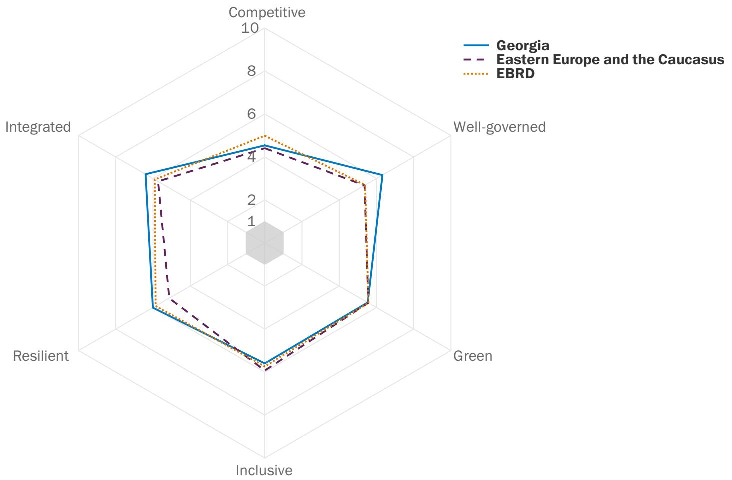
Macroeconomic performance

The economy is expanding at a brisk pace. GDP growth picked up from an average of 2.9 per cent in 2015-16 to 5.0 per cent in 2017, supported by an upswing in exports of goods and services and household consumption. Economic growth is estimated to have accelerated to 5.4 per cent in the first half of 2018, before slowing down to an estimated 4.0 per cent year-on-year in the third quarter. Exports of goods and services in nominal US dollar terms increased by approximately one-fifth in 2017 and in the first half of 2018, supported by the burgeoning hospitality sector. The influx of international travellers to Georgia increased sharply by 17.6 per cent in 2017 and by 11.2 per cent year-on-year in the first nine months of 2018. The inflow of money transfers increased by 19.8 per cent in 2017 and by 16.0 per cent in the first half of 2018 in US dollar terms, and amounted to approximately 9.1 per cent of GDP in 2017. The trade, construction and transport sectors were the largest contributors to GDP growth last year.

FDI remains the key source of external financing. On the back of strong export revenues and remittances, the current account deficit dropped to a still-significant 8.8 per cent of GDP in 2017 after averaging 12.9 per cent of GDP in 2015-16. This deficit was more than offset by FDI inflows reaching approximately 12.1 per cent of GDP in 2017 and directed mostly to infrastructure, financial intermediation and energy. The Georgian lari was stable against the US dollar in the first seven months of 2018, although more recently exchange rate pressures were triggered by volatility in large trading partners among other factors. Inflation slowed from an average of 6.0 per cent in 2017 to 2.7 per cent year-on-year in September 2018. In July 2018, the National Bank of Georgia (NBG) lowered its refinancing rate by 0.25 percentage points to 7 per cent.

Economic growth prospects are predominantly positive. With an extensive network of free trade arrangements, as well as its attractiveness as an investment and tourism destination, Georgia is well positioned to benefit from favourable external economic conditions. GDP growth is forecast at 4.5 per cent of GDP in 2018 and 2019. Downside risks stem from a possible deterioration in external economic conditions and geopolitical vulnerabilities.

Assessment of transition qualities (1-10)



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Major structural reform developments

Georgia is on track with implementation of the IMF-supported reform programme. As of September 2018, US$ 127 million has been disbursed out of US$ 285 million envisaged under the three-year Extended Fund Facility arrangement signed in April 2017. The main pillars of the programme include improvements to the fiscal framework and administration, strengthening financial supervision and regulation, and advancing growth-enhancing reforms, in particular those related to infrastructure and education. The second programme review was successfully completed in June 2018, with Georgia making notable progress according to the IMF. In October 2018, the IMF reached staff-level agreement with the authorities on the third review.

Macroprudential regulation was strengthened and steps were taken to promote responsible lending practices. In December 2017, the NBG introduced countercyclical capital buffers for the banking sector and additional capital requirements for three systemically important banks, which are to be phased in by 2021. New regulations for responsible lending came into force in May 2018, aiming for better alignment with the European directives, raising underwriting standards and improving loan portfolio quality. To enhance institutional capacity, the NBG has created a new financial stability department and strengthened the operational framework of the Financial Stability Committee. At the end of 2017, the NBG's supervisory powers were expanded to include microfinance institutions, credit unions, currency exchange units and money transfer agents.

Improvements in public finance management are under way. The changes are focused on streamlining the public sector wages bill and on optimisation of the Revenue Service (RS). In December 2017, civil service remuneration reforms were introduced, involving grade structures with a corresponding compensation grid, aiming to improve the link between performance and remuneration. In the first half of 2018, the authorities reorganised the RS and transferred all core functions from field offices to the headquarters. A specialised unit was created at the RS to review overdue VAT refund obligations.

A new PPP law has been adopted. The Parliament of Georgia adopted the PPP law in May 2018. The new law is a significant step towards more active participation of the private sector in the national infrastructure development agenda. It was developed according to the best practices and internationally accepted standards. Work is under way on reviewing and amending primary and secondary legislation. The PPP framework aims to scale up private sector involvement in infrastructure investments while keeping contingent fiscal liabilities at bay.

Pension reform is advancing. A pension reform law was adopted by the Parliament of Georgia in July 2018 with the aim of improving pension replacement rates for workers. This marks the transition to compulsory retirement savings, although the merits of the new system are yet to be tested. The new funded pillar will be additional to Georgia's existing universal basic pension coverage. Contributions into individual retirement accounts will become mandatory for the employed population under the age of 40 and will require monthly contributions from the employee, employer and the state, each in the amount of 2 per cent of gross salary. Contributions from the self-employed and those aged over 40 will be optional. The law also provides for setting up a dedicated pension agency. At the same time, Georgia's track record of macroeconomic volatility and its underdeveloped domestic capital market pose significant challenges for the new system's long-term viability.

The authorities have broadened tax initiatives for small businesses. Before the recent changes, small businesses were defined as companies with an annual turnover of up to 100,000 Georgian lari (approximately US$ 40,000) and were subject to a 5 per cent turnover tax. From July 2018, this tax regime has been applied to enterprises with an annual turnover of up to 500,000 lari (US$ 200,000), thus widening the spectrum of businesses eligible for favourable tax treatment. The turnover tax rate was lowered to one per cent and its advance payment was abandoned. Tax declarations and payments by small businesses are now performed monthly, based on simplified tax accounting.

MOLDOVA

Highlights

- **Economic output has been growing steadily.** GDP grew by 4.5 per cent in 2017 supported by a favourable external economic environment and a recovery in household consumption. In the first half of 2018 growth continued at a similar pace.
- **Foreign investors have entered two systemically important banks**. The recent acquisitions of a 39.2 per cent stake in Victoriabank and a 41.09 per cent stake in Moldova Agroindbank by fit and proper investors are steps towards transforming the banking sector. These also mark the first entries since 2007 of foreign bank investors into Moldova.
- **Recent business environment reforms include welcome improvements but have also raised concerns.** New tax simplification and deregulation measures should contribute to a more enabling business environment, but an amnesty regarding previous offences may obstruct the administration of justice.

Key priorities for 2019

- **Shareholder fitness should be restored at one of the country's systemic banks as soon as possible.** In order to shore up financial stability, the removal of opaque shareholders needs to be finalised in the second largest bank which remains under the temporary administration of the National Bank of Moldova.
- **IMF programme implementation should continue without delays.** Implementation of structural reforms and macroeconomic policies agreed under the programme is crucial for maintaining investor confidence and for receiving financial support from international development partners.
- **Supervision of the non-bank financial sector should be enhanced.** To mitigate migration of risks from the banking sector, more needs to be done to strengthen supervision of non-bank financial institutions, as well as to enhance the capacity of the financial sector regulator.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.8	-0.4	4.3	4.5	4.0
Inflation (average)	5.1	9.7	6.4	6.6	3.6
Government balance/GDP	-1.9	-2.3	-2.1	-1.0	-3.5
Current account balance/GDP	-7.1	-7.1	-4.2	-5.9	-7.4
Net FDI/GDP [neg. sign = inflows]	-3.8	-3.2	-1.2	-1.6	-2.8
External debt/GDP	80.9	93.1	91.4	72.8	n.a.
Gross reserves/GDP	27.0	27.0	32.6	29.3	n.a.
Credit to private sector/GDP	36.4	31.2	25.8	18.9	n.a.

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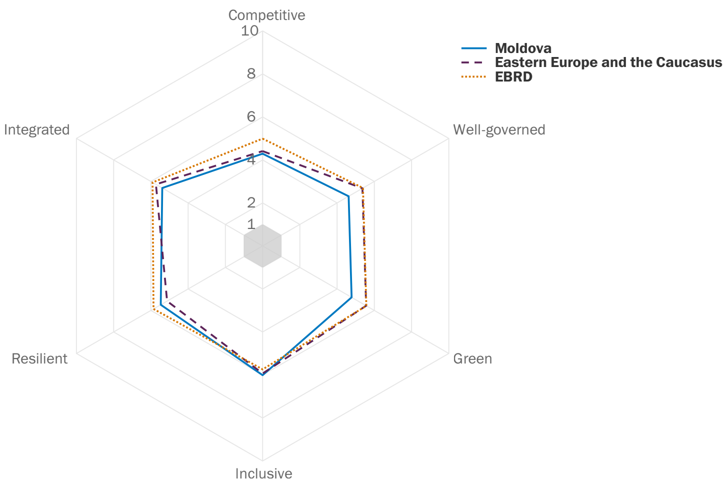
Macroeconomic performance

Robust economic growth has continued. Real GDP grew by 4.5 per cent in 2017, supported by a favourable external economic environment. Exports of goods and services continued to expand in 2017 on the back of growing exports to the European Union (EU). The volume of agricultural output increased by 7.9 per cent in 2017. Rising remittances and real wages have bolstered household consumption which, in turn, increased by 5.3 per cent in 2017. After contributing negatively to GDP growth in 2015-16, gross fixed capital formation rebounded in 2017, expanding by 5.2 per cent in real volume terms. GDP continued to grow by 4.5 per cent year-on-year in the first half of 2018.

Economic stabilisation is aided by a benign external environment. The current account deficit widened from 4.2 per cent of GDP in 2016 to 5.9 per cent of GDP in 2017, reflecting consumption-driven import growth. At the same time, remittances to Moldova increased by 12.8 per cent and exports of goods and services by 18.9 per cent in nominal US dollar terms. The expansion of Moldova's international trade was driven chiefly by increased cross-border flows with EU countries under the supportive framework of the Deep and Comprehensive Free Trade Agreement (DCFTA) signed in 2014. The Moldovan leu appreciated by 16.8 per cent during 2017 and by a further 1.4 per cent by the end of September 2018. International reserve assets of the National Bank of Moldova (NBM) increased from US$ 2.2 billion at the end of 2016 to US$ 3.0 billion in September 2018, covering approximately six months of imports. Inflation slowed from an average of 6.6 per cent in 2017 to a more manageable 3.7 per cent in the first nine months of 2018. At 1.0 per cent of GDP in 2017, the fiscal deficit was lower than projected as delays in external financing and the reorganisation of ministries led to under-execution of spending.

Structural and demographic challenges may act as a drag on potential growth. The economy is forecast to grow by 4.0 per cent in 2018 and in 2019. The lack of diversification in the economy is a key constraint holding back medium-term growth prospects. Agriculture's significant weight in economic value creation leads to volatility of growth and low overall productivity. Population ageing and the outflow of migrants are also key challenges that, if not addressed, will dampen the economy's long-term potential.

Assessment of transition qualities (1-10)



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Major structural reform developments

Reforms committed to under the IMF programme are on track. In June 2018 Moldova completed the third review of the IMF's Extended Credit Facility and Extended Fund Facility arrangements, signed in November 2016, which remain an important facilitator of reforms. To satisfy programme conditionalities, significant strides were made in a number of areas, including steps to instil shareholder transparency in the banking sector, improve the regulation of the non-banking sector and adjust the electricity tariff-setting methodology.

Major governance reforms have advanced in the banking sector. Procedures for share cancellation, issuance and sale of newly issued shares were amended in December 2017 to enable the removal of unfit shareholders. This was followed by the replacement of the non-transparent shareholder with fit and proper investors in two of the systemic banks. In January 2018, a strategic investor from Romania acquired a 39.2 per cent equity stake in Victoriabank, which was the third largest bank by assets at the time of the transaction. The new shareholder has launched a modernisation of the bank by, inter alia, introducing sound corporate governance as well as risk management standards and practices. In October 2018, a consortium of international investors acquired a 41.09 per cent stake in Moldova Agroindbank, the largest commercial bank in Moldova. At the same time, shareholder fitness in the third systemic bank remains to be restored.

The financial sector's legal, regulatory and supervisory framework has been further strengthened. A new anti-money laundering (AML) law was adopted in February 2018. All banks were instructed to conduct self-assessments of corporate governance practices. In April 2018, the NBM approved the list of related party exposures for the three largest banks and the time-bound plans for unwinding related party exposures were submitted and agreed with the NBM. The NBM completed onsite inspections and shareholder checks in non-systemic banks in May 2018. The government published a report on the findings of the independent investigator of the 2014 bank fraud and in March 2018 submitted it to the Anti-Corruption Prosecutor's Office which, in turn, developed a strategy to recover assets containing time-bound actions. The Central Securities Depository, responsible for the registration, book-keeping and settlement of financial securities issued by legal entities, became operational in July 2018. In the same month, the deposit guarantee ceiling was increased from approximately US$ 1,200 to US$ 3,000, risk-based banks' contributions were set up, and conditions under which the NBM or the Ministry of Finance could finance the guarantee fund were clarified.

The authorities are setting up a regulatory and supervisory framework for non-bank credit organisations. The aim is to prevent migration of risks from the banking sector to the non-bank financial sector. The law on non-bank credit organisations came into force in March 2018. It sets the regulatory framework and introduces capital requirements for these entities. Organisations covered by the law will be subject to a minimum capital requirement of 5 per cent of assets. If book value of assets exceeds 25 million lei (approximately US$ 1.5 million), such organisations will be required to perform an external audit of financial statements. The register of non-bank organisations is to be held at the National Commission for Financial Markets.

Pro-business tax measures have been adopted, along with reduced penalties for economic crimes. The package of business reforms was introduced in July 2018 to lower the regulatory and tax burden on businesses, but it also includes an ill-conceived capital amnesty and legislative revisions to reduce criminal liability for certain economic crimes. Progressive personal income tax rates of 7 per cent and 18 per cent were replaced by a single flat rate of 12 per cent. The employer social contribution rate was lowered from 23 per cent to 18 per cent. The value added tax rate for hotels, restaurants and cafes was cut to 12 per cent. A capital amnesty introduced by the package allows for registration of financial means and property without the need to provide documents attesting their origin until the end of 2018, conditional on paying 3 per cent of the asset value. This possibility does not apply to public officials. Furthermore, the package reduces the severity of punishment for a range of economic crimes in exchange for higher monetary fines. A reform of the state control function adopted in the second half of 2017 reduced the number of control institutions from 70 to 18 and streamlined procedures. In July 2018, the government launched a single window for issuing permits.

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A new methodology for calculating electricity tariffs is in place. The revised version was developed, adopted and published by the regulator (ANRE) and agreed with the Energy Community Secretariat, and is consistent with the new energy law. The methodology provides for annual setting of tariffs via established rules for determining costs, capital investment and profitability.

UKRAINE

Highlights

- **The economy is on a moderately paced recovery path.** Economic output expanded by 2.5 per cent in 2017, with domestic demand as the main driver, and the pace of growth has picked up so far in 2018.
- **Progress in the legislative reform agenda has been mixed.** The parliament has adopted a number of milestone laws, including on establishment of an anti-corruption court, privatisation, currency and currency operations, corporate governance in state-owned banks, and creditors' rights protection. These legislative changes, however, have yet to yield tangible results.
- **Cooperation with the IMF is to be extended under a different arrangement.** If approved and duly implemented, the new 14-month Stand-By Arrangement will help to address Ukraine's external financing needs and maintain macroeconomic stability during the programme period.

Key priorities for 2019

- **Ukraine needs to preserve macroeconomic stability.** Cooperation with the IMF remains vital. The country will require continued IMF and donor support, and consistent access to international capital markets to address foreign exchange debt payment liabilities falling due in 2018-20.
- **Ukraine should step up implementation of recently adopted energy sector laws.** Unbundling of the gas transmission system operator from Naftogaz and implementation of its corporate governance action plan, together with the establishment of the gas exchange, are priorities. The Public Sector Obligation (PSO) of Naftogaz and its subsidiaries requires an overhaul to phase out subsidisation and incentivise payment discipline by utility companies.
- **Reform of the state-owned banks should be vigorously pursued.** Emphasis should be placed on the execution of the corporate governance reform and transformation of the state-owned banks, thus leading to their privatisation.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-6.6	-9.8	2.4	2.5	3.5
Inflation (average)	12.1	48.7	13.9	14.4	10.9
Government balance/GDP	-4.5	-0.9	-2.1	-1.3	-2.1
Current account balance/GDP	-3.4	1.8	-1.4	-2.2	-3.1
Net FDI/GDP [neg. sign = inflows]	-0.2	-3.3	-3.5	-2.3	-2.1
External debt/GDP	94.6	130.4	121.7	103.9	n.a.
Gross reserves/GDP	5.6	14.6	16.6	16.8	n.a.
Credit to private sector/GDP	64.3	49.4	41.9	34.1	n.a.

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Macroeconomic performance

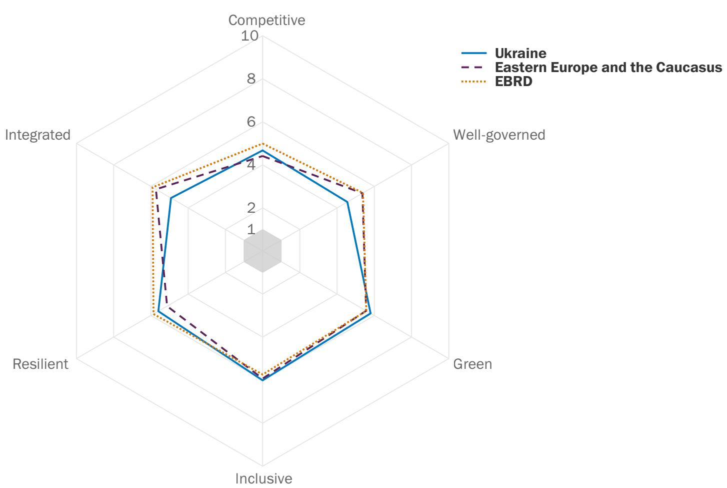
Growth has gained some momentum but remains modest. GDP growth accelerated from 2.5 per cent in 2017 to an estimated 3.5 per cent (year-on-year) in the first half of 2018. Household consumption increased by 8.4 per cent in 2017 on the back of a strong real wage recovery, an increase in the average pension and a rise in the inflow of remittances from abroad. In 2017, investment in fixed assets increased by 18.2 per cent. In the same period, exports of goods and services also grew modestly in real volume terms following five consecutive years of contraction. Consumer price inflation has slowed from the peak levels of 2015 but remains elevated at 11.4 per cent year-on-year in the first nine months of 2018. The National Bank of Ukraine (NBU) raised its key policy rate six consecutive times from 12.5 per cent in October 2017 to 18.0 per cent in September 2018 to counter the inflationary pressures.

The emigration of working-age people has intensified. This has led to labour market pressures and is dragging down industrial output growth. At the same time, outward labour migration has led to an increased inflow of remittances from abroad. According to the recently revised methodology of the NBU, personal remittances are estimated to have increased from US$ 7.0 billion (approximately 7.6 per cent of GDP) in 2015 to US$ 9.3 billion (8.3 per cent of GDP) in 2017. Real wages increased by 12.8 per cent year-on-year in the first nine months of 2018.

The IMF's four-year Extended Fund Facility (EFF) is set to be replaced with a shorter, smaller-scale Stand-By Arrangement (SBA). In October 2018, the authorities and the IMF reached a staff-level agreement on a new 14-month SBA for the total amount of US$ 3.9 billion. If approved by the IMF Executive Board and duly implemented, the new SBA will help to address Ukraine's near-term external financing needs and to maintain macroeconomic stability throughout the electoral cycle next year. Following the staff-level agreement with the IMF, Ukraine returned to international capital markets in October 2018, issuing a dual-tranche Eurobond for the total principal amount of US$ 2 billion. Since April 2018 international reserves have been on a declining path, falling from US$ 18.4 billion to US$ 16.6 billion (approximately 2.9 months of imports) as of September 2018, although this trend is expected to be reversed after the renewal of cooperation with the IMF.

Growth prospects depend on the speed of implementation of key structural reforms and on addressing external refinancing needs. Ukraine's GDP is forecast to grow by 3.5 per cent in 2018 and by 3.0 per cent in 2019, although the political economy context may become less conducive for structural reforms ahead of the new election cycle in 2019. Ukraine needs to refinance foreign exchange public debt liabilities falling due in 2018-19 without draining foreign exchange reserves to maintain the confidence of investors and strengthen the medium-term outlook. Continuation of engagement with the IMF remains vital in this respect.

Assessment of transition qualities (1-10)



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Major structural reform developments

State-owned enterprise reform is moving forward slowly. A draft of the SOE corporate governance law that paves the way for independent boards with broad statutory powers at the SOEs has been prepared and submitted to the parliament. A revised Nomination Policy for SOE board members and CEOs was approved by the government in March 2018. This was followed by progress in appointing independent board members at a number of strategically important SOEs. The law on privatisation of state property, adopted in January 2018, has rectified shortcomings in the privatisation process and introduced the notions of small- and large-scale privatisations. According to the law, privatisation of small-scale state assets (up to approximately US$ 9.4 million in value) is to be made through the online state auction platform (Prozorro.Sale). The bylaws supporting the new law on privatisation were developed and approved by the Cabinet of Ministers in May 2018, but no major privatisation has taken place so far.

The stage has been set for reforming the state-owned banks (SOBs). In February 2018, the authorities approved the key principles of strategic reform of the state-owned banking sector, which accounts for approximately 55 per cent of total banking assets. Four major priorities were identified: implementation of strategies to restore commercial soundness and profitability; improvements in corporate governance, discipline and strategy execution; measures to improve the quality of assets and strengthen balance sheets; and exit of the state from the ownership of banks in the medium term. A law on improving the functioning of the financial sector in Ukraine was approved by the parliament in July 2018. It introduces independent professional supervisory boards appointed on a competitive basis. By law, the boards will have wide powers such as approval of key strategies and appointment of the executive management. Corporate governance standards set by the new law aim to increase operational efficiency, insulate the SOBs from undue political influence, and prepare them for eventual privatisation.

The new law on currency and currency operations replaces obsolete regulations. Adoption of the law in July 2018 marks a shift from an outdated, fragmented and cumbersome set of currency regulations and controls to a modern system compliant with EU directives and Ukraine's obligations under the Association Agreement. The currency operations are to be carried out without restrictions, unless provided otherwise by applicable anti-money laundering laws, national security laws, applicable international treaties or measures introduced by the central bank. The NBU remains authorised to abolish restrictions on foreign exchange operations or the movement of capital depending on macroeconomic conditions, but also to establish temporary protective measures at its discretion in case of identified threats to financial stability. The capital control and foreign exchange restrictions remaining in Ukraine are expected to be gradually lifted on the implementation of the law and contingent on satisfactory macroeconomic conditions.

Progress in energy sector reforms has been mixed and delays have occurred. The new majority-independent Supervisory Board of Naftogaz was selected in November 2017, after independent members of the previous board tendered their resignation while pointing to delays in the implementation of reforms. In December 2017, the government approved resolution on the monetisation of housing and utilities subsidies (HUS) at the utility level, introducing improvements to the HUS settlement process. Further work is needed to move the HUS monetisation further down to the level of households. In April 2018, the government established the Energy Reform Coordination Council (ERCC) in an effort to enhance delivery of energy sector reforms through strategic guidance and improved coordination between the government, Naftogaz and development partners. The ERCC is to focus on the three energy reform priorities that have experienced considerable delays: unbundling of gas transmission from production and supply functions; reforming the Public Sector Obligation (PSO) – Naftogaz's responsibility for the supply of natural gas to households and district heating utilities under regulated prices; and better targeting and monetisation of HUS. In May 2018 the President of Ukraine appointed five new Commissioners of the Energy and Utilities Regulator from the list pre-selected by the Independent Nomination Commission, reinstating the quorum and clearing the way for the regulator to make decisions.

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Investment climate reforms have advanced but significant challenges remain. In November 2017, the parliament adopted legislation that limits the powers of law enforcement agencies in carrying out criminal proceedings against businesses. The law requires all searches of enterprises by law enforcement agencies to be recorded on video with the right of an attorney to be present at any stage of the process. The law also limits the possibility of unwarranted seizure of business-critical computer hardware from private companies, among other measures. In February 2018, the parliament passed a law to establish an NBU-based centralised credit registry to foster information exchange and credit risk assessment by banks. A number of gaps undermining creditors' rights protection were targeted by the law on resumption of lending, adopted in July 2018. The landmark legislation for the establishment of the High Anti-Corruption Court was adopted in June 2018, despite strong political resistance. At the same time, asset declaration requirements for non-governmental organisations and board members of SOEs have not been abolished. The National Anti-Corruption Bureau of Ukraine (NABU) continues to face pressures and attempts to compromise its investigative activities. A moratorium on agricultural land sales was extended until January 2019. Ukraine ranks 71st out of 190 economies in the World Bank *Doing Business 2019* report, moving up in the rankings compared with the previous year. However, weaknesses in Ukraine's business environment are reflected in the low scores with respect to resolving insolvency, getting electricity, trading across borders and protecting minority investors.