CROATIA

Highlights

- **Economic recovery has continued.** The growth rate decelerated from a post-recession high of 3.5 per cent in 2016 to 2.6 per cent in 2018, but rose again in the first half of 2019.
- **Croatia is back to investment grade.** The country is rated BBB-/Positive by Fitch (June 2019) and BBB-/Stable by Standard & Poor's (March 2019), following significant macroeconomic improvements in recent years.
- **Plans for joining the eurozone have advanced.** The authorities have sent a letter of intent, representing the first formal step towards joining the Exchange Rate Mechanism II (ERM II) in 2020, which would be one stage ahead of joining the eurozone.

Key priorities for 2020

- **Reforms aiming to prepare the country for joining ERM II and the banking union should be stepped up.** While Croatia has improved its macroeconomic conditions to become part of ERM II, the authorities should speed up key structural reforms, focusing in particular on improving public-sector governance.
- **Acute shortages in skilled labour need to be addressed sustainably**. Several sectors (tourism, in particular) have long been experiencing a lack of qualified staff. Increased quotas for foreign workers are helping to provide a short-term fix, but a longer-term solution is needed, including a further reduction in labour market rigidities.
- **Business environment reforms should continue to be prioritised.** Despite improvements, bureaucratic processes remain an obstacle to doing business. In addition, state-owned enterprises remain dominant in some sectors, and privatisation of these enterprises, including through initial public offerings, would attract investors and increase the competitiveness of the economy.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.4	3.5	3.1	2.6	3.0
Inflation (average)	-0.3	-0.6	1.3	1.6	1.0
Government balance/GDP	-3.3	-1.1	0.8	0.3	0.1
Current account balance/GDP	4.5	2.6	3.9	2.7	2.3
Net FDI/GDP [neg. sign = inflows]	-0.5	-4.3	-2.6	-1.4	-1.4
External debt/GDP	100.1	85.1	87.4	73.2	n.a.
Gross reserves/GDP	30.2	27.6	34.1	32.9	n.a.
Credit to private sector/GDP	62.3	57.7	55.4	54.4	n.a.

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Macroeconomic performance

Growth has somewhat moderated in the past year, but remains solid. The economy experienced growth of 2.6 per cent in 2018, its fourth consecutive year of recovery following a six-year recession from 2009-14. Private consumption remained the main driver of growth, fuelled by increased earnings, a higher employment rate and an increasing pace of household lending. The unemployment rate as of June 2019 was about 7.0 per cent, down from 18.3 per cent in 2014 (the final year of recession). Investment continued along its recovery path from 2015, helped by the growing disbursement of funds from the European Union (EU), rising economic sentiment and low interest rates, rising 4.0 to 5.0 per cent per year on average ever since, and thus contributing around one percentage point to growth per year. Gross domestic product (GDP) grew by 3.1 per cent year-on-year in the first half of 2019, driven again by broad-based domestic demand. Inflation turned positive in 2017 but remained low in 2018, averaging 1.6 per cent. The current account was in surplus in 2018 (2.9 per cent of GDP), despite stronger imports.

Fiscal adjustment has continued in 2018, albeit at a slower pace. The 2018 budget surplus is estimated at 0.3 per cent of GDP, following a budget surplus of 0.8 per cent in 2017, and is underpinned by expenditure restraint, lower interest costs and higher revenues from favourable macroeconomic developments. A balanced budget is expected in 2019, despite an increase of 5.0 per cent in the public wage bill. Also expected are revenue losses from reductions in excises, value added tax (VAT) rates on some products and social security contributions. Public debt ratios have come down from a peak of 85.0 per cent of GDP in 2014 to an estimated 75.0 per cent by the end of 2018. The government's commitment to joining the ERM II, as part of the euro adoption strategy, should serve as an anchor for prudent fiscal policy in the coming years.

Croatia's credit rating was raised to investment grade. In June 2019, Fitch raised the country's credit rating from "BB+" to "BBB-", with a positive outlook. This follows Standard & Poor's upgrade in March 2019, which also raised Croatia to investment grade "BBB-". In June 2019, the government successfully issued a 10-year Eurobond, raising €1.5 billion with an annual coupon interest rate of 1.125 per cent. In August 2019, the government issued a one-year Eurobond with a negative interest rate of 0.05 per cent. For shorter maturities, average yields in local currency have remained close to zero.

Economic performance is expected to stay at solid levels in the short term. We expect GDP growth of 3.0 per cent in 2019, in line with that of the first half, and light moderation to 2.5 per cent in 2020, broadly in line with the country's current growth potential, as supply side constraints for the tourism sector become apparent. Growth is expected to be driven by private consumption and supported by positive labour market developments, low inflation and steadily increasing remittances. Risks to the projection come from possibly weaker demand from Croatia's main economic partners, such as the eurozone. While convergence prospects remain high, with GDP per capita (in power purchasing standards) standing at just 63.0 per cent of the EU average, a further tightening of labour market conditions and an increasingly difficult demographic profile are making it challenging for employers to fill highly qualified positions amid emigration and an ageing population, which could weigh on long-term growth prospects.

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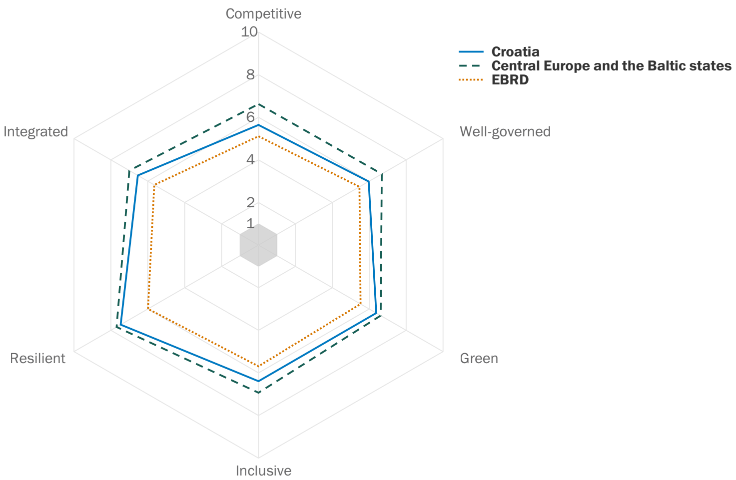
Assessment of transition qualities (1-10)



Major structural reform developments

Croatia's business environment has improved over the past year. Croatia has made a number of reforms over the past year making it easier to do business. The country made starting a business easier by abolishing certain requirements for company registration, and by reducing the paid-in minimum capital requirement. Also, it made dealing with construction permits less costly by reducing the water contribution for building a warehouse. Transferring property has been facilitated by a decrease in the real estate transfer tax and a reduction in the time to register property title transfers. However, Croatia made accessing credit information more difficult by ending the distribution of individual credit data. The overall sum of reforms and reversals helped Croatia to rise by seven places, ranking 51st (out of 190 economies) in the World Bank's *Doing Business 2020* report.

The restructuring of Agrokor continues. The company was, at one point, Croatia's biggest employer but almost collapsed in 2017 due to a debt crisis. Following the agreement between Agrokor and its creditors in July 2018 on a debt-for-equity settlement deal, implementation started in April 2019, when the management of the company was transferred from emergency administration to a new company called Fortenova Group. The biggest shareholder in the new company is Russia's Sberbank, with a 39.0 per cent stake.

Croatia has sent a letter of intent to join the ERM II. The letter was sent by the authorities to the European Commission in July 2019. It represents the first formal step towards joining ERM II, intended for 2020, which would be one stage ahead of joining the eurozone. Croatia has committed to implementing reforms in six areas in the following ways: (i) further strengthening the supervision of the banking system by establishing close cooperation between the Croatian National Bank and the European Central Bank; (ii) strengthening the framework for implementing macroprudential policies; (iii) strengthening the framework for the prevention of money laundering; (iv) improving the system for collecting, processing and publishing statistical data; (v) improving public-sector governance; and (vi) reducing the administrative and financial burden on the economy.

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New pension reforms, designed to make the pension system more sustainable, have been partly reversed. In December 2018, the parliament approved changes to the pension system which were meant to make the system more sustainable. Among other measures, it was envisaged that the statutory retirement age of 67 years for both men and women would be introduced as of 2033, from the current 65 for men and 62 for women. But following a widespread campaign against the changes, in September 2019 the government agreed to reinstate the retirement age to 65 and change the law accordingly. However, all pensioners will now be allowed to hold part-time jobs (of up to four hours a day) without losing their pensions. In addition, measures were introduced to boost population growth by allowing additional months of service for parents when they fulfil the retirement conditions.

Tax reforms have advanced. A new package introduced in January 2019 includes: lowering the VAT rate on a number of food products and cultural professions (for example, writers, composers and artists) to 13.0 per cent from the standard rate of 25.0 per cent, and on both non-prescription and over-the-counter drugs to 5.0 per cent; raising the salary range to which the lower income tax rate of 24.0 per cent is applied, from the current monthly HRK 17,500 (€2,350) up to HRK 30,000 (€4,000), with the higher rate of 36.0 per cent remaining for higher salaries; and raising the tax-free amount of annual bonuses for employees to HRK 7,500 (€1,000) from HRK 2,500 (€340).

Oil and gas sector production capacity is being enhanced. According to the Croatian Hydrocarbon Agency, in July 2019 four companies placed bids for six (of the seven) offered sites in the Pannonian Basin, in northern Croatia. As a result of the first onshore tender, two new drilling wells have been opened in Croatia's eastern region of Slavonia by Canada-based Vermilion. In addition, in February 2019 the government launched a tender for gas and oil exploration in the southern part of the country, with a deadline for September 2019. Croatia is also in the process of building a liquefied natural gas terminal on its island of Krk, and is participating in the Ionian-Adriatic Gas Pipeline, which is a continuation of the Trans Adriatic Pipeline that brings natural gas from Azerbaijan's gas field of Shah Deniz to Bosnia and Herzegovina, Croatia and Montenegro. Both of these plans should have an important role in diversifying the natural gas supply as well as ensuring security of a natural gas supply not only for Croatia, but also for the wider region. In addition, the Croatian natural gas transmission operator Plinacro announced that two-way gas flow between Croatia and Slovenia has been enabled, thus fulfilling its obligation under EU regulations regarding gas supply security measures.

Rail transport infrastructure is being enhanced. Croatia has received 10 bids for the construction of its €297 million 43-kilometre rail project on the Krizevci-Koprivnica-Hungarian border. This is the largest railway infrastructure project in Croatia's recent history and will help modernise the rail line shipping cargo from the Adriatic port of Rijeka to central Europe through the capital, Zagreb. The EU is financing 85 per cent of the total cost of the project. The implementation of this project will raise the capacity of railroads, increase the speed of traffic with a modern two-lane line and enhance the level of safety in the corridor.

ESTONIA

Highlights

- **Gross domestic product (GDP) growth has decelerated somewhat.** Higher investments, mainly by non-financial companies, and increased government spending underpinned GDP growth in the first half of 2019. At the same time, household consumption has moderated despite rising wages.
- **Anti-money laundering supervision has been strengthened.** The Nordic and Baltic states' financial supervisors have agreed on measures to enhance the cooperation among the countries' authorities, with the aim of fighting money laundering and the financing of terrorism.
- **The banking sector has expanded and become more concentrated.** The acquisition of Luminor Bank by Blackstone was one of the largest mergers and acquisitions (M&A) transactions in the history of the Baltic states.

Key priorities for 2020

- **The development of new and innovative technologies in the country's financial markets should advance.** Regulatory sandboxes, which are a live testing environment for technology and FinTech companies against regulation, may help in designing an environment that supports innovative start-ups.
- **Reforming the second pillar pension system should take into account the system's sustainability.** The established funded pension working group will need to work out appropriate solutions to the problem of pension sustainability in the context of a rapidly ageing population and adverse demographics.
- **Strengthening anti-money laundering (AML) supervision should remain a priority.** While AML risks in the banking sector have declined markedly and the risk-based supervision of financial institutions has been implemented, efforts at further deepening regional cooperation should be continued.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	1.8	2.6	5.7	4.8	3.2
Inflation (average)	0.1	0.8	3.7	3.4	2.5
Government balance/GDP	0.1	-0.5	-0.8	-0.6	-0.2
Current account balance/GDP	1.8	1.7	2.7	2.0	1.5
Net FDI/GDP [neg. sign = inflows]	0.6	-2.4	-3.9	-4.7	-4.0
External debt/GDP	92.2	88.5	83.1	76.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	68.6	70.2	64.5	62.1	n.a.

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Macroeconomic performance

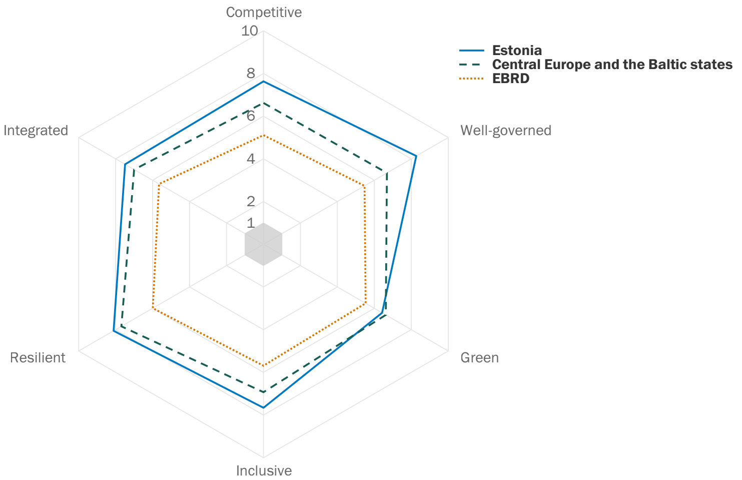
Domestic demand continues to fuel economic growth. GDP growth decelerated to 4.9 per cent in 2018, largely driven by strong consumption-driven imports, which significantly outperformed exports. In the first half of 2019, economic expansion decelerated to 4.2 per cent, mainly due to moderating household consumption. Nominal wage growth reached almost 8.0 per cent on average in the first half of 2019, causing unit labour costs to grow faster than labour productivity. This reflects a shrinking labour market and raises concerns about Estonia's prospective competitiveness.

Investment has recovered. Following a slowdown to 1.7 per cent in 2018, gross fixed capital formation rose by 21.4 per cent in the first six months of 2019. Non-financial enterprises registered higher investment expenditures into transportation equipment and machinery. Household expenditures into dwellings increased markedly as well. Credit to non-financial companies turned positive in the third quarter of 2018, especially long-term credit (over five years), which has grown by more than 10.0 per cent since then.

Fiscal expenditures will continue to grow. In 2018, the general government balance fell to a deficit of 0.6 per cent of GDP, mainly due to higher-than-expected social spending and investment. According to the ruling coalition's action programme for 2019-23, fiscal expenditures are expected to grow, especially on family policies, pension hikes, healthcare and defence. Public debt continues to fall, reaching 8.4 per cent of GDP in 2018. According to European Commission estimates, it will likely remain low, at around 8.5 per cent of GDP in the coming years.

Short-term GDP growth will remain buoyant. The tightening labour market will result in further wage increases, keeping household consumption elevated. At the same time, mounting labour shortages and competitive pressures will likely force companies to invest in efficiencies unless the outlook worsens severely. Negative risks to the outlook come from intensification of trade tensions and weaker export demand in advanced economies, especially in the Nordic region. As a result, GDP growth is anticipated to slow to 3.2 per cent and 2.6 per cent in 2019 and 2020, respectively.

Assessment of transition qualities (1-10)



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Major structural reform developments

Cross-border cooperation on AML supervision has strengthened. In May 2019, the heads of the Nordic and Baltic states' financial supervisors agreed on measures to enhance their cooperation with the aim of fighting money laundering and combating the financing of terrorism (CFT). In July 2019, the Estonian government decided to amend the penal code and relating laws to adopt the European Union (EU) directives on protection of EU financial interests, which increases the maximum length of imprisonment for money laundering. Further work on strengthening the AML/CFT framework will continue. Recently, the total share of non-resident deposits from high-risk clients without any links to the Estonian economy dropped substantially. It went down from 18.6 per cent at the end of 2014 to 7.2 per cent at the end of 2018, while the share of offshore deposits declined from 3.9 per cent to just 0.5 per cent over the same period.

The banking sector has expanded and became more concentrated. In September 2018, the Nordic banks Nordea and DNB announced that they would sell a 60 per cent stake in Luminor Bank, which operates in the three Baltic states, to Blackstone, the United States of America-based private equity giant. This acquisition, with a value of €1 billion, is one of the largest M&A transactions in the history of the Baltic states. As a result, the size of the banking sector in Estonia will increase from 102 per cent to 145 per cent of GDP and the sector will become more concentrated, as the three largest banks hold a market share of 85 per cent. In January 2019, the European Commission cleared the deal and stated that it raises no competition concerns, given its limited impact on the market structure. The deal is still awaiting the approval of the European Central Bank before it materialises in late 2019.

A covered bond law has entered into force. Estonia is the first of the Baltic states to adopt covered bond legislation, which came into force in March 2019. Estonia, Latvia and Lithuania started work on developing covered bond and securitisation frameworks in late 2017, with the aim of creating a pan-Baltic covered bond market. The new law enables banks to diversify funding sources and limit their reliance on parent funding. Estonia's Luminor Bank is expected to make the first covered bond issuance, preceded by various structural and ownership changes in 2019 that will help to raise new secured funding in the pan-Baltic market.

The pension system is becoming more flexible. In December 2018, the parliament adopted a bill that ties the retirement age to average life expectancy, starting from 2027. In addition, the pension payment will depend on both the final salary and the person's length of service. The flexible pension will allow employment on a part-time basis. In addition, the government plans to reform the second pillar pension fund. As a result, FinanceEstonia, a public-private financial sector cluster organisation, established a funded pension working group in June 2019 to formulate solutions for the Estonian social security system.

Additional measures for preventing corruption were introduced. In January 2019, the parliament adopted an amendment to the law to reduce the risk of corruption and conflicts of interest at the local government level. Compared with the previous year, Estonia advanced three places to joint 18th (out of 180 countries) in Transparency International's 2018 Corruption Perception Index.

Estonia is advancing in climate change adaptation. In December 2018, Estonia joined a political declaration that focuses on comprehensive and sustainable management of forests, accepted at the UN Climate Change Conference in Katowice, Poland. The declaration emphasises the importance of forests as carbon sinks and stresses that their ability to adapt to climate change needs to be improved. Estonia is rich in woodland, and the share of strictly protected forests is at the forefront of EU efforts to combat the negative effects of climate change.

HUNGARY

Highlights

- **Investment has been the key driver of recent gross domestic product (GDP) growth.** Strong credit growth, substantial foreign direct investment (FDI) and funds inflows from the European Union (EU) are supporting investment, while household consumption also remains strong, boosted by sharp wage growth and increased government spending.
- **An economic protection programme has been introduced.** According to the authorities, this programme aims to increase the GDP growth rate by an additional two percentage points above the EU average in the coming years.
- **The cost of funding for eligible corporates has decreased.** The National Bank of Hungary (NBH) has launched a new scheme for corporate bond purchases. While the scheme provided liquidity to the market, it remains to be seen whether it will be able to trigger new private investment flows to the market.

Key priorities for 2020

- **Market-based non-bank financial instruments and a wider investor base should be further developed.** The capital market remains shallow and reliant on stimulus measures by the NBH. A greater availability of modern alternative sources of finance from the private sector would enhance investment and productivity.
- **Transparency and governance of EU funds' absorption need to improve.** In its annual report, the European Anti-Fraud Office concluded 52 probes into misuse of EU funds and recommended to the European Commission (EC) to recover 3.8 per cent of payments. This is the highest proportion within the EU.
- **More domestic enterprises should be integrated into global value chains.** Despite the great openness of the economy, domestic small and medium-sized enterprises (SMEs) are largely excluded from international value chains and do not benefit from technology and international skills diffusion.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.8	2.2	4.3	5.1	4.6
Inflation (average)	0.1	0.4	2.4	2.9	3.4
Government balance/GDP	-2.0	-1.8	-2.4	-2.3	-1.9
Current account balance/GDP	2.4	4.5	2.3	-0.5	-0.8
Net FDI/GDP [neg. sign = inflows]	-1.3	-2.2	-1.6	-2.1	-2.5
External debt/GDP	107.4	96.1	84.3	80.8	n.a.
Gross reserves/GDP	26.6	20.3	19.7	19.9	n.a.
Credit to private sector/GDP	68.6	70.2	64.5	62.1	n.a.

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Macroeconomic performance

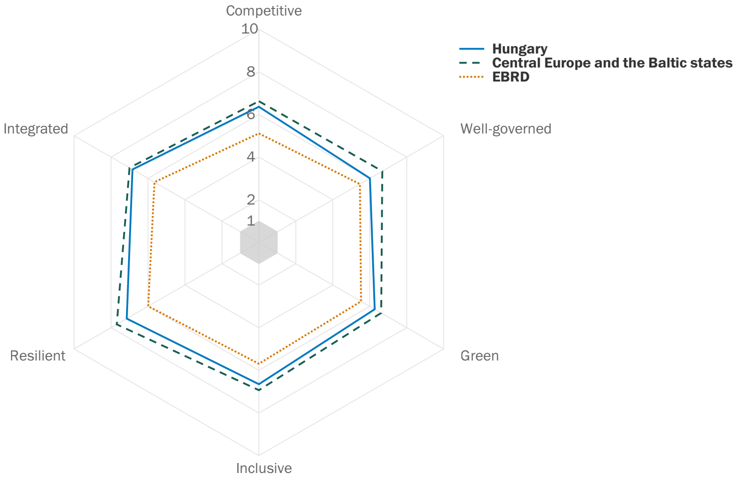
Investment and consumption are boosting GDP growth. Following the 5.1 per cent GDP growth in 2018, the economy continued to grow at the same pace in the first half of 2019. A substantial hike in investment and continuously strong household consumption were the key drivers of the strong GDP performance. Consumption was fuelled by strong gross nominal wage growth (above 10.0 per cent in annual terms) in both the private and public sectors. Salaries of employees in the central public administration were raised on average by 30.0 per cent from January 2019.

Investment growth has been impressive. Since 2017, investment has registered an average annual growth rate of more than 17.1 per cent and accelerated further to 20.6 per cent in the first half of 2019, the highest among the economies in central Europe and the Baltic states. In June 2019, the corporate loan stock increased by almost 15.0 per cent, supported by new subsidised lending by the NBH. Moreover, amid greater EU fund inflows, FDI inflows reached 6.3 per cent of GDP in 2018 but slowed down somewhat in the first half of 2019. Relatively strong FDI inflows are expected to continue as foreign companies, mainly in the automotive and aviation industries, and have already announced further greenfield and capacity expansion investments in the coming years.

Pro-cyclical government policies are preventing a greater budget deficit reduction. In 2018, the general government deficit narrowed slightly to 2.3 per cent of GDP, in a favourable macroeconomic environment. The government is planning both a 2.5 percentage point cut in employers' social contribution rates and higher expenditures related to various development programmes, such as family support or village development schemes. Despite this, the headline deficit is expected to fall to 1.9 per cent of GDP in 2019. According to EC estimates, the public debt is projected to fall below 70.0 per cent of GDP by the end of 2019, with a targeted reduction to 60.0 per cent of GDP by 2022.

Economic expansion is expected to decelerate, mainly due to weakening external demand. The stronger-than-expected performance of the economy in the first half of 2019 will help ensure continued strong growth of 4.6 per cent in 2019, but in 2020, we anticipate GDP growth to moderate to 3.1 per cent. This slowdown will be partially offset by domestic demand, powered by a double-digit recovery in corporate credit and still-strong wage hikes. The latter is largely a result of the tightening labour market, caused by the falling working-age population and mounting skill-mismatches. EU funds absorption will likely further underpin investment in 2019, but reduced EU fund inflows will constitute a drag on public investment from 2020 onwards. Trade disputes and the economic performance of Hungary's main trading partners, such as Germany, constitute negative risks to that scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

State withdrawal from the banking sector remains slow. The planned sale of Budapest Bank, acquired by the state in 2015, is on hold, as government plans and the timeline remain unclear. In January 2019 a minister without portfolio in charge of state assets was mandated to hold talks with potential investors regarding a potential sale of the bank.

The corporate bond market lacks a wider investor base. Currently, the corporate bond market represents around 1.6 per cent of GDP, below that of 6.0 to 7.0 per cent in peer countries such as Poland or the Czech Republic. In July 2019, the NBH launched a new HUF 300 billion (€930 million) scheme for corporate bond purchases (up to 70.0 per cent of a series). While the scheme provided liquidity to the market, it remains unclear whether this will introduce new private investors to the market.

An economic protection programme has been announced. The programme, initially announced by the Finance Ministry in May 2019, contains 16 economic support measures to counteract the negative impact of the economic slowdown in the eurozone. The measures include a reduction of social contributions by two percentage points, various tax changes and simplifications, more loan guarantees and research and development funding, assistance to companies for providing worker accommodation facilities and support for irrigation in agriculture. The authorities claim that this programme will boost the GDP growth rate by an additional two percentage points above the EU average in the coming years.

The government is taking measures to improve competitiveness. In June 2019, the NBH, at the government's request, unveiled 330 proposals in 12 areas for reforms to make the economy more competitive. The goal is to achieve higher productivity growth, driven by improvements in efficiency and export capacity of SMEs, reduced state bureaucracy and a renewal of the financial model (for example, through a prudent increase in lending, by strengthening alternative forms of financing or by promoting digital solutions). The NBH report also proposed reforms in healthcare. The report echoes largely the recommendations of the Competitiveness Council, a consultative body at the Finance Ministry, from November 2018.

The government has introduced measures to alleviate labour market shortages. In December 2018 the President signed an amendment to the labour code, raising the annual ceiling on working overtime from 250 to 400 hours. The amendment triggered a number of street protests and strike threats by trade unions. However, the Constitutional Court found the new law to be valid, noting that proposed overtime hours are still below some other EU countries.

A generous family support scheme aims to address demographic challenges. In order to enhance greater birth rates, the parliament approved new demographic and family support measures in April 2019, taking effect in July 2019. Measures in the adopted legislation include interest-free loans for married couples, grants for family purchases of seven-seated vehicles, write-offs of mortgage loans depending on the number of children in a family, and permanent income tax reliefs to women with at least four children. The anticipated cost of this family support is expected to add 0.1 per cent and 0.5 per cent of GDP to the budget deficit in 2019 and 2020, respectively. According to the EC 2018 Ageing report, the share of the working-age population in Hungary will fall by more than 11 percentage points in the next 50 years.

The EC has referred Hungary to the European Court of Justice for non-compliance with EU law for its asylum-and-return legislation with the EU. In September 2018 the European Parliament adopted a resolution proposing that the Council determine whether there is a risk of a serious breach of the values on which the Union is founded.

LATVIA

Highlights

- **Economic growth is moderating.** In 2018, the improved absorption of European Union (EU) funds and positive economic sentiment resulted in strong investment and gross domestic product (GDP) growth, but both investment and household consumption have been subdued in the first half of 2019.
- **Supervision of the banking sector has improved.** Following the accusations of money laundering in 2018 at ABLV Bank, the government has introduced several measures to reduce exposure to risky banking operations.
- **The government is encouraging small and medium-sized enterprise (SME) presence on the stock exchange.** The goal is to increase the international competitiveness of SMEs and to develop local capital markets.

Key priorities for 2020

- **Further efforts to strengthen banking supervision are needed.** In order to restore the reputation of Latvia's financial sector, extra reforms are required in order to prove the effectiveness of the regimes of anti-money laundering (AML) and combating the financing of terrorism (CFT).
- **Poor health outcomes should be addressed.** Life expectancy remains among the lowest in the European Union (EU), while amenable mortality is high. The long-awaited healthcare reform should be continued and more public funds should be devoted to improving patient access to treatment.
- **Productivity and GDP growth require greater investment in innovation.** Amid a shrinking population, a greater focus needs to be placed on knowledge-intensive activities. The recent efforts by the largest state-owned enterprises to boost innovation were welcome, but more private-sector involvement is needed early on.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.3	1.8	3.8	4.6	2.6
Inflation (average)	0.2	0.1	2.9	2.6	2.8
Government balance/GDP	-1.4	0.1	-0.5	-0.7	-0.8
Current account balance/GDP	-0.8	1.4	0.7	-0.7	-1.5
Net FDI/GDP [neg. sign = inflows]	-2.3	0.0	-2.0	-2.3	-2.5
External debt/GDP	143.7	148.6	140.3	120.9	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	49.7	49.2	43.8	38.0	n.a.

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Macroeconomic performance

Economic growth is moderating. After reaching 4.8 per cent in 2018, GDP growth slowed to 2.4 per cent in the first half of 2019. Domestic demand continued to be strong in 2018, fuelled by strong household and government consumption and a double-digit hike in investment. Net exports weighed on GDP performance in 2018 (by negative 2.2 percentage points), as investment-driven imports robustly outperformed weak exports. In the first half of 2019, almost all GDP components (except exports) saw some deceleration.

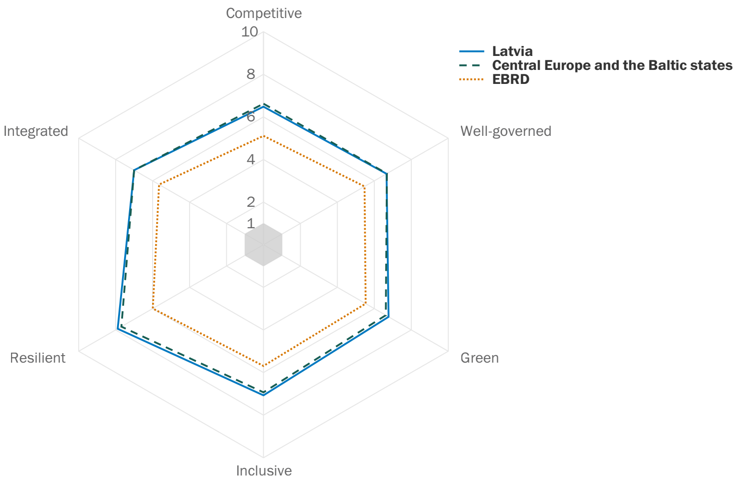
Investment remains strong despite a credit decline. Investment growth of 16.4 per cent in 2018 was mainly caused by improved EU funds absorption. As of mid-2019, 77.0 per cent of EU funding available in 2014-20 (€5.63 billion) was already invested in various projects. On the other hand, restructuring of the banking sector has continued to reduce banks' balance sheets. In the first half of 2019, the decline in lending activity to the private sector decelerated somewhat from -5.8 per cent in 2018 to -3.3 per cent year-on-year. Overall, the stock of credit to the private sector shrank to about 36.8 per cent of GDP by mid-2019, compared with almost 50.0 per cent at the beginning of 2016.

Growth of labour costs have been among the highest in the EU. Since 2010, unit labour costs increased by more than 35.0 per cent, the third-highest rate in the EU. Over the same period, real labour productivity improved by almost 28.0 per cent. Wage growth was 8.4 per cent in 2018, driven by labour shortages and an increase in the minimum wage. Wages are expected to increase further in the short term, albeit at a slower rate.

General government budget deficit widens. Following a small surplus in 2016, the general government balance turned negative in 2017 and dropped to a deficit of 0.7 per cent of GDP in 2018 as a result of increased public investment and higher public-sector wages. The government deficit is expected at 0.8 per cent of GDP in 2019. Government debt will likely decrease further, from 36.4 per cent of GDP in 2018 to below 35.0 per cent of GDP in 2020.

Labour shortages and restrained financing will weigh on growth. GDP growth is projected to decelerate to 2.6 per cent in 2019 and further to 2.2 per cent in 2020. The slowdown is due to a combination of factors, including decelerating economic growth in advanced European countries, adverse demographics and the reduced availability of sources of finance, such as EU funds and bank credit. However, additional rises in wages will drive further consumption growth.

Assessment of transition qualities (1-10)



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Major structural reform developments

Supervision of the banking sector continues to tighten. Following the completion of the financial system assessment by the Council of Europe's Moneyval committee (Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism), the prime minister signed three decrees on a further reform of the financial sector's supervisory system in February 2019. These measures are designed to address concerns raised in the Council of Europe's report about Latvia's AML/CFT regime. The new measures strengthen the Financial and Capital Market Commission, enable the government to expel banks involved in money laundering and enable more focus of the courts and prosecutors on more serious financial crimes.

T**he government is attracting more local companies to the stock exchange**. In May 2019, the Finance Ministry proposed regulations to encourage more SMEs to be listed on the Riga Stock Exchange. The goal is to increase the international competitiveness of the companies and to develop local capital markets. A support scheme is expected to promote and support financing availability for SMEs. Stock capitalisation in Latvia remains relatively small (4.6 per cent of GDP), compared with neighbouring Baltic states, and way below the EU average of 78.0 per cent. So far, reasons given by SMEs for not listing their shares include: high costs, low market liquidity, and insufficient awareness of the potential benefits.

Regional development has been enhanced. In April 2019, the parliament adopted a draft resolution on launching an administrative-territorial reform. According to the reform, the number of local governments would be reduced from 119 to 35. The economically weaker regions would be merged with stronger ones, with the goal of enhancing regional development and ensuring equal services to all residents The reform constitutes a continuation of the territorial reform started in 1998 and is expected to be completed by 2021.

The business environment is improving. In May 2019, the government endorsed a finance ministry plan to enhance the business environment in 2019-20. The key principles of the 40 measures in the plan include a consumer-friendly public administration, the expansion of e-governance, a competitive tax system, and promotion of the rule of law and innovation. Moreover, a specialised court for handling economic cases is expected to be established by 2021. According to the American Chamber of Commerce, the slow and unpredictable proceedings of complicated economic crime cases have contributed to corruption and make Latvia appear less attractive for investors. In the World Bank *Doing Business 2020* report, Latvia remained at 19th position (out of 190 countries).

The government has set targets to shrink the shadow economy. According to the action plan prepared by the government in April 2019, the shadow economy should be reduced from 21.3 per cent of GDP in 2017 to 17.1 per cent in 2022. The priority measures aim to improve tax payments and introduce fair competition in those economic sectors with the highest risks of informality, such as the construction and retail sectors.

LITHUANIA

Highlights

- **Gross domestic product (GDP) growth remains solid.** Rising disposable incomes, boosted by higher wages and, to a limited extent, the cut in the labour tax wedge, continue to stimulate consumption, while the accelerated absorption of funds from the European Union (EU) is fuelling investment.
- **Linkages between business and science are strengthening.** The Economy and Innovation Ministry and the European Organisation for Nuclear Research (CERN) have signed an agreement to set up two business incubator centres in Lithuania's two largest cities, Kaunas and Vilnius.
- **Power grid synchronisation is accelerating.** The Lithuanian parliament adopted a law on the synchronisation of the power grid with the continental European system, as well as 14 associated projects to facilitate the process, which should be finalised by 2025.

Key priorities for 2020

- **Enhanced interaction between business and academia should improve innovation.** Business research and development expenditures remain among the lowest, so particular efforts should be made to capitalise on the recent establishment of the two CERN technology centres to promote innovation among businesses in Lithuania.
- **Fintech and technology-focused innovative solutions should be fostered.** At the same time, the associated risks need to be addressed by enhanced supervisory capacity and strengthened anti-money laundering safety measures.
- **Skill mismatches and adverse demographic changes need to be tackled.** Upskilling the labour force, increasing employment among people with disabilities and introducing smart migration policies are all necessary to counteract unfavourable labour supply trends.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.0	2.6	4.2	3.6	3.6
Inflation (average)	-0.7	0.7	3.7	2.5	2.3
Government balance/GDP	-0.3	0.2	0.5	0.6	0.7
Current account balance/GDP	-2.4	-1.1	0.5	0.3	1.2
Net FDI/GDP [neg. sign = inflows]	-1.7	-0.9	-2.0	-0.8	-1.0
External debt/GDP	76.8	86.2	82.6	81.5	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	41.4	42.7	41.0	40.7	n.a.

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Macroeconomic performance

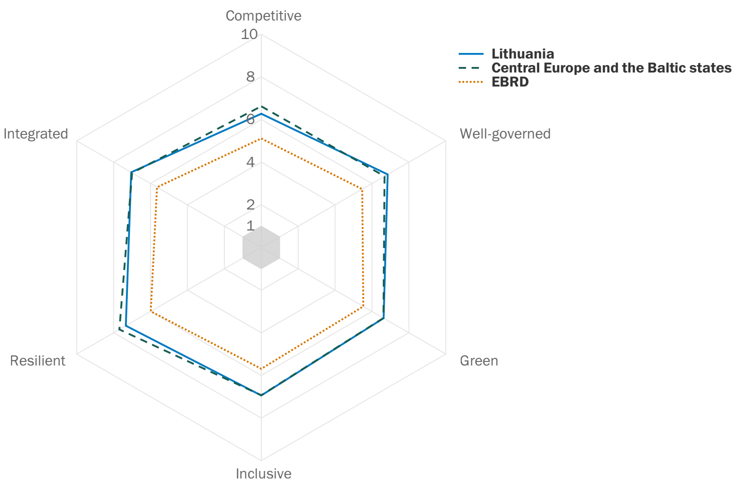
The economic expansion remains robust. GDP growth, at 3.5 per cent in 2018 and 4.1 per cent year-on-year in the first half of 2019, continues to be supported by vibrant household consumption, investment and exports. Recent labour tax reforms have effectively reduced the tax wedge in 2019 and, amid rising wages and low unemployment rates, have provided an additional boost to household spending. Investment growth is strong as a result of better utilisation of EU funds. Net exports have also positively contributed to growth, especially in the first half of 2019, despite the weaker external environment and a strong base effect.

Investment continues to be the critical engine of GDP growth. In 2018, investment grew by 6.5 per cent, and then accelerated to 8.2 per cent year-on-year in the first half of 2019. The improved utilisation of EU funds (66.0 per cent of the funds already allocated at the end of 2018), greater investments in automation by corporates and a positive business sentiment were the key factors in explaining strong investment performance. By contrast, increases in bank lending to non-financial corporates started to decline in the middle of 2018, before coming to a halt in June 2019. This temporary slowdown is largely due to financial imbalances in the Nordic countries, where the headquarters of some parent banks of major Lithuanian banks are located, along with the money laundering scandals that have occurred in all three Baltic states recently.

Public finances saw surpluses for three years in a row. In 2018, the general government balance remained in surplus, at 0.6 per cent of GDP. The structural fiscal position stayed broadly neutral and the achieved surpluses resulted from the better-than-expected economic environment. The government balance is estimated to reach a surplus of 0.7 per cent of GDP in 2019, before it balances in 2020. The pre-financing of 2020 bond redemptions are expected to hit government debt in 2019, which is expected to reach 37.0 per cent of GDP by the end of the year, 2.8 percentage points higher than in the previous year.

Structural factors and demographics are the main risks over the medium term. In the short term, GDP growth is expected to reach 3.6 per cent in 2019 and 2.3 per cent in 2020. Domestic demand will likely remain the key growth engine, driven by strong household consumption and investment, as companies continue to invest in automation amid mounting labour shortages. Greater investment in productivity could partially offset negative demographic trends associated with ageing and emigration.

Assessment of transition qualities (1-10)



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Major structural reform developments

Power grid synchronisation is accelerating. In July 2019, the parliament adopted a law on the synchronisation of the power grid with the continental European system, which, among other effects, will facilitate conditions for land acquisition. In August 2019, the government approved a list of 14 projects, such as the expansion of LitPol power interconnection and the reconstruction of the electricity transmission line between the Lithuanian power plant and Vilnius, which all were granted the status of national importance. In January 2019, the European Commission approved €323 million of financing for the first stage of the grids' synchronisation. The disconnection from the Russian BRELL network (the energy ring linking Belarus, Russia, Estonia, Latvia and Lithuania) and full synchronisation with the continental European system is expected to be completed by 2025.

Lithuania has applied to join the International Energy Agency (IEA). Following acceptance from the IEA's governing board of Lithuania's membership application in June 2019, the accession process will likely start at the end of 2019. As a member, Lithuania will be able to benefit from the experience of advanced economies and actively shape energy, environment and climate-related policies with the other 30 members of the organisation. The process of becoming an IEA member typically takes from two to five years.

Immigration rules are being relaxed to boost labour supply. In April 2019, the government proposed a law introducing quotas for third-country nationals coming to work in Lithuania. These quotas should enter into force in 2021 and be set annually by the Employment Service in response to labour market needs. Highly skilled workers will be exempted from those quotas. Also, citizens of the most economically strong countries who do not require a visa to travel to Lithuania will be easily granted temporary residence permits for up to three years, and will be allowed to bring their families with them. Amid shrinking demographics and mounting labour market shortages, these measures are designed to mitigate the impact of labour supply constraints on Lithuania's competitiveness and growth potential.

The size of the shadow economy is being addressed. In June 2019, the government adopted a set of measures to reduce the shadow economy in the construction, meat and car sectors. The size of the grey economy in these three sectors is estimated by the government at €800 million, with the greatest contribution coming from the construction sector. For the latter, the plan envisages the introduction of mandatory identity cards for builders and a related information system. According to the Shadow Economy Index for the Baltic countries, produced annually by the Stockholm School of Economics, the extent of the shadow economy in Lithuania is 18.7 per cent of GDP in 2018, above Estonia (16.7 per cent) and below Latvia (24.2 per cent).

Linkages between business and science are strengthening. In July 2019, CERN signed an agreement to set up two business incubator centres in Lithuania's two largest cities, Kaunas and Vilnius. The two centres will support the development and application of innovative ideas in technical areas relevant to CERN activities. The Lithuanian businesses will be able to participate in CERN's multi-million euro public procurement projects, while researchers will be able to contribute to major inventions, mainly to research particle physics. Lithuania became an associate member state of CERN in 2018.

The government is creating disincentives for the purchase of cars run on diesel. In August 2019, the government announced that it aims to reduce the country's reliance on old diesel-fuelled cars. The government envisages cash subsidies of €1,000 for citizens who choose to exchange their old diesel cars for newer ones running on petrol, gas or hybrid, which pollute the air less. Currently, about 75 per cent of all cars in Lithuania run on diesel.

Plans for a rail connection between the Baltic Sea and the Black Sea are advancing. In May 2019, the railway representatives of Belarus, Ukraine and Lithuania signed an agreement to launch a container train service between Klaipeda and Odessa. The cargo train connection aims to replace road transportation, is more environmentally friendly and may reduce transportation costs by an estimated 25 per cent.

POLAND

Highlights

- **Domestic demand continues to drive strong economic growth.** Robust household consumption, underpinned by rising disposable incomes, has been the key driver of growth since 2016, while investment growth accelerated in 2018 and in the first half of 2019.
- **A massive fiscal package has been announced.** The cost of the proposed five measures, including pre-election tax cuts and social spending increases, is estimated at 1.8 per cent of GDP annually.
- **The Occupational Pension Scheme (PPK), a new voluntary retirement savings scheme, began in June 2019.** As part of the pension system changes, the government has published a bill that liquidates the second pillar pension funds (OFEs) from 2020.

Key priorities for 2020

- **Controversies related to judicial reform remain to be resolved.** A satisfactory resolution would have a positive effect on business sentiment and could help increase private-sector investment. In related business environment news, Poland fell seven spots to 40th position (out of 190 economies) in the World Bank *Doing Business 2020* report, which makes a total loss of 16 places relative to the 24th position in 2016.
- **The increasing role of renewables should be further reinforced.** In the draft National Energy and Climate Plan (NECP) the country proposed a 21 per cent target for the renewables share in final energy consumption by 2030.
- **National capital markets should be further strengthened.** The draft capital market strategy, adopted by the government in October 2019, sets out two primary goals for the Polish capital market: (i) break down the barriers preventing accessible finance; and (ii) further develop infrastructure that will allow for more agile market development and innovation.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.8	3.1	4.9	5.1	3.9
Inflation (average)	-0.7	-0.2	1.6	1.2	2.3
Government balance/GDP	-2.6	-2.4	-1.5	-0.2	-1.7
Current account balance/GDP	-0.6	-0.5	0.1	-1.0	-0.9
Net FDI/GDP [neg. sign = inflows]	-2.1	-0.9	-1.4	-2.5	-2.2
External debt/GDP	71.8	76.4	67.0	63.9	n.a.
Gross reserves/GDP	19.9	24.3	21.4	20.0	n.a.
Credit to private sector/GDP	51.1	52.4	52.1	51.0	n.a.

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Macroeconomic performance

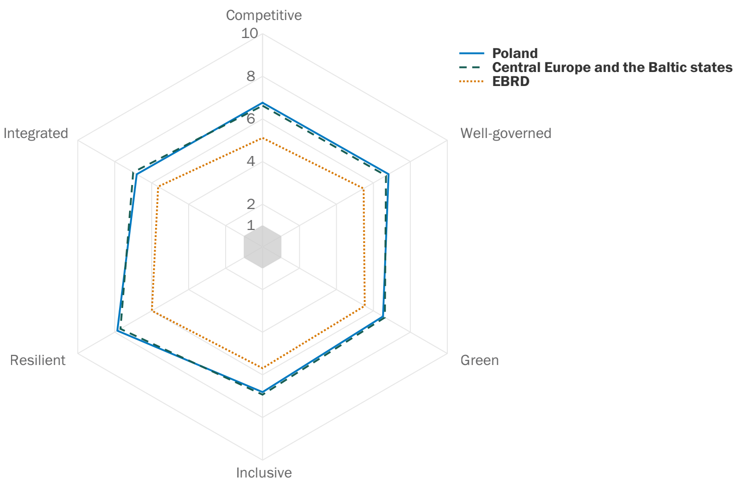
Government spending is providing a substantial boost to GDP growth. Poland's economy grew by 5.1 per cent in 2018, the highest growth rate in central Europe and the Baltic states, then slowed to 4.6 per cent in the first half of 2019. Domestic demand was the principal engine of growth, driven by recovered investment, continuously robust household consumption and especially by strong government consumption, at 4.5 per cent growth in the first half of 2019. A significant wage increase in the economy, averaging 7.1 per cent in the first half of 2019, substantial government transfers and favourable labour market trends have all contributed to increases in household disposable incomes and consumer confidence.

Investment growth improves. Overall, investment rose by 8.7 per cent in 2018. In the first half of 2019, it accelerated further to 10.5 per cent year-on-year, with non-financial corporate investment registering an increase of 19.0 per cent. In particular, companies have been investing strongly in buildings and structures, transport equipment, followed by machines and technical devices. A more intense inflow of European Union (EU) funds has provided a boost to corporate investment, amid mounting needs for greater automation as a result of labour shortages and higher labour costs. The stock of credit to the private sector remains stable, slightly above 50.0 per cent of GDP in the middle of 2019, whereas foreign direct investment inflows slowed from almost 4.0 per cent of GDP in 2016 to 2.8 per cent in 2018.

Fiscal deficits are improving on the back of strong nominal growth, one-off measures and extra taxes. The general government deficit narrowed to 0.2 per cent of GDP in 2018. A sharp increase in fiscal expenditures, such as the child benefit programme or the reduction in the pension age, was largely offset by improvements in tax compliance, including higher revenues derived from the economy's buoyant cyclical position and the introduction of a tax on assets of financial institutions. New social security contributions and one-off revenues, mostly gained from the conversion of the second pension pillar assets and CO2 emission rights, will counterbalance some of the new fiscal measures, with the budget draft forecasting a 0.3 per cent general government deficit (and a 1.3 per cent deficit without one-offs) in 2020. The general government debt to GDP ratio continues to fall and is estimated to drop below 48 per cent by the end of 2020.

Robust growth will continue but the weakening external environment constitutes a negative risk. The Polish economy will likely continue to grow robustly in 2019 and 2020, at 3.9 and 3.5 per cent, respectively. Rising household disposable incomes will drive further strong consumption, which will be only marginally trimmed by rising inflation. For the time being, investment will remain supported by substantial inflows of funds from the EU and government-led investments, including those financed by savings in the Occupational Pension Scheme. Nevertheless, the approaching slowdown in Poland's key trading partners in the EU represents an important risk to that scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

The government has adopted a new capital market strategy. The new strategy, drafted with support from the EBRD and the EU and adopted in October 2019, aims to help Poland's economy to compete successfully in rapidly changing and challenging international markets. The strategy is one of the tools for developing Polish capital markets and is in line with the Strategy for Responsible Development adopted by the Polish government in February 2017. The document sets out 90 steps including measures to improve the regulatory environment by creating a frictionless marketplace, and to develop market infrastructure and introduce new products and services.

A massive fiscal package has been announced. In February 2019, the government announced a package of pre-election tax cuts and social spending increases. They amount to about 1.8 per cent of GDP annually. Among other measures, an expanded (non-means tested) child subsidy increase of about €4 billion a year almost doubles the child subsidy programme introduced in 2016, which ultimately amounts to 1.7 per cent of GDP annually. A "13th" old-age pension disbursement adds an additional 0.4 per cent of GDP in both 2019 and 2020. A uniform reduction of the labour tax wedge for regular contracts adds another 0.2 per cent of GDP. The elimination of personal income tax for those under 26 years old (leaving the social security contribution unchanged) constitutes another 0.04 per cent of GDP and 0.06 per cent of GDP in 2019 and 2020, respectively. Subsidies to public transport for underserved regions are expected to cost 0.03 per cent of GDP. Also, from 1 January 2018, all entrepreneurs conducting research and development (R&D) activities (regardless of their size) can benefit from an additional deduction of 100 per cent of eligible costs, and research and development centres up to 150 per cent. Along with the increase of deductions for R&D tax relief, the catalogue of eligible costs was extended. Furthermore in 2019, preferential taxation of income generated on the basis of intellectual property rights (IP Box) entered into force with a 5 per cent rate. IP Box relates to income obtained from the commercialisation of entrepreneurs' intellectual property rights.

Pension system reform continues. The Occupational Pension Scheme (PPK), a new voluntary retirement savings scheme, began in June 2019. The main goal of the scheme is to increase the domestic savings rate, as participants will put aside between 0.5 and 4.0 per cent of their income, topped up by an additional 1.5 per cent to 4.0 per cent by the employer and some additional money by the state. The extra money saved by participants is aimed to partially offset the low pension replacement rates. In addition, in May 2019, the government published a bill that liquidates the second pillar pension funds (OFEs) from 2020. The OFEs' assets will be transferred either to the first pillar pension funds or to the Personal Retirement Accounts (IKEs). As the IKE option privatises the pension fund assets, a 15.0 per cent conversion fee will be charged. While the government predicts that 80.0 per cent of future pensioners will choose the IKE option, both options are expected to raise one-off income for public finances. In fact, the remaining 20.0 per cent will be credited to the Social Insurance Fund (FUS), from which pensions are paid out.

"Pro-family" measures have been extended. In March 2019, special pension rights, at the level of the minimum old-age pension, to women giving birth to at least four children. Moreover, the Family 500+ programme was extended to include all children in July 2019. As many beneficiaries of the latter change are mid to high-income, the short-term consumption, income equality or natality effect is likely to be limited. The expected costs of the programmes are 0.03 per cent and 1.7 per cent of GDP, respectively.

Disagreement raised by judicial reform has continued. The European Commission (EC) and the Polish government have continued to engage in the rule-of-law dialogue in the framework of the Article 7(1) procedure triggered by the EC in December 2017. On 3 April 2019, the EC launched an infringement procedure against Poland on the grounds that the new disciplinary regime for Polish judges undermines their judicial independence and does not guarantee to protect judges from political control. The new procedure follows two previous infringement procedures concerning the law on ordinary courts (launched in July 2017) and regarding the law on the Supreme Court (launched in July 2018), both on the grounds of their retirement provisions and their impact on the independence of the judiciary and of the Supreme Court. The Court of Justice of the EU delivered its

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final judgment on the Polish law on the Supreme Court (case C 619/18) in June 2019, having found that lowering the retirement age of judges of the Supreme Court in Poland was contrary to EU law and breached the principle of judicial independence. Prior to the final judgment of the Court of Justice of the EU, Poland adopted a law on 21 November 2018 reinstating the Supreme Court judges previously forced into retirement, thus correcting the effects of the law on the Supreme Court.

Electricity prices have been frozen. Following a sharp increase in electricity prices in 2018 (a 43.0 per cent increase of the average day-ahead electricity price on the Polish power exchange), largely driven by rising coal prices and carbon emission costs, the government adopted a law in January 2019 to keep electricity prices in 2019 at the level registered in the first half of 2018. Following EU objections to this measure, the authorities have been working with the EC to adjust the underlying regulations so that they are consistent with EU regulations, while still temporarily reducing the burden of high electricity prices for end-consumers. These developments have somewhat hindered the liquidity of the electricity market, but, more importantly, have sent a negative signal for the regulatory predictability in the sector. However, with the interim nature of the price freeze, these negative implications are expected to be temporary.

A clear path for change in the energy mix has been set. The first large-scale renewables auctions were successfully conducted in November 2018, attracting a wide range of investors and demonstrating the increasing competitiveness of renewables. The winning projects are expected to add over 1.5 GW of renewable energy capacity to the Polish energy system. Poland has also reconfirmed its long-term ambitions to diversify the energy mix. In the draft NECP the country has proposed a 21.0 per cent target for the renewables share in the final energy consumption by 2030. This translated to a target of approximately 27.0 per cent renewables in net electricity production, which would require a near tripling of renewable electricity generation in the next decade. The final NECP, to be submitted by the end of 2019, may also include an even more ambitious target, following discussions between the EC and the Polish government.

SLOVAK REPUBLIC

Highlights

- **Gross domestic product (GDP) growth has lost momentum.** Following solid growth stemming from strong household consumption and investment in 2018, the economy has slowed in the first half of 2019, although exports continue to perform well.
- **Measures to simplify foreigners' recruitment have been introduced.** New legislation is intended to shorten the time required for assessing requests from those who live outside the European Union (EU) for residence and employment in the Slovak Republic, particularly in professions with identified labour shortages.
- **Improvements in the fight against corruption have entered into force.** A new independent state administration body provides protection and remuneration to whistleblowers, and monitors the compliance of authorities with the new anti-corruption law.

Key priorities for 2020

- **Educational reform should focus on matching labour demand and supply.** Key short-term measures should include fostering skills, in particular through training and requalification programmes, with a greater engagement of the business sector.
- **Sustainability of the healthcare system needs to improve.** Measures proposed in the Value for Money project in November 2018 would make current healthcare spending more efficient and effective and could free up around €140 million for additional spending in the sector.
- **Decommitment of funds from the EU that have already been allocated should be avoided.** Efforts should be intensified to improve strategic planning, strengthen capacity and overcome administrative problems so that allocated EU funds can be used effectively.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	4.8	2.1	3.0	4.0	2.5
Inflation (average)	-0.3	-0.5	1.4	2.5	2.6
Government balance/GDP	-2.7	-2.5	-1.0	-1.1	-0.9
Current account balance/GDP	-2.1	-2.7	-1.9	-2.6	-2.0
Net FDI/GDP [neg. sign = inflows]	-0.1	-0.8	-2.8	-0.9	-0.1
External debt/GDP	85.2	92.2	107.8	113.0	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	53.3	57.3	60.4	62.5	n.a.

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Macroeconomic performance

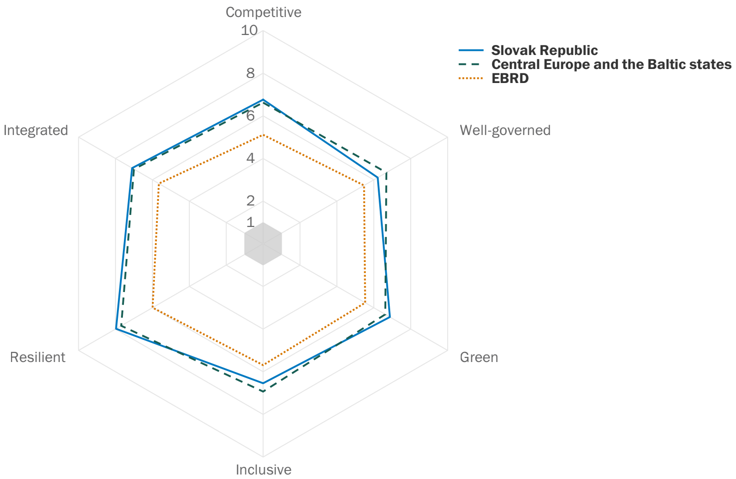
Economic growth has slowed. Domestic demand, particularly household consumption and investment, continued to underpin GDP growth of 4.1 per cent in 2018. However, a slowdown is evident in the first half of 2019, with the economy growing by just 3.0 per cent year-on-year. Despite weakening external demand in western Europe, exports grew by 3.9 per cent in the first half of the year. Inflation accelerated to 2.5 per cent in 2018, and further to 3.0 per cent in July 2019. Service price inflation saw the greatest hikes, in line with expectations of rapidly rising wages and positive consumer confidence.

Investment has moderated. As many large investment projects were completed in 2018, such as the construction of the Jaguar plant and some other upgrades of existing automotive capacities, investment growth decelerated from 3.7 per cent in 2018 to 1.3 per cent in the first half of 2019. While further foreign direct investment is expected this year, such as the Swiss Mubea Automotive project to construct a manufacturing plant in Presov, one of the least-developed regions in the Slovak Republic, overall investment is expected to slow, largely due to cyclical reasons. Lending to private-sector companies, especially with a maturity over five years, remains robust, but also started to lose steam in the first half of 2019.

The fiscal deficit remains historically low. The strong GDP upswing in 2018 resulted in higher tax revenues, which enabled an increase in current transfers and subsidies and higher public-sector wages. The general government deficit saw a slight deterioration to 1.1 per cent of GDP in 2018. In 2019, it is expected to improve to 0.9 per cent of GDP, before it increases somewhat in 2020, partially driven by the upcoming elections. Public debt dropped below 49.0 per cent of GDP in 2018, and will likely decrease further in the short term.

External uncertainties are the main risks to further economic growth. GDP growth will likely continue to be driven by domestic demand, although its strength will moderate. We expect growth to slow to 2.5 per cent in both 2019 and 2020. Key negative risks include the possibility of a hard Brexit and the eurozone's economic slowdown. By contrast, improved absorption of EU funds provides upside potential to that scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

A new retirement age cap is a setback to pension sustainability. In March 2019, the parliament amended the constitution by introducing a retirement age ceiling of 64 years, effective from July 2019. Previously, the formula for pension calculations tied the retirement age to average life expectancy, which is revised annually. The amended law allows women to retire earlier if they raise children and up to a year and a half early in the case of three children or more. Amid a rapidly ageing population and a rising life expectancy, embedding the retirement age cap in the constitution will adversely affect public finances and threaten the sustainability of the future pension system. According to the fiscal responsibility council, the measure will reduce future pensions by 10 per cent and will lead to a level of GDP 9 per cent lower than in a status quo scenario by 2067.

Improvements in the fight against corruption have entered into force. In February 2019, the President signed a law on the protection of whistleblowers that sees the formation of an independent state administration body with nationwide power. Effective from March 2019, the law provides protection and remuneration to whistleblowers, monitors adherence to the new anti-corruption law and educates the public about the fight against corruption. The amended law makes the protection of whistleblowers more flexible and faster than before. Until now, only whistleblowers who brought information that significantly contributed to clarifying a deed were eligible for protection. In 2018, the Slovak Republic was ranked 57th in the perception of corruption index by Transparency International, three spots lower than in the previous year.

Legislation to enhance the business environment has been proposed. In February 2019, the government approved a package of 36 measures to reduce the administrative burden on businesses and to promote digitalisation. The majority of measures are expected to be implemented by the end of 2019 and the rest in 2020. This package follows two other anti-bureaucratic packages, approved in June 2017 and May 2018, respectively. All three are expected to provide businesses savings of more than €100 million annually. In the World Bank's *Doing Business 2020* report, the Slovak Republic dropped three places to 45th out of 190 countries. The most significant deterioration was registered under the resolving insolvency sub-category. In contrast, the score for starting a business improved significantly, largely due to the abolition of the requirement to obtain and submit information on tax arrears.

Measures to simplify the recruitment process for foreigners aim to mitigate the impact of labour shortages. An amendment to the Act on Employment Services came into force in January 2019. It is intended to shorten the time for assessing non-EU nationals' requests for residence and employment in the Slovak Republic, particularly in professions with identified labour shortages. For instance, the process linked to employing foreigners has decreased in length from around 150 to 90 days. According to the country's employers' union, the Slovak economy currently needs approximately 100,000 extra workers. The Slovak Ministry of Labour estimates that the economy will need more than 500,000 new workers by 2023, mainly in industry, commerce, education, healthcare, transport and construction. As of the end of June 2019, there were more than 73,000 foreign workers in the Slovak Republic.

EU funds absorption has remained problematic. According to the prime minister's office, the Slovak Republic placed 23rd in the EU and last among the Visegrad-4 countries in terms of the share of payments received at the end of 2018 from the country's 2014-20 EU funds allocation. The government expected that the absorption of EU funds would exceed €5 billion by the end of 2019, which would represent 33 per cent of the total allocation of €15.3 billion. According to the European Commission, the lack of capacity, the absence of strategic planning as well as administrative problems are the key obstacles preventing the smooth absorption of EU funds. Consequently, the Slovak Republic has already lost €120 million in funding, partially driven by the scandals at the education ministry in 2017.

A law on the impact of Brexit is expected to lessen the potential negative impact. In March 2019, the government passed legislation amending several acts in preparation for a potential hard Brexit by the United Kingdom (UK). These measures would be effective only if the UK leaves the EU without a deal. A potential no-deal Brexit outcome is expected to have an impact not only on direct trade between the Slovak Republic and the UK, but also on indirect exports through value chain integration within the EU. According to EBRD estimates, indirect exports account for 30 per cent of overall domestic value added exports to the UK.

SLOVENIA

Highlights

- **Robust economic growth is continuing.** Gross domestic product (GDP) grew by 4.1 per cent in 2018, following 4.8 per cent in 2017. Growth was broad-based, and among the highest in the European Union (EU).
- **Fiscal performance remains strong.** Following the balanced budget in 2017, the government reached an overall fiscal surplus in 2018, the first time since the country gained independence.
- **The restructuring of the banking sector has been completed.** The privatisation processes of NLB and Abanka have been completed, in accordance with the country's commitments to the European Commission (EC) following the government's bailout of, and state aid to, the banking sector in 2013.

Key priorities for 2020

- **Further fiscal adjustments are needed to reduce public debt sustainably.** In light of still-high public debt levels, the authorities should keep expenditure growth under strict control to achieve their medium-term fiscal targets, while an ageing population highlights the need to reform the pension, health and long-term care systems.
- **Privatisation of state-owned enterprises (SOEs) needs to be prioritised as it would enhance competitiveness and productivity.** SOEs remain dominant in a few sectors, therefore privatisation should be accelerated so that performance can be improved.
- **Despite significant improvements in recent years, corporate over-indebtedness highlights the need for more capital market financing (primarily equity) and governance improvements.** Notwithstanding the substantial deleveraging in recent years, the country still has one of the highest ratios of long-term debt of over-indebted companies to GDP among the peer central and eastern European countries.[1]

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.2	3.1	4.8	4.1	3.0
Inflation (average)	-0.8	-0.2	1.6	1.9	1.8
Government balance/GDP	-2.8	-1.9	0.0	0.8	0.7
Current account balance/GDP	4.5	5.5	7.2	6.4	5.8
Net FDI/GDP [neg. sign = inflows]	-3.3	-2.1	-1.2	-2.0	-1.0
External debt/GDP	116.4	104.5	105.3	88.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	48.7	45.7	44.0	42.2	n.a.

CONTINUES

[1] The long-term debt is concentrated in a small number of companies, including in the Slovenian highways company, reflecting major investments in this sector over the last 20 years.

Macroeconomic performance

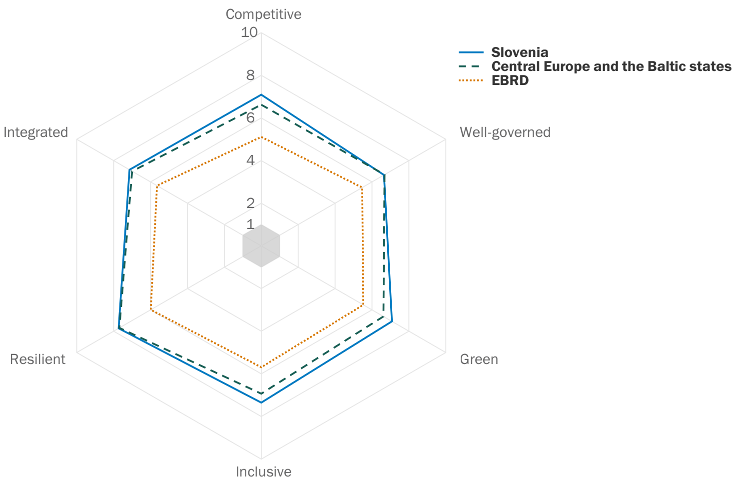
The economy continued to grow strongly in 2018. Real GDP growth was 4.1 per cent, among the fastest growth rates in the EU, following 4.8 per cent in 2017. Growth was broad-based, with investment being the largest contributor in both years, rising by more than 10.0 per cent each year. The strong labour market (unemployment being just 4.4 per cent as of the end of 2018), combined with a 3.0 to 4.0 per cent earnings growth in both 2017 and 2018, contributed to rising private consumption, of which growth remained robust at around 3.0 per cent. Exports continued their strong performance and grew by more than 6.0 per cent in 2018, helping net exports to contribute positively to growth despite a domestic demand expansion, which also pushed imports up. GDP increased 2.9 per cent year-on-year in the first half of 2019. Inflation has picked up but remained relatively low, averaging 1.9 per cent in 2018 (measured by the change in the Harmonised Index of Consumer Prices).

The fiscal position has improved significantly. The general government budget was balanced in 2017 for the first time since independence in 1991 and in surplus by 0.8 per cent of GDP in 2018. The improvement in the fiscal position came as a result of expenditure restraint (due to existing austerity measures in the field of social and family benefits and labour costs in the public sector), the strong cyclical growth in revenues, and the reduction in the interest payment burden on outstanding debt. The budget surplus and strong nominal GDP growth led to a significant decline in the ratio of public debt to GDP, from a peak of 83.0 per cent in 2015 to 70.0 per cent in 2018. The declining trend is expected to continue.

The sovereign credit rating has improved further. In June 2019 Standard & Poor's rating agency upgraded Slovenia's sovereign credit rating from A+ to AA-, with a stable outlook. In July 2019 Fitch upgraded Slovenia's rating from A- to A, also with a stable outlook. The upgrades reflect Slovenia's strong growth developments, fiscal surpluses and public debt improvements. This follows the country's exit from the EU's Macroeconomic Imbalances Procedure (MIP) in 2018 (having entered the procedure in 2013), following the EC's assessment that the country had made significant progress in fiscal consolidation, bank resolution and corporate deleveraging.

Growth is likely to moderate in the medium term. The economy is projected to grow at 3.0 and 2.8 per cent in 2019 and 2020, respectively, as the temporary effects of the new investment cycle wear off and the economy reaches its potential. Private consumption, supported by rising employment and wages, and favourable bank lending conditions, are expected to play a major role in maintaining solid growth rates over the forecasting period. The risks to the downside come from possibly weaker demand from main trading partners, as the country's economy, which is highly integrated into eurozone supply chains, significantly relies on exports. On the other hand, a stronger-than-envisaged government investment cycle and growth in private consumption could push up short-run growth rates above projections.

Assessment of transition qualities (1-10)



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Major structural reform developments

The business environment is improving. Slovenia ranks 37th (out of 190 economies) in the World Bank's *Doing Business 2020* report, three positions higher than the year before. The country ranks 35th among 141 countries (the same position as in the previous year) in the World Economic Forum's Global Competitiveness Index 2019. Slovenia scores particularly well on macroeconomic stability (that is, inflation and debt dynamics), but significant obstacles are the small market size (82nd), and the depth and stability of the financial system (61st).

Slovenia's foreign direct investment has risen sharply in recent years due to takeovers. These include instances of privatisations in the banking sector, including that of the country's largest bank, NLB, through an initial public offering (IPO), but also includes China's Hisense takeover of the Slovenian household appliances maker Gorenje in 2018 and Generali Group's acquisition of insurer Adriatic Slovenica and fund manager KD Funds in 2019.

The privatisation processes of NLB and Abanka have been completed. With the sale of the remaining 10.0 per cent stake on the London Stock Exchange in June 2019, the Republic of Slovenia completed the privatisation process of NLB, the largest bank in the country. The first phase of the privatisation process was implemented in November 2018, when the Slovenian Sovereign Holding (SSH), in the government's name, carried out the IPO of a 65.0 per cent stake, listing the shares of NLB on the Ljubljana and London Stock Exchanges. A further 10.0 per cent was sold in June 2019; the Republic of Slovenia will remain the largest shareholder of NLB, with a 25.0 per cent stake plus one share. In June 2019 the SSH signed the sale and purchase agreement for Abanka, which is 100.0 per cent state-owned and the country's third-largest bank, with a market share of about 10.0 per cent, with the NKBM bank, the country's second-largest, which is owned by US investment fund Apollo and the EBRD. The closure of the transaction is subject to receiving all necessary approvals from the relevant authorities. Following the acquisition, the combined market share of the two banks will reach 22.0 per cent, almost equal to that of NLB. Also, in May 2019 Hungary's OTP Bank signed a deal to buy SKB Banka, the subsidiary of Société Générale, as part of a regional buy-out. SKB Banka has a market share of 9.0 per cent and is the fourth-largest bank in Slovenia.

The parliament has approved the Act on judicial and out-of court relief granted to holders of qualified bank credit (the so-called "bailout law"). The objective of the Act is to prescribe a process for judicial protection of former holders of qualified bank credit, compliant with the Constitutional Court decision on the topic. Any potential compensation will be paid by the Bank of Slovenia, subject to the rules on liability for damages in force at the time of the imposition of the extraordinary measures arising from the 2013 banking system overhaul. At the time, the sector was burdened with a large number of bad loans, and six banks – NLB, NKBM, Abanka, Banka Celje, Probanka and Factor banka – received capital from the government. In the meantime, Probanka and Factor banka were liquidated, while Banka Celje was merged with Abanka, which (as noted above) was recently bought by NKBM. At the same time, a total of around €600 million of subordinated bonds were scrapped. Many former subordinated bondholders and shareholders are now suing the banks and the central bank to get their money back.

Slovenia has adopted energy law amendments. In June 2018 the parliament adopted amendments to the Energy Law, which bring in a number of changes, including transposing EU directives' provisions on energy efficiency, following a warning on non-compliance from the EC. In addition, if it does not meet the targets for electricity generation from renewable energy sources, the amendments will allow the country to meet these obligations by making renewable energy payments to other EU countries. Energy consumption from renewable sources in Slovenia, at 22.0 per cent in 2018, is still below the 2020 target of 25.0 per cent.

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The government has passed pension and tax system reforms, aimed at better social protection and longer labour activity. In October 2019 the government adopted various measures, including increases in vesting percentage, disability benefits and minimum pensions, and more generous benefits for pensioners with more than 40 years in employment and for those on maternity or paternity leave. The changes also include raising the replacements rates and providing further incentives to remain in the insurance scheme and prolong active participation in the labour market. The government will also continue the dialogue with social partners to address other issues of the pension system, such as the retirement age. The ageing population of the country is one of the main challenges for Slovenia, making healthcare and long-term care among the high-level priorities of the Slovenian government. This issue is expected to put an increasing burden on public finances in the long run. At the same time, the government adopted measures to lower labour taxation to boost growth. After reduction in the taxation of the holiday allowance, implemented in spring 2019, the additional tax changes include reducing the tax rate for personal income within certain brackets, and increasing general tax allowances. The revenue implications of these measures will be offset by the restriction on the use of corporate tax reliefs up to a certain percentage of the tax base, by some changes in capital taxation for individuals and rental income, and by putting an extra effort into improving the efficiency of collecting fiscal duties.