CROATIA

Highlights

- **Growth accelerated in 2016.** GDP grew by 3.0 per cent in 2016 after 2.3 per cent in 2015, supported by a good tourism season, stronger external demand and lower oil prices. Growth is expected to remain at a similar rate in 2017.
- **The general government deficit fell from 5.1 per cent of GDP in 2014 to 0.9 per cent of GDP in 2016.** The fiscal consolidation was helped by lower public investments, subsidies and wage bills as well as increasing revenues on the back of stronger economic growth. Public debt started to decrease in 2016, but was still high at 82.9 per cent of GDP.
- **The 2017 National Reform Programme reinforced a wide-ranging reform agenda.** The programme focuses on boosting competitiveness, as well as employment, through better linking education with labour market needs, and enhancing the sustainability of public finances.

Key priorities for 2018

- **Fiscal discipline needs to be sustained and underpinned by further structural measures,** as envisaged in the Convergence Programme. Sustainable reduction of the public debt requires targeted public expenditure cuts, increased efforts to tap European Union (EU) funds, and improvements in the efficiency of state-owned enterprises (SOEs).
- **Business environment reforms should be accelerated to attract much-needed investment.** The announced measures, including a gradual reduction of administrative costs and para-fiscal charges, improvement in the cadastre and land registry systems, enhancement of the management and monitoring of SOEs, and making court procedures more efficient are welcome.
- **Further resolution of (corporate) non-performing loans (NPLs) and corporate restructuring are needed to sustain long-term economic growth.** NPL levels have fallen and sales of NPL portfolios by banks have picked up recently but the levels of corporate NPLs and long-term debt of overleveraged companies remain high by regional standards.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	-0.6	-0.1	2.3	3.0	2.9
Inflation (average)	2.2	-0.2	-0.5	-1.1	1.1
Government balance/GDP	-5.3	-5.1	-3.3	-0.9	-1.2
Current account balance/GDP	1.0	2.1	4.8	2.6	4.0
Net FDI/GDP [neg. sign = inflows]	-1.9	-1.6	-0.6	-4.2	-2.7
External debt/GDP	105.3	108.0	103.0	90.9	n.a.
Gross reserves/GDP	29.7	29.5	31.1	29.5	n.a.
Credit to private sector/GDP	70.0	69.3	65.5	61.7	n.a.

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Macroeconomic performance

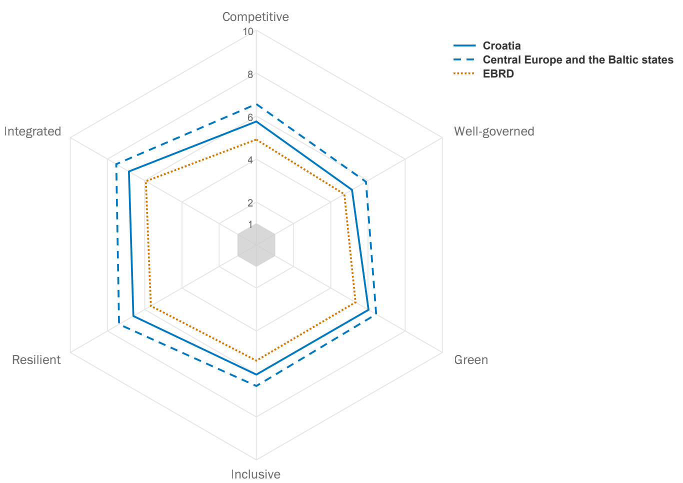
Growth accelerated in 2016, backed by several cyclical factors. After 2.3 per cent growth in 2015, the recovery continued in 2016 with 3.0 per cent GDP growth, driven by strong exports and domestic demand. The economy expanded by 2.7 per cent in the first half of 2017 on the back of strong consumption and exports growth. Unemployment decreased from 13.1 per cent in September 2016 to 10.8 per cent in September 2017. As the economy is recovering inflation has started to pick up, reaching 1.4 per cent year-on-year in September 2017.

Agrokor's financial problems have not resulted in significant adverse economic effects, but some risks remain. Agrokor is the largest private Croatian company, a concern that (in)directly employs more than 60,000 employees in the region, of whom around 30,000 are in Croatia. It is also the biggest food producer and retailer in the Western Balkans with annual revenues of some HRK 50 billion (€6.7 billion) and liabilities of around €6 billion. Credit ratings of the company have been downgraded in the past 12 months due to the high level of indebtedness, potentially jeopardising its long-term future and the jobs of current employees. As a consequence, the parliament has adopted a law aimed at protecting the sustainability of business operations of systemically important companies (including Agrokor), allowing the government to appoint a trustee to manage them for up to 15 months with the ultimate goal of reaching a settlement with creditors and eventually restructuring the company.

The large fiscal adjustment was supported by the economic recovery. The general government deficit fell from 5.1 per cent of GDP in 2014 to 0.9 per cent of GDP in 2016, on the back of lower public investments, subsidies and wage bills as well as increasing revenues. As a result, Croatia exited the Excessive Deficit Procedure in June 2017. Public debt, while still high, started to decrease in 2016, reaching 82.9 per cent of GDP by the end of 2016. The 2017 fiscal deficit is estimated at 1.2 per cent of GDP, based on the assumption of accelerating growth boosted by the planned tax reform, which includes the reduction of personal income and corporate profit taxes. Given the expectations that economic growth will support further improvements on the fiscal side, in September 2017 Standard & Poor's upgraded its outlook on Croatia's sovereign rating (BB/B) to positive from stable.

Growth may decelerate somewhat in 2018 as key drivers face capacity constraints. Economic growth is projected to reach 2.6 per cent in 2018 after 2.9 per cent in 2017. The slight slow-down is partly due to the tourism sector again experiencing a record year, making it unlikely to be repeated next year without capacity increases and upgrades. High corporate over-indebtedness, a potential slow-down in investment and a potentially disruptive restructuring process at Agrokor are all risk factors that could hold back growth.

Assessment of transition qualities (1-10)



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Major structural reform developments

Some steps have been taken towards improving the investment climate, but long-standing difficulties have not yet been addressed. Croatia ranks 51st (out of 190 economies) in the World Bank's *Doing Business 2018* report (down eight places from the previous year). The country's ranking worsened significantly in paying taxes, due to lower efficiency of post-filing processes. While dealing with construction permits remains an important obstacle (ranking 126th), transferring property has become less costly. Croatia's competitiveness remains low according to the Global Competitiveness Index published by the World Economic Forum, as it ranks 74th among 137 countries (unchanged from last year). Despite improvements in some areas (the macroeconomic environment, technological readiness, health and primary education), Croatia has worsened its standings in others (higher education, innovation, institutions). The main obstacles for doing business remain unchanged from last year (inefficient government bureaucracy, tax rates and regulations, policy instability and corruption).

The government has taken steps to reduce the administrative burden and barriers for doing business. A new regulation, effective from January 2017, cuts some state administration charges by 30 per cent, including those payable for issuing passports and driving licences, as well as establishing a company. The government has promised to introduce 104 measures in 2017 to reduce the administrative burden on enterprises, which are projected to result in savings for businesses amounting to HRK 1.5 billion (€200 million).

Tax reform has advanced. The tax reforms for 2017 include: cutting the corporate income tax rate from 20 to 18 per cent (and to 12 per cent for small and medium-sized enterprises), adopting two rates of personal income tax (36 and 24 per cent instead of 12, 25 and 40 per cent), and increasing non-taxable income to HRK 3,800 from HRK 2,600 (around €510 and €350, respectively). Rates for the value added tax (VAT) were also adjusted to make the VAT system less regressive, and excise taxes on fuels were aligned with EU legislation. The expected direct budgetary effect is a revenue reduction of 0.6 per cent of GDP in 2017 and an additional 0.2 per cent in 2018.

Privatisation has been moving ahead, albeit slowly. In 2016, the sale of stakes in (non-strategic) companies yielded income of only 0.2 per cent of GDP in 2016. No significant steps were taken in the first half of 2017, but the government has announced the potential renationalisation of the local oil and gas company INA through a buy-back of MOL's share in the company (49 per cent, including the management rights), and the recapitalisation of defence-to-construction company Djuro Djakovic, which will reduce the state share below 50 per cent. In addition, the state-controlled chemical producer Petrokemija is in the process of privatisation.

The highly indebted road sector is to be restructured. In March 2017 the government announced that state-owned road companies are to be merged and their debt is to be restructured, with World Bank support. The reforms are expected to be completed by 2020. The three road companies (HC, HAC and ARZ) have amassed a debt of €5.2 billion (more than 10 per cent of GDP), due to the fast expansion and modernisation of the road infrastructure in the past 20 years, which has been supported by state guarantees.

NPL resolution has progressed, mostly through market transactions. According to the Croatian National Bank, NPLs amounting to HRK 6 billion (around €800 million) were sold in 2016 (up from €240 million the year before), while the purchase price improved to 30.1 per cent of total sold claims, from 21.6 per cent in 2015. In the first quarter of 2017, another HRK 1 billion (around €130 million) was sold at the purchase price of 26.9 per cent. As a result, the NPL ratio fell from 16.7 per cent at the end of 2015 to 13.2 per cent in June 2017. The tax reform allows one-off deductibility of NPL write-offs, which may facilitate their faster resolution in 2017.

ESTONIA

Highlights

- **Economic expansion is accelerating.** Following a slow-down in 2015, GDP growth has been gaining momentum since 2016. Investment growth, which turned positive only in 2017, and robust private consumption will likely boost GDP growth further.
- **Digital Europe and the free movement of data are key priorities in Estonia's EU presidency.** Estonia is chairing the work of the European Council during the second half of 2017 and the focus on an open and innovative European economy builds on the country's reputation as one of the world's most digitally advanced countries.
- **Several changes to the pension system have been introduced.** Among others, the retirement age will be tied to average expected life expectancy from 2027 onwards, a solidarity-based first pillar will be introduced from 2037, and special pensions for some professions will be abolished from 2020.

Key priorities for 2018

- **The government should continue with its efforts to address the labour shortage issue.** After several good labour market policies have been introduced, such as the work ability reform, further efforts to mobilise labour supply for the private sector remain necessary. For example, some labour resources could be freed up from the public sector or more immigration from outside the European Union (EU) could be allowed.
- **A successful implementation of administrative reform will likely deliver substantial efficiency gains.** The already-undertaken local government reform is aimed at a more efficient tasks distribution between municipalities and local government as well as at implementing the local government's financing scheme.
- **Cooperation between business and academia should be further enhanced.** While Estonia substantially outperforms its regional peers in innovation, the still-low level of business investment in technological development and weak research and development commercialisation remain challenges for productivity growth and for increasing the value-added of exports.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.9	2.9	1.7	2.1	3.7
Inflation (average)	3.2	0.5	0.1	0.8	3.5
Government balance/GDP	-0.2	0.7	0.1	-0.3	-0.1
Current account balance/GDP	0.1	0.3	2.0	1.9	1.9
Net FDI/GDP [neg. sign = inflows]	1.0	2.3	0.6	-2.4	-3.6
External debt/GDP	93.1	96.4	94.3	90.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	69.5	68.8	70.1	72.1	n.a.

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Macroeconomic performance

GDP growth is gaining momentum. Following a sharp slow-down in 2015, GDP growth accelerated somewhat to 2.1 per cent in 2016 and further to 5.2 per cent in the first half of 2017. This year, investment growth has turned positive for the first time since 2013 (see below). Private consumption, which was the key growth engine over the last four years, has been gradually superseded by strongly recovering investment and exports.

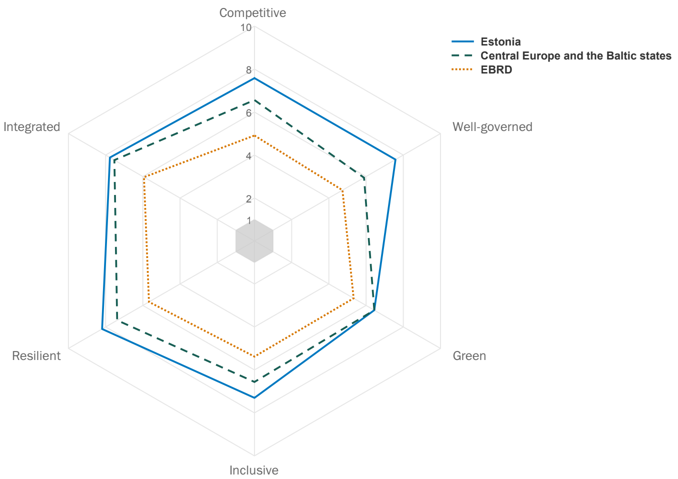
Investment growth has picked up. Investment started to recover at a rate of 17.6 per cent during the first half of 2017, after registering a cumulated contraction of above 12 per cent during 2013-16. A gradual rise in EU funds utilisation from the current EU budget is expected to boost public investment, further supported by fiscal loosening in 2017 and 2018. Amid strong private credit growth and improving external demand, private investment is also likely to rebound in the near term.

Employment rates are booming. An increase in the effective pension age, rising real wages and the recent government's active labour market policies (see below) have resulted in historically high employment rates. In the first half of 2017, the employment rate reached 75.5 per cent (20-64 age group), placing Estonia among the highest countries on this measure in the European Union.

The fiscal balance is expected to turn slightly negative in the short term. In 2016, public finances saw a marginal budget deficit of 0.3 per cent of GDP. However, starting from 2017, the new State Budget Act, adopted by the parliament in June 2017, allows the government to run temporary structural budget deficits of up to 0.5 per cent of GDP in a single year in the account of previously accumulated structural surpluses, but still targeting structural balance in the medium term. Higher fiscal spending is expected to finance government investment programmes as well as some new programmes in healthcare, education, social funding and in local governments. At the same time, public debt is expected to remain below 10 per cent of GDP.

Strengthening investment is expected to boost GDP growth. Amid substantial recovery in both public and private investment, GDP growth will likely accelerate to 3.7 per cent this year and 3.4 per cent in 2018. The impact of recovering external demand on GDP will be somewhat neutralised by strong investment-driven imports. The main downside risks are associated with a possibly weaker-than-expected recovery in Finland and Russia as well as low shale oil prices.

Assessment of transition qualities (1-10)



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Major structural reform developments

Changes to the pension system are ongoing. In January 2017, the ruling coalition agreed to make substantial changes to the pension system. First, the retirement age will be tied to the expected average life expectancy from 2027 onwards. Second, a solidarity-based first pillar will be introduced from 2037, in which the insurance component would be replaced by a length of service component, exclusively dependent on the number of years worked. And third, special pensions for some professions, such as military, prosecutors and police would be abolished from 2020. The draft bill is expected to be ready at the beginning of 2018.

The government has agreed to sell stakes in four state-owned enterprises. In April 2017, the government approved a decision to list 30 per cent of the Port of Tallinn in the first half of 2018. Also, the railway company EVR Cargo, the road construction company Eesti Teed and Eesti Energia's sustainable energy division are scheduled to be sold through initial public offerings. More details will be announced by the end of 2017. The government believes these operations would revive local financial markets by providing new opportunities for residents and local institutional investors to invest in Estonia.

Estonia's EU presidency is to give a strong push towards Digital Europe and the free movement of data. During its presidency, which started in July 2017 and will last until the end of the year, Estonia's priorities include the promotion of an open and innovative European economy, EU security, ensuring free movement of data and fostering an inclusive and sustainable Europe, mainly by modernising the rules to promote labour mobility. As Estonia is one of the world's most digitally advanced countries, especially in terms of e-governance and e-residency, the digital transformation and cross-border movement of data, in particular in the context of e-health, are expected to top its presidency's agenda.

The first offshore wind farm project is moving forward. In August 2017, the council of the Hiiu municipality signed a cooperation agreement with Nelja Energia, the Estonian wind energy developer, to build an offshore wind farm near Hiiumaa island in the Baltic Sea. According to the plans, the offshore wind farm would comprise 100 to 160 wind turbines with an aggregate capacity of 700 to 1,100 MW. Construction is expected to start in the second half of 2018. With a renewable energy share of 27.9 per cent in 2015, Estonia has already exceeded its 25.0 per cent target for 2020. Nevertheless, the national energy development plan, which was adopted by the government in October 2016, targets renewable energy to account for 50.0 per cent of total electricity consumption by 2030, with renewables to cover 80.0 per cent of the entire heat production by that time.

Perception of corruption remains the lowest in the region. In the 2016 Corruption Perception Index prepared by Transparency International, Estonia moved up one position to 22nd, which is ahead of all EU new member states. By and large, the corruption-related risks have been effectively reduced through the well-developed e-services sector. Today, all voting can be done online and about 95 per cent of tax returns are being completed in this way.

The government has introduced further active labour market policies. Following the successful introduction of a reforms package in January 2016 aimed at bringing more workers with disabilities into the workforce, a new employment programme was approved by the government in November 2016, which aims to provide fresh measures to help people stay active in the labour market. In particular, it concentrates on excluded groups such as people lacking specialised education or having outdated education, those lacking a good command of the Estonian language, and people older than 50 years of age. The shrinking working-age population and labour skill-mismatch remain the key challenges for further productivity growth of the Estonian economy.

HUNGARY

Highlights

- **Recovering investment is boosting growth amid strong private consumption.** Following a slow-down of GDP growth in 2016, growth is accelerating again in 2017, underpinned by rising investment and private consumption and a resumption of positive credit growth to the private sector.
- **Measures to enhance competitiveness are being introduced.** Among other things, in November 2016, the government and the trade unions reached a long-term agreement on significant changes in taxation. Further, a Competitiveness Council was established in March 2017, which has issued recommendations for improvements in areas such as construction, utility services, tax compliance and ease of doing business.
- **Cooperation with China has strengthened.** Hungary joined the Asian Infrastructure Investment Bank in June 2017. The country is also becoming an important partner in China's Belt and Road Initiative.

Key priorities for 2018

- **Addressing labour shortages will be critical for higher productivity.** Further measures to improve labour skills, such as through job training programmes, are necessary, and efforts should continue to support the transition of workers from public work schemes to the primary labour market.
- **Banking sector recovery should be sustained.** Following some positive regulatory and tax environment changes in 2016, including the reduction of the bank levy, the banking sector returned to profitability last year. Efforts to clean up the banks' loan portfolios should be continued, and this is expected to be further supported by the recovering local real estate market and strong economic growth.
- **Market-friendly financing instruments should be further promoted.** As the European Union (EU) funds available after 2020 may decline, a wider usage of repayable instruments would allow for their recirculation afterwards, in contrast to pure grant financing.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.1	4.0	3.1	2.2	3.8
Inflation (average)	1.7	0.0	0.1	0.4	2.6
Government balance/GDP	-2.6	-2.7	-2.0	-1.9	-2.3
Current account balance/GDP	3.8	1.5	3.4	6.1	4.2
Net FDI/GDP [neg. sign = inflows]	-1.1	-2.8	-1.0	-1.7	-1.8
External debt/GDP	118.2	117.7	109.2	97.2	n.a.
Gross reserves/GDP	34.5	30.2	27.2	20.8	n.a.
Credit to private sector/GDP	69.5	68.8	70.1	72.1	n.a.

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Macroeconomic performance

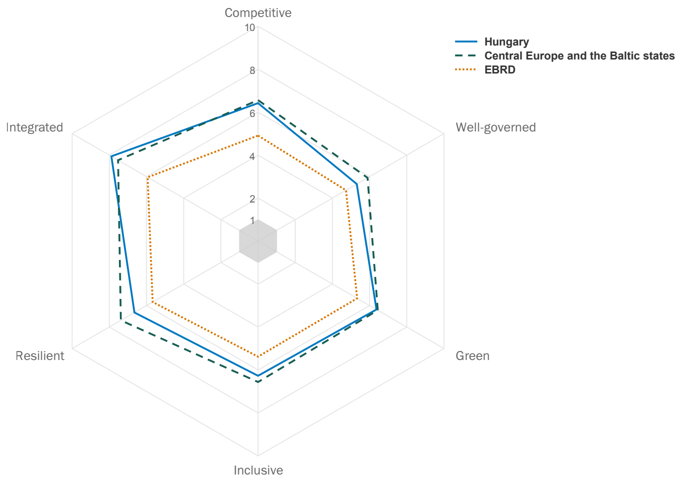
Robust private consumption has supported recent growth. GDP growth slowed to 2.2 per cent in 2016 as investment decreased by 10.6 per cent, mostly explained by the low utilisation of EU funds. In contrast, private consumption remained strong, underpinned by rising employment and wages. Household disposable incomes were driven by rising real wages and falling unemployment. In the first half of 2017, GDP growth accelerated to 3.6 per cent year-on-year, driven by a solid rebound in investment and robust private consumption. Investment is up by 24.1 per cent year-on-year in the first half of 2017, backed by accelerated EU fund transfers as well as a return to positive credit growth (after seven years of negative credit growth) to the private sector.

Labour market shortages started weighing on growth. The unemployment rate dropped to its lowest rate since transition began: 4.4 per cent, in December 2016, and has decreased slightly further during the first half of 2017. As the labour market is tightening, employment growth has slowed and companies have started experiencing shortages of qualified labour. As a result, wage pressures are mounting, increasing unit labour costs and reducing Hungary's international competitiveness. Compared with the other EU new member states, Hungary has experienced the lowest cumulated productivity growth per person, of less than 1.0 per cent, since 2010. At the same time, nominal unit labour costs have gone up by almost 15.0 per cent until 2016, substantially above the regional average of 10.5 per cent.

High revenues and weak public investment have kept the fiscal deficit at a low level. The fiscal deficit in 2016 saw a slight improvement to 1.9 per cent of GDP relative to the previous year. Last year's budget benefited substantially from some temporary factors such as the improved tax collection and the accumulated savings from unrealised EU co-financed investments. The 2017 fiscal deficit, however, is expected to widen somewhat. According to the European Commission's (EC's) autumn estimates, the public debt is estimated to fall from 73.9 per cent in 2016 to 72.6 per cent of GDP in 2017.

Investment and consumption are expected to drive robust GDP growth. Accelerated EU funds absorption and recovering credit to the private sector are set to support growth over the short term. The expected increases in wages, driven by agreements with the state-owned companies and car manufacturers; and a higher minimum wage and social security contribution cuts, will further support strong consumption, despite rising inflation. On balance, GDP growth is expected to accelerate to 3.8 this year and 3.4 in 2018. Weaker-than-anticipated private sector investment and sluggish recovery of the eurozone are key risks to this scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

The government is taking measures to improve competitiveness. In May 2017, the Competitiveness Council, which was established in March 2017, submitted to the parliament the first package of measures aimed at improving Hungary's competitiveness. The proposed measures target improvements in areas such as construction, utility services, tax compliance and ease of doing business. Another package is expected to be ready by the end of 2017 and will be related to education, employment and digitalisation. These new policy measures follow a tax package, adopted by the parliament in November 2016, which targeted excessive "red tape", higher small and medium-sized enterprise (SME) tax breaks and a reduction of the "grey" economy. In the World Bank *Doing Business in the European Union 2017* report, which assessed the ease of doing business in seven cities in the country, business start-up costs, access to power and construction permits came behind the EU average. In the overall Doing Business ranking, Hungary scores 48th (out of 190 countries) in 2018.

The government launched several measures to ease the lack of qualified workers. In order to provide immediate relief to the mounting problem of qualified labour shortages, the government has taken measures to facilitate the hiring of non-EU workers. Up to mid-2017, more than 10,000 foreign workers had been granted work permits, mostly from Serbia and Ukraine. In addition, for those sectors urgently lacking a qualified labour force, employers can hire foreign workers for 90 days without a work permit. Other measures include launching an employment rehabilitation programme, announced by the government in May 2017, targeted at people with disabilities who find it difficult to find jobs on the open labour market and may require skills requalification. Moreover, beyond the existing subsidy for municipalities that create additional accommodation for incoming workers, a tax package adopted by the parliament in June 2017 also envisages some relief on employers' costs for employee resettlement, which is expected to improve labour mobility in the country.

Additional gas delivery routes are being created. In July 2017, Hungary signed an agreement with Gazprom for constructing a new gas pipeline for gas delivery from Russia, to be finalised by the end of 2019. The new connection would be an extension of the Turkish Stream project, which is already under construction and will run partly along the route of the suspended South Stream gas pipeline. In addition, Hungary is expected to be able to buy gas from Croatia from the first quarter of 2019. The two governments signed a letter of understanding in June 2017 to construct a bi-directional gas interconnection, which will allow for a reverse flow of gas to Hungary from Croatia.

A new railway will be constructed as part of China's Silk Road project. Work on a 350-km long railway connecting Budapest with the Serbian capital, Belgrade, will start in November 2017. The railroad will become part of the Pan-European Corridor X, facilitating the central and south-eastern Europe (CSEE) region's access to Asia by sea. For the time being, however, the project remains subject to an EC investigation on state aid rules. Under China's Silk Road project launched in 2013, known officially as the Belt and Road Initiative (BRI), China's attention has increasingly focused on the CESEE region, launching the 16+1 framework for Chinese cooperation with 16 of the CESEE countries. As a member of the 16+1 framework, Hungary can also access the China-Central and Eastern Europe Investment Cooperation Fund that has been set up to support infrastructure, high-tech and green investments in the 16 member countries. In June 2017 Hungary joined the Asian Infrastructure Investment Bank (AIIB), which is headquartered in Beijing.

New regulations have been adopted on the sale of foreclosed houses. In March 2017, the parliament approved an amendment to the law on the sale of foreclosed houses. The amendment specifies that repossessed homes are sold at no less than 100 per cent of their market value during the first year after foreclosure. The floor would be reduced to 90 per cent if not sold in the first year. Earlier, foreclosed homes could be sold at 70 per cent of market value. According to the authorities, selling the foreclosed homes at higher prices would allow for a greater reduction in household indebtedness, which ultimately would support about 150,000 households that are at risk of foreclosure. The EBRD initiated the creation of a Working Group along with the Ministry of National Economy and the National Bank of Hungary to assess the impact of the amendment. The Working Group has subsequently solicited feedback from the Banking Association and the discussion is ongoing.

LATVIA

Highlights

- **Improving external demand and investment are set to drive GDP growth.** After collapsing last year, European Union (EU) co-financed investment has been slowly recovering. Amid robust private consumption and recovering exports GDP growth is expected to strengthen in 2017 and 2018.
- **Recently introduced reforms are designed to increase competitiveness and combat the "grey" economy.** A tax reform involves changes to the corporate, excise and labour taxes and also includes measures to reduce informality.
- **Work on healthcare reform has been launched.** The approval by the government of a healthcare conceptual reform plan is expected to bring more efficiency to the healthcare system, as well as to increase its funding.

Key priorities for 2018

- **The success of the recently approved tax reform will depend on its efficient implementation.** Any potential poor communication from the government may lead to only limited willingness to cooperate.
- **EU funds absorption needs to improve.** The current slow withdrawal of the EU funds is largely driven by the poor quality of project applications. Of all contracts signed by the end of 2016, almost 90 per cent of them required a resubmission.
- **Listing some of the state-owned enterprises (SOEs) at the stock exchange will improve corporate governance and increase transparency in those companies.** Currently, Latvian SOEs' stock in the free market amounts to merely 3 per cent of GDP, substantially below the global average of about 20 per cent.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.6	1.9	2.8	2.1	4.7
Inflation (average)	0.0	0.7	0.2	0.1	3.1
Government balance/GDP	-1.0	-1.2	-1.2	0.0	-0.6
Current account balance/GDP	-2.7	-2.0	-0.8	1.4	-0.2
Net FDI/GDP [neg. sign = inflows]	-1.6	-1.6	-2.3	0.0	-1.7
External debt/GDP	134.1	144.1	143.9	149.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	59.5	52.3	49.8	49.4	n.a.

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Macroeconomic performance

A sharp drop in investment in 2016 has held back GDP growth. In 2016, economic growth decelerated to 2.1 per cent, largely hampered by lower investment. In contrast, household consumption remained strongly supportive to growth, being underpinned by rising real wages and falling unemployment. During the first six months of 2017, the economy strengthened substantially, with growth reaching 4 per cent, backed by improving external demand and recovering investment.

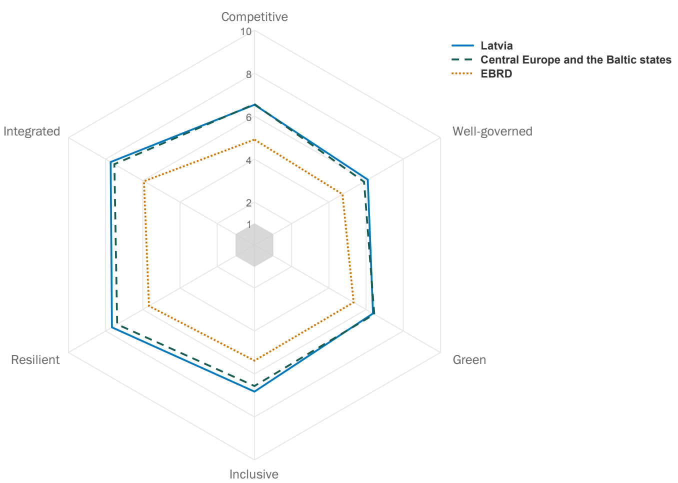
EU co-financed investment is rebounding slowly. Following a dramatic drop of 15.0 per cent in 2016, investment growth recovered to 17.5 per cent during the first half of 2017. Two factors are behind this improvement. First, the already substantially delayed investments co-financed by the EU funds have slowly started to materialise. Second, the recovering credit to non-financial corporates indicates that private investment is also picking up, supported by positive expectations regarding external demand.

Real wage growth exceeded productivity growth. In 2016, real wage growth decelerated somewhat to 4.9 per cent, from 6.6 per cent in the previous year, although it still exceeded real productivity growth by nearly three percentage points. Unit labour costs have been growing faster than those of Latvia's regional peers, and, if sustained, this trend could have a negative impact on the country's international competitiveness by eroding companies' profitability and deterring investment. Besides, the persistent net outward migration and low fertility rates are expected to further reduce the working-age population, which, as a result, will likely further weigh on potential growth in the medium term.

The general government's position has balanced for the first time since 1998. Thanks to a much smaller deficit at the central government level, Latvia's government fiscal position improved substantially in 2016, after it saw a deficit of 1.3 per cent of GDP in the previous year. However, the expected pick-up in capital spending, higher public sector wages and a new 2018 tax package, which is forecast to cost about 1.5 per cent of GDP during the first three years of its implementation, will likely result in fiscal deficits over the coming years. According to the European Commission autumn report, the government deficit should reach 1.0 per cent of GDP in 2018 and 1.1 per cent in 2019.

A further recovery in GDP growth will depend on higher investment. Private consumption will likely remain strong, underpinned by improving labour markets and recovering domestic credit. Together with rising EU co-financed investment, GDP growth is expected to reach 4.7 per cent this year and 4.1 per cent in 2018. However, downside risks come from lower-than-expected EU funds absorption and/or weak external demand.

Assessment of transition qualities (1-10)



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Major structural reform developments

A package of tax reform has been introduced. The reforms are designed to increase competitiveness and combat the "grey" economy. In July 2017, a package of 12 tax reform bills was adopted by the parliament and will enter into force from January 2018. The reform involves changes to the corporate, excise and labour taxes and also includes measures to reduce informality. A greater rate of progression in personal income taxation is expected to have a positive impact on consumer spending, although the reduction in the tax wedge will likely boost Latvia's competitiveness only marginally. The reform of corporate taxation, which envisages a tax deferral until actual distribution, is expected to improve transparency and boost investment. Expansion of the reverse VAT payment in some problematic sectors, the reduction of VAT thresholds and the introduction of an online trade transactions register should help in combating the informal economy, which is estimated by the Stockholm School of Economics in Riga at greater than 20 per cent of GDP in 2016.

Healthcare reform has been initiated. The government approved a healthcare conceptual reform plan in July 2017. It is expected to bring more efficiency to the healthcare system, as well as to increase its funding. At the moment, public spending on health in Latvia is among the lowest in the EU (3.7 per cent of GDP against the EU average of 7.2 per cent in 2014). Some additional funding will come from higher social security contributions, which will be increased as part of the broad tax reform from January 2018.

The government aims at privatisation of some state-owned enterprises. Following a sale of 20 per cent of the shares in Latvia's national carrier airBaltic to a German investor in 2016 and subsequent acquisition of this shareholding by a Danish aviation investor, the government plans to further reduce its stake in the company to below 50 per cent by the end of 2017. A potential buyer would be required to keep the existing network of the company as well as to maintain Riga Airport as the airline's home base. Listing of the company at the stock exchange has not been considered. Nevertheless, the government's intention is to increase the amount of Latvian SOEs on the stock exchange, with some initial proposals being announced by the end of the year. Currently, Latvian SOEs' stock in the free market amounts to merely 3 per cent of GDP, substantially below the global average of about 20 per cent.

A reform plan to enhance the efficiency of public administration has been announced. According to a reform proposal announced in July 2017 by the State Chancellery, the current number of employees in public administration is expected to be cut by 6 per cent by 2020, while the creation of new vacancies would be frozen. Besides, the proposed reform also details increasing the salaries of remaining employees to up to 80 per cent of wages paid in the private sector. Further improvements in public governance should be explored during the revision of functions of small state institutions, including options for their centralisation.

EU funds absorption remains low. By mid-2017, about half of the total EU funding available to Latvia of €5.6 billion in 2014-20 had been approved by the Ministry of Finance. However, only about 8 per cent of the financing has been disbursed so far, mainly in the spheres of transportation, employment and education. Similar to the other EU new member states, Latvia also experiences difficulties in withdrawing EU funds from the current EU budget. During the first half of 2017, the amount of EU transfers to the country represented only 0.5 per cent of what had previously been the annual average since 2010. In contrast, EU funds for the state roads' construction are expected to be fully utilised already in 2019.

Getting electricity and resolving insolvency remain key business obstacles in Latvia. In the World Bank *Doing Business 2018* report, Latvia slipped by five places to number 19 globally, still remaining behind its two Baltic peers, Estonia (12th) and Lithuania (16th). Latvia ranked best in getting credit and paying taxes categories, whereas getting electricity and resolving insolvency were scored the lowest. The number of days to obtain a permanent electricity connection is 28 days longer than the OECD average of 79 days.

LITHUANIA

Highlights

- **Domestic demand and exports are underpinning robust growth.** GDP growth accelerated further during the first half of 2017, underpinned by accelerated investment and rising external demand. Private consumption has remained strong, backed by increasing wages and falling unemployment.
- **Lithuania is aiming for clean energy and greater energy independence.** Among other things, the new national energy strategy sets an ambitious goal to make electricity and heat production independent from fossil fuels by 2050, when all the electricity consumed should be generated domestically. At the same time, renewable energy and other clean sources are set to be the primary source in electricity.
- **The recently approved labour code is expected to boost labour productivity.** In the new legislation labour relations have been made more flexible and the expanded unemployment benefits system now better supports income security.

Key priorities for 2018

- **Full OECD membership is expected in mid-2018.** However, before full accession to the OECD is to materialise, Lithuania still needs to improve its land sale procedures, to reform state-owned forestry and road maintenance companies, and to continue efforts to fight corruption.
- **EU funds absorption needs to improve.** The preparation and presentation of documentation, specifically the guidelines on eligibility criteria, should be shortened and simplified as these are the main reasons for delays.
- **The innovation promotion system requires consolidation.** Its high fragmentation and the narrow focus of each of the advisory and implementation institutions make it difficult to navigate and keep administrative costs high. According to the *European Innovation Scoreboard 2017*, Lithuania largely underperforms in exports of high-tech goods and services, attractive research systems and patent applications.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.5	3.5	2.0	2.3	3.6
Inflation (average)	1.2	0.2	-0.7	0.7	3.6
Government balance/GDP	-2.6	-0.6	-0.2	0.3	0.1
Current account balance/GDP	0.8	3.2	-2.8	-1.1	-1.5
Net FDI/GDP [neg. sign = inflows]	0.6	0.0	-1.9	-0.4	-2.0
External debt/GDP	70.4	69.9	75.7	85.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	42.8	40.5	41.3	42.9	n.a.

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Macroeconomic performance

Strong private consumption has supported GDP growth. Following a deceleration to 2.0 per cent in 2015, economic growth accelerated to 2.3 per cent in 2016 and further to 4.1 per cent year-on-year in the first half of 2017. Private consumption, supported by rising wages and consumer lending, was the key growth driver, but its leading positive impact on GDP growth has been somewhat mitigated by recovering investment and export demand. Strong export growth was particularly registered in low value-added manufacturing, such as furniture and dairy products, but also in high value-added services, which have been constantly growing since 2011.

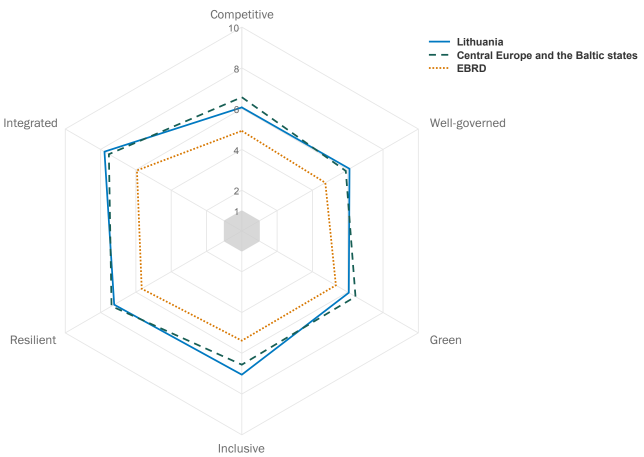
Investment has the potential to rebound sharply. After registering a drop of 0.5 per cent in 2016, investment growth recovered by 5.7 per cent during the first six months of 2017. Some turnaround in EU funds absorption at the beginning of this year has lifted public investment, while the historically high capacity utilisation of Lithuanian companies, amid rising corporate credit, provided a strong push for higher private sector investment. The latter is expected to strengthen further, as rising labour shortages force companies to invest in capacity expansion and technological advancement.

Labour shortages constitute a challenge for Lithuania's international competitiveness. The employment rate exceeded 75.0 per cent in mid-2016, which is the second highest such rate in the central Europe and the Baltic states region, although its further growth has stalled. This slow-down is attributed to the shrinking working-age population and persistent net emigration, which, on the other hand, contributes to high wage pressure and strong competition for experienced staff among companies. Rising salaries, at 8.0 per cent in real terms in 2016, have lifted up unit labour costs, which have been growing faster than productivity since 2012. Such developments may further weigh on Lithuania's export market shares, which have dropped by 12.0 per cent since the Russian sanctions were imposed in 2014.

Public finances saw their first ever surplus in 2016. The 2015 budget deficit of 0.2 per cent of GDP turned into a surplus of 0.3 per cent last year, as strong tax collection was boosted by a buoyant labour market and lower-than-expected fiscal expenditures. However, the expected high costs of labour market reforms, together with an increase in public wages and pensions, are expected to put the public finances back into deficit from this year. According to the European Commission autumn estimates, public debt is expected to reach 41.5 per cent of GDP in 2017 and 37.9 per cent in 2018.

Exports and investment are expected to further boost short-term growth. Lithuania's GDP growth is set to recover further, particularly driven by strengthening investment and external demand, including from Russia. At the same time, robust wage growth will maintain strong private consumption. Overall, GDP growth rates are forecast to reach 3.6 per cent and 3.5 per cent in 2017 and 2018, respectively. Risks to that scenario are lower-than-expected EU funds absorption and weaker-than-anticipated recovery of external demand.

Assessment of transition qualities (1-10)



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Major structural reform developments

Lithuania aims at full electricity production independence by 2050. The new national energy strategy is expected to be approved by the parliament by early 2018. It sets an ambitious goal to make electricity and heat production independent from fossil fuels by 2050, when all the electricity consumed should be generated domestically. The strategy also envisages a link of the country's electricity grid to continental Europe via Poland (the so-called LitPol pipeline) from 2020. Renewable energy and other clean sources are foreseen to be the primary source in the electricity, heating and transport sectors. In 2015, with a share of 25.8 per cent, Lithuania had already achieved its Europe 2020 renewable energy mix target of 23.0 per cent. Biomass and waste represent 92.0 per cent of the renewable energy mix production.

Full OECD membership is expected in 2018. Since the kick-off of the accession process in mid-2015, Lithuania has made significant progress in unifying its legislation with the other OECD countries. Among others, amendments to the VAT law were approved by the government in August 2017, which will allow foreign investors to claim a refund of the value-added tax paid in Lithuania. However, before full accession to the OECD could materialise (now expected in mid-2018), Lithuania still needs to improve its land sale procedures, to reform state-owned forestry and road maintenance companies, and to continue efforts to fight corruption. Once membership is finalised, Lithuania is expected to attract more investment and to further reduce its international borrowing costs, which have already dropped substantially since the country's eurozone accession in 2015.

A modern labour code has been adopted. The new labour code entered into force in July 2017. It is now incorporating amendments agreed in the Tripartite Council. In the new legislation labour relations have been made more flexible and the expanded unemployment benefits system now better supports income security. The new law is an important step towards enhancing competitiveness and the quality of the business environment. Any potential deficiencies should be addressed at a later stage, once the new regulations work in practice.

Low-income households and small businesses will receive government support. The prime minister announced in June 2017 that the government planned to allocate an extra €0.5 billion annually (1.3 per cent of GDP) for social-related purposes. Some extra money should be provided to pensioners and children, including the doubling of child benefits. Also, the non-taxable threshold may be increased to the minimum wage level, with the expectation that the latter is lifted to €500 per month in January 2018, from the current €380. On the business side, all new small companies should be provided with a one-year break from corporate taxes, along with tax breaks from social security contributions.

EU funds absorption is proceeding slowly. Up until mid-2017, only about 15 per cent of the funds available for 2014-20 had been absorbed so far. According to the Ministry of Finance, some €2.14 billion is expected to be allocated by the end of 2017, which is 20 per cent less than initially planned at the beginning of the year. Preparation of measures' documentation, specifically guidelines on eligibility criteria, are listed as the main reasons for the delays, according to the 2017 KPMG *Progress summaries* 2014-2016 report. For the period 2014-20 around €8.4 billion is allocated to Lithuania through three national programmes, of which €726 million is expected to be delivered through the so-called financial instruments.

POLAND

Highlights

- **Private consumption has propelled GDP growth.** The collapse in investment was the main factor behind the GDP slow-down in 2016, but household consumption strengthened further, underpinned by rising wages and generous social programmes. GDP growth is expected to accelerate this year and next, backed by recovering investment.
- **The new laws on renewables discourage new investments and may jeopardise the existence of the current renewable energy producers.** The law, which establishes a new way to calculate the replacement fee for Poland's green energy producers, follows earlier legislation that sharply restricts inland wind farm placements.
- **The lowering of the retirement age weighs on Poland's growth potential.** The labour force is projected to shrink substantially as the population ages. By 2025 the working-age population is estimated to fall by more than 10 per cent. The process of labour supply decline will likely accelerate due to the lowering of the retirement age in 2017 and will likely exacerbate age-related fiscal and labour market problems.

Key priorities for 2018

- **The government should look at a wider range of clean energy sources, such as renewables, in order to lower emissions and improve air quality.** Air pollution is linked to coal-fired installations and the growing use of private vehicles.
- **There needs to be wider participation in a well-functioning third pillar pension system to help develop capital markets and potentially ease long-term public finance pressure.** Development of the capital markets has faced a number of hurdles, such as people's low propensity to save, an already-high burden on employers and relatively high charges in individual schemes (IKE and IKZE).
- **State-owned enterprises (SOEs) need to be more transparent and improve corporate governance.** There is limited transparency as to the extent of state ownership, while ownership roles are split between several ministries. Evaluation of boards is irregular and targets unclear. Higher transparency is especially important in the context of a government strategy that envisages a stronger role for the state in the economy.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.4	3.3	3.8	2.9	4.1
Inflation (average)	0.8	0.1	-0.7	-0.2	2.0
Government balance/GDP	-4.1	-3.6	-2.6	-2.5	-1.8
Current account balance/GDP	-1.3	-2.1	-0.6	-0.3	-0.8
Net FDI/GDP [neg. sign = inflows]	-0.8	-2.4	-2.1	-1.2	-0.4
External debt/GDP	69.8	72.7	71.8	76.2	n.a.
Gross reserves/GDP	20.2	18.4	19.9	24.4	n.a.
Credit to private sector/GDP	50.4	49.8	51.1	52.7	n.a.

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Macroeconomic performance

Strong household consumption has upheld GDP growth but investment remains slow. In 2016 economic growth decelerated to 2.9 per cent, largely dragged down by a sharp decrease in investment. The slow start of the EU 2014-20 funds utilisation and persistent regulatory uncertainty were the key reasons behind the weak investment in 2016. In contrast, household spending remained strong, and its dynamics strengthened even further at the beginning of 2017, backed by vigorous wage growth and deferred effects of higher social spending. As a result, GDP growth accelerated to 4.3 per cent year-on-year (2010 prices) in the first half of 2017.

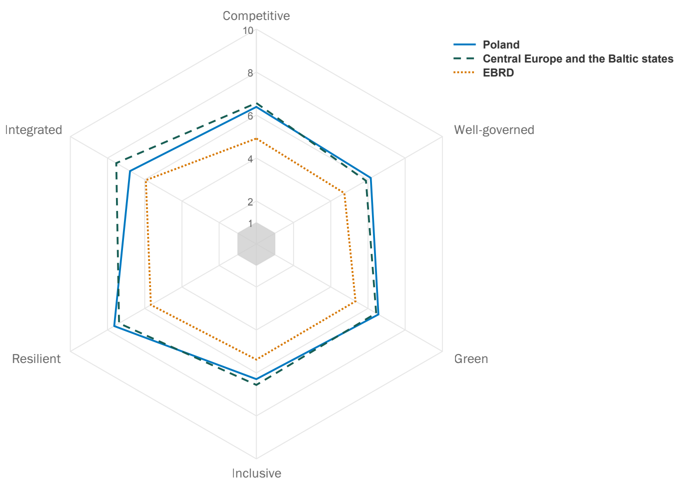
The EU co-financed investment is set to rebound. In 2016 investment dropped by 7.9 per cent. Weak public investment was largely affected by the delays in moving towards the new regulatory and operational requirements of the EU 2014-20 budget, whereas private investment was largely hit by legislative uncertainty. Public sector investment is set to rebound from the second half of 2017, additionally boosted by the approaching local government elections in 2018. Private investment is fragile and still constitutes a higher risk to growth. The investment-to-GDP ratio, which dipped below 18 per cent in mid-2017, has registered its lowest level since 1996.

Labour productivity growth is strong amid net immigration and low unemployment. In June 2017 the unemployment rate dropped to an historic low, reaching 4.7 per cent. The tightening labour market has driven faster wage growth, which reached 4.2 per cent in real terms in 2016. Yet, a potentially higher growth in wages has been prevented by an inflow of additional labour from Ukraine, estimated at about half a million at any given time. While labour productivity growth remains moderate, at about 2.0 per cent in 2016, the approaching adverse demographics and the reversal of the statutory retirement age, effective from October 2017, may hold back potential economic growth.

Fiscal consolidation has stalled despite high domestic demand. At 2.5 per cent of GDP in 2016, the general government balance saw the lowest deficit since 2007, a result likely to be improved on in 2017. These outcomes were largely driven by improved tax compliance, increased consumption-driven VAT receipts and a slow-down in public investment. The 2018 draft budget envisages a fiscal loosening, despite a very strong economy. Compared with 2016, it needs to accommodate the full year effect of the child benefits programme, the lowered retirement age, and higher public capital spending. While some of the expenditures are expected to be financed by revenue gains from tax administration reforms and the postponed VAT rate reduction, further improvement in tax compliance will be more difficult. Overall, the pro-cyclical fiscal stance will limit the room for manoeuvre in subsequent economic slow-downs.

Short-term growth will be strong. Household consumption, boosted by accommodative policies and the tightening labour market, along with recovering investment, are expected to accelerate GDP growth to 4.1 per cent this year and to 3.4 per cent next year. Nevertheless, a weaker-than-expected recovery in investment and lower external demand constitute potential risks to that scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

Previous measures to raise the retirement age have been reversed. Under the new law, which entered into force in October 2017, the government has reversed plans to raise the retirement age to 67 from 60 and 65 years for women and men, respectively. This measure may exacerbate age-related fiscal and labour market problems. At the same time, the government plans to strengthen the voluntary retirement pillar from mid-2018. The changes, not yet legislated, could include automatic enrolment and eventual privatisation of a part of the assets of the current obligatory and privately managed second pillar.

The broad push for higher tax compliance is bringing results. Electronic reporting, stricter penalties, a general anti-abuse rule, which is aimed at eliminating transactions made explicitly to avoid taxes, have all contributed to better revenues in 2017. The side effect, however, is lower corporate liquidity. The tax on certain financial institutions, introduced in February 2016, brought PLN 1.1 billion, of which PLN 0.9 billion (about €0.2 billion) was paid by commercial banks to the government in the first quarter of 2017. As a result, it has translated to 50 basis points-higher loan costs, prompting bigger firms to use foreign creditors. The introduction of a retail tax, which was deemed to be violating EU state aid rules, was postponed until 2018.

Business environment indicators are mixed. Poland remained the best central European country in the 2016 Corruption Perception Index (29th out of 176 countries overall). It has, however, fallen by six spots to 45th place in the 2017 Economic Freedom Index, by three spots in the World Bank *Doing Business 2018* report, to 27th position, and by seven spots to 54th in the 2017 World Press Freedom Index.

The Polish Development Fund (PFR) is being strengthened. A new bill on state development institutions, which is expected to be approved by the cabinet by the end of 2017, would give the PFR over PLN 150 billion (8 per cent of GDP) under management. Its investments include direct equity, venture capital investments, corporate loan guarantees, real estate financing and financing foreign expansion of Polish firms.

The state is increasing its share in the financial and energy sectors. The government continued its domestication strategy with the opportunistic purchase of Bank Pekao from Unicredit by state-controlled institutions in June 2017. Also, the state-controlled power firm PGE agreed to buy French utility EDF's Polish assets in a conditional agreement. The latter deal is expected to be finalised by January 2018.

New legislation may deter renewable energy investments. In August 2017 the president signed a new law on renewable energy, which establishes a new way to calculate the replacement fee for Poland's green energy producers. The new legislation will benefit only particular energy distributors, which will be able to renegotiate lower substitution fees that they pay as an alternative to the obligation to buy green certificates. As a result, the income of renewable energy producers, which includes subsidies, will be reduced further, which may discourage new investments and could jeopardise the existence of the current renewable energy producers. The law follows earlier legislation that sharply restricts inland wind farm placements. In 2015 Poland's share of energy from renewable sources was 11.8 per cent, which is still far below the 2020 target of 15.0 per cent, and these recent developments have reduced the probability of meeting that target on time. On a positive note, the government issued an important air quality directive restricting the production and use of polluting heating installations.

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Energy supply diversification continues. In July 2017 an agreement was reached between the United States of America and Poland for supplying US liquefied natural gas (LNG) as an alternative to Russia-sourced gas. Renegotiation of the contract for the latter is due in 2019. Poland wants to increase energy sector resilience and reduce its energy dependence on Russia through alternative sources such as the planned pipeline with Norway, to be ready in autumn 2022, as well as through shipping the LNG from Qatar and the United States of America via its LNG terminal on the Baltic Sea.

EU co-funded public investment is picking up. Poland reached 38.2 per cent in absorption of EU funds (measured by funds contracted) by early August 2017. At €4.2 billion, payments are far lower, below 10 per cent of the allocated envelope. However, the amount still constitutes over one-third of the EU total.

SLOVAK REPUBLIC

Highlights

- **The economy has been growing robustly.** In 2016 GDP grew by 3.3 per cent, largely propelled by strong household consumption and net exports. At the same time, investment, particularly in the public sector, saw a sharp decline.
- **New covered bond legislation is being introduced.** The new law is expected to jump-start the Slovak covered bond market, provide banks with cheaper term funding, attract international investors to the market, and in turn result in better conditions for mortgages.
- **Public finances have been improved through greater efficiencies.** The Finance Ministry's programme to seek efficiencies in public spending has identified potential savings of almost 2.5 per cent of GDP since its launch in 2016.

Key priorities for 2018

- **Workforce skills need to be enhanced.** The Slovak Republic faces high structural unemployment, particularly among the low-skilled. A sustained effort is needed to improve labour mobility and ensure that tertiary education and vocational training better match the needs of the labour market.
- **Municipal waste management remains one of the main environmental challenges.** Still, the landfilling rate of municipal waste, at 68 per cent in 2015, remains significantly above the EU average levels of 25 per cent. The recycling rate stands only at 15 per cent, whereas the EU average is 45 per cent. A new law on waste management came into force in January 2016, although reaching the 50 per cent recycling target by 2020 remains questionable.
- **Weak EU funds absorption needs to be addressed.** This will require a stronger focus on addressing regulatory requirements in the current EU budget, focusing on a greater share of repayable instruments in projects, as well as more attention on combating fraud and other misuse of funds.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.5	2.8	3.9	3.3	3.3
Inflation (average)	1.5	-0.1	-0.3	-0.5	1.3
Government balance/GDP	-2.7	-2.7	-2.7	-2.2	-1.5
Current account balance/GDP	1.9	1.1	-1.7	-1.5	0.2
Net FDI/GDP [neg. sign = inflows]	-0.3	-0.6	-0.1	0.6	-1.1
External debt/GDP	82.1	90.2	85.4	91.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	49.0	51.0	54.0	57.4	n.a.

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Macroeconomic performance

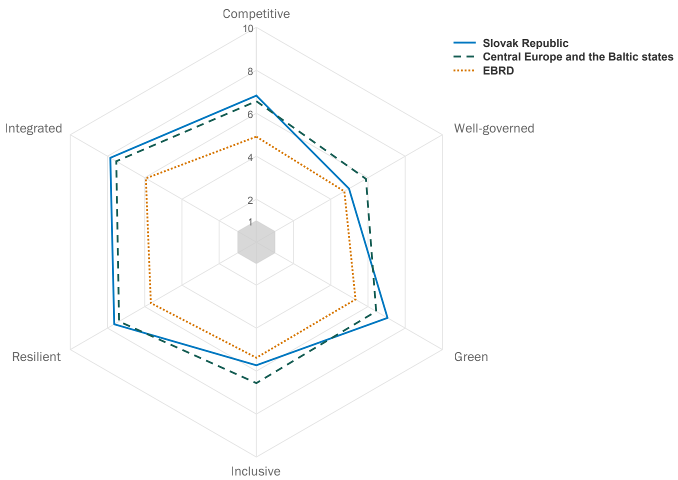
GDP growth has been robust. Economic growth slowed somewhat from 3.9 per cent in 2015 to 3.3 per cent in 2016, but still remained the strongest in central Europe and the Baltic states in 2016. Solid employment growth, rising disposable incomes and double-digit growth in credit to households supported strong private consumption. In contrast, investment expenditures declined by 8.3 per cent in 2016 and continued to fall over the first six months of 2017, by 3.4 per cent, as the drawing of EU funds has been sluggish. During the first half of 2017, economic growth reached 3.2 per cent year-on-year.

The labour market is tightening. Shortages of qualified labour have been a problem for some time in the automotive industry and are now slowing the development of the IT industry, which is located in the eastern part of the country and where the unemployment rate remains high, at 13.2 per cent in 2016. Overall, the national unemployment rate fell to 7.6 per cent in June 2017, but the increasingly cited labour shortages are putting more and more pressure on wages, which increased year-on-year by 4.2 per cent in nominal terms in the first half of 2017. A rapidly declining working-age population is also a threat to the Slovak Republic's development model.

Improved VAT collection has delivered strong results. According to the Slovak financial administration, the VAT collection ratio improved to 75 per cent in 2016 from only 50 per cent in 2012, thanks to the introduced tax avoidance measures, such as the new VAT filing system – the so-called VAT ledger statements. The fiscal budget has gained more than 3.0 per cent of GDP of additional revenues since 2012. In 2016 the budget deficit declined to 2.2 per cent of GDP, which was also a result of the slump in public investment. Further fiscal measures already being introduced include a reduction in the corporate income tax rate (from 23 to 22 per cent), the introduction of a dividend tax, a levy on non-life insurance and changes in social and health security contributions (increase and abolishment of maximum assessment bases).

Solid household consumption and a gradual recovery in investment are set to underpin strong GDP growth. In 2017 GDP growth is forecast to reach 3.3 per cent before it accelerates to 3.5 per cent in 2018. Risks to the outlook constitute a weaker-than-anticipated recovery in the eurozone as well as slow absorption of EU funds.

Assessment of transition qualities (1-10)



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Major structural reform developments

Further measures to improve the governance of public projects have been introduced. In July 2017 the government approved a new methodology to evaluate the return on capital intensive projects and their compliance with the state's strategy. According to the methodology's proponents, it is expected to be a direct tool against corruption of public funds, including those from the EU. In addition, in January 2017 the government signed a Memorandum of Understanding with the OECD to carry out an audit of anti-corruption legislation. The audit is designed to determine whether the legislation is effective and whether it could pose a threat to economic growth.

The public efficiency spending programme has been extended to new sectors. Following its introduction in March 2016, the "value for money" programme was extended in 2017 to three new areas: education, social and labour market policies, and the environment. The government believes that there is potential for savings of almost 0.5 per cent of GDP in these areas. The idea of the value-for-money programme is to put more pressure on public administration to carefully calculate and rationalise expenditure decisions and execute the best available alternative through projects that add the most value. Last year's review, carried out in transport, healthcare and IT services, identified potential savings of some 2 per cent of GDP by 2020.

The government is working on measures to address qualified labour shortages. A reform package, presented as part of the 2018 state budget, was adopted by the government in October 2017. Measures are aimed at increasing the income of workers and enhancing labour mobility, particularly in the regions of most interest to investors. Cross-border integration of labour is also advancing. As a first step, the Hungarian and Slovak authorities signed a Memorandum of Understanding in April 2017 on cooperation between the two countries' social security companies, ministries and other labour market agencies. Skilled-labour shortages are reaching unprecedented levels, with almost 25 per cent of industry respondents of the European Commission's business survey citing qualified labour shortages as a limiting factor on production. This is significantly above the EU-28 average of 13 per cent in mid-2017.

The capital market is being strengthened through a new covered bond law. In August 2017 the government passed a resolution adopting a draft law on covered bonds. The new law, put together with technical support from the EBRD, extensively amends the existing framework and aligns it with current international standards, including the European Banking Authority's recommendations and the European Commission's position on covered bonds. It is expected to jump-start the Slovak covered bond market, provide banks with a cheaper way of term funding, attract international investors to the market, and in turn result in better conditions for mortgages. The law will come into force from January 2018.

Energy security is being enhanced. The Hungarian and Slovak national power grid operators signed in March 2017 an agreement to construct a new cross-border power interconnection between the two countries. The project is to be completed by the end of 2020. Also, in November 2016 the Polish and Slovak gas carrier companies signed an application to construct a new gas pipeline by 2020. The investment will be co-financed by the European Commission's Connecting Europe Facility fund and will be part of the North-South-East corridor, which will link gas infrastructure and liquefied natural gas terminals in central Europe. The final investment decision on the gas interconnection is expected by mid-December 2017.

The Slovak Republic may become a gateway into Europe for Chinese investors. The Slovak Republic's involvement in the Belt and Road Initiative (BRI) is steadily increasing, although not necessarily in the construction of physical infrastructure. In April 2017 the Slovak government passed a resolution to develop economic ties with China until 2020 and in May government representatives of the two countries agreed to include the Slovak Republic in the BRI.

Several measures were introduced to improve insolvency regulations. An amendment to the act on bankruptcy and restructuring, introduced in March 2017, cancels the option of forgiving more than half of debts. At the same time, it imposes a five-year maturity on the remaining portion of the debt under corporate restructuring, unless creditors voluntarily agree otherwise. In the World Bank *Doing Business 2018* report, resolving insolvency is ranked 42nd out of 190 countries. Length and costs of insolvency proceedings still remain more than double the OECD average.

SLOVENIA

Highlights

- **Economic recovery is accelerating.** After growing 2.3 per cent in 2015, the economy expanded by 3.1 per cent in 2016 on the back of rising exports and private consumption, and the pace of growth has picked up further in the first half of 2017.
- **Consolidation of public finances has advanced further.** This follows the exit of Slovenia in June 2016 from the European Commission's Excessive Deficit Procedure. The budget deficit dropped further to below 2 per cent of GDP in 2016, supported by over-performance of direct taxes and contributions, reflecting better-than-expected labour market developments.
- **Privatisations continue rather slowly.** Out of 33 state-owned enterprises (SOEs) reserved for privatisation in 2016, three have been successfully privatised, while a tender process is currently ongoing for 13 of them. The majority of the remaining companies are scheduled to be privatised this year. In June 2017 the government terminated the sale procedure for the country's largest bank, NLB.

Key priorities for 2018

- **Improving corporate governance and speeding up the privatisation of SOEs are key for future convergence.** High corporate indebtedness, complex ownership structures and the large footprint of underperforming SOEs in the economy weigh on investments, whose share in GDP has been falling almost constantly since 2008.
- **Remaining non-performing loans (NPLs) and corporate debt should be tackled.** Banks still hold significant bad portfolios in relation to small and medium-sized enterprises (SMEs) and, despite significant deleveraging in recent years, the long-term debt of over-indebted companies is still high.
- **Business environment reforms should focus on improving competitiveness and governance.** Measures that should be high on the agenda include: privatisation, improving SME access to finance, easing construction permits, improving contract enforcement, and enhancing SOE corporate governance standards.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	-1.1	3.0	2.3	3.1	4.0
Inflation (average)	1.8	0.2	-0.5	-0.1	1.6
Government balance/GDP	-14.7	-5.3	-2.9	-1.9	-0.9
Current account balance/GDP	4.4	5.8	4.4	5.2	5.7
Net FDI/GDP [neg. sign = inflows]	-0.1	-1.6	-3.3	-2.2	-1.0
External debt/GDP	114.9	125.5	120.1	110.9	n.a.
Gross reserves/GDP	1.9	2.0	2.0	1.7	n.a.
Credit to private sector/GDP	66.3	54.9	50.3	47.3	n.a.

CONTINUES

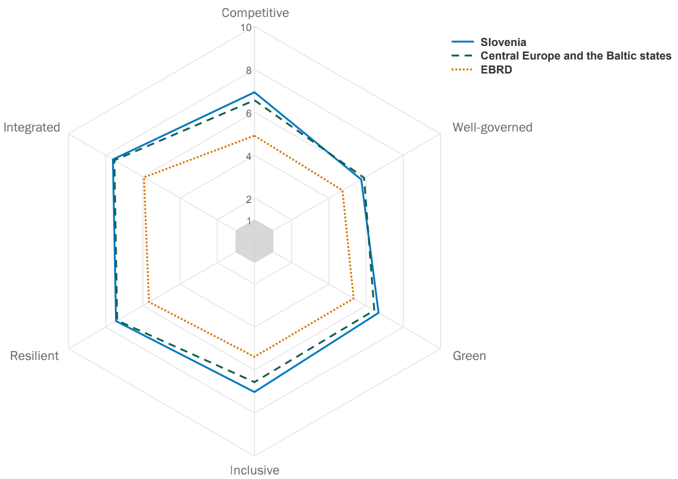
Macroeconomic performance

Economic growth has accelerated since 2016. Strong consumption growth of 4.3 per cent, backed by an improving labour market, helped economic growth accelerate from 2.3 per cent in 2015 to 3.1 per cent in 2016. Investments fell on the back of the termination of the previous EU funding cycle and imports caught up with exports on stronger consumption. Growth accelerated further to 4.8 per cent year-on-year in the first half of 2017, driven mainly by consumption and recovering investments. Inflation picked up from 0.5 per cent year-on-year at the end of 2016 to 1.5 per cent on average in the first nine months of 2017, mainly due to higher food and oil prices.

The general government deficit declined further from 2.9 per cent of GDP in 2015 to 1.9 per cent in 2016. Public debt is also down from 82.6 per cent of GDP in 2015 to 78.5 per cent in 2016, but remains high by regional standards. Achieving the medium-term objective of a balanced budget by 2020 requires further efforts. External debt is also elevated at 110.9 per cent of GDP but has been falling since 2015 due to large current account surpluses, including a surplus of 5.2 per cent of GDP in 2016.

Faster growth is likely in the short term. Slovenia's economy is expected to grow at a faster pace in 2017 (4.0 per cent) and slow down somewhat in 2018 (to 2.9 per cent). The growth will be driven by higher private and public investment as well as further recovery of household consumption. Although high corporate over-indebtedness as well as the slow pace of business environment reforms and privatisation could act as a drag on growth, overall risks to the projection are tilted to the upside.

Assessment of transition qualities (1-10)



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Major structural reform developments

Developments in the business environment have been mixed over the past year. The country ranked 37th among 190 countries in the World Bank's *Doing Business 2018* report (down seven places from the previous year), remaining slightly below the OECD high-income regional average. A noticeable improvement was recorded in getting credit, while the rankings in other areas have worsened or remained broadly unchanged. While Slovenia is doing well in trading across borders, protecting minority investors, getting electricity and resolving insolvency, in other areas, such as dealing with construction permits (100th) and enforcing contracts (122nd) as well as in getting credit (105th), it is well behind its peer countries. On the other hand, the country's competitiveness has improved according to the WEF's Global Competitiveness Index, ranking 48th out of 137 countries in 2017-18, up eight places from the previous year. The biggest improvement was reported in the macroeconomic environment, financial market development, technological readiness and business sophistication. However, the most problematic factors for doing business remain the same as previously – tax rates and regulations, government bureaucracy and (restrictive) labour regulations. Access to financing is now seen as an issue by 7.7 per cent of the polled managers (up from 5.4 per cent in the previous report).

Governance of SOEs has improved somewhat. A new comprehensive framework for the management of SOEs was implemented for the first time in 2016. In January 2017, the government approved a plan for 2017 quantifying performance indicators for each SOE and updating a list of assets for divestment prepared by the Slovenian Sovereign Holding (SSH). In June 2017, two new members of the SSH's supervisory board were appointed, which potentially enables a smoother privatisation process as all privatisation deals need the approval of the board.

Further actions have been taken in relation to the resolution of SME NPLs. Although the overall NPL ratio has fallen from 18 per cent in September 2013 to 5 per cent at the end of 2016, NPLs to SMEs remain elevated at 13.4 per cent as of the end of 2016. Many micro, small and medium-sized enterprises (MSMEs) are highly over-indebted and account for the majority of banks' NPLs, as the attention of banks and the regulator was until recently focused on large corporates. In March 2017, the *Handbook for Effective Management and Workout of MSME NPLs* was issued, with the cooperation of the World Bank and Bank of Slovenia. The manual is intended for practical application by the banks and provides for the operational implementation of previously adopted *Guidelines for the restructuring of micro, small and medium-size enterprises*, prepared by Bank of Slovenia and Banking Association of Slovenia.

Financial sector resilience has been improving further. In June 2017, the Slovenian "bad bank" (BAMC) announced that it had recovered over half of the value of the portfolio of assets transferred to it and that the €1 billion inflow generation threshold required for 2019 had already been achieved in May 2017. Consolidation of the banking sector continued with a merger of NKBM and KBS in January 2017. Early in 2017, the central bank launched an electronic credit register that covers both private individuals and businesses.

Progress on privatisation has been sluggish. Of 33 SOEs planned for privatisation in 2016, three have been successfully privatised, while the tender process has started for another 13 companies. The majority of the remaining enterprises are in the privatisation plan for 2017, which envisages the sale of 20 state-owned companies in total, including Slovenia's largest and third-largest banks (NLB and Abanka, respectively). In February 2017 the SSH announced the acceptance of a takeover bid for the tissue maker Paloma, while in May 2017 the sale of car parts maker Cimos was successfully completed. On the government's request, the European Commission approved the sale of 50 per cent of NLB by the end of 2017 and the remaining 25 per cent in 2018. The government announced plans to proceed with an initial public offering (IPO) of at least 50 per cent of its existing ordinary shares on the Ljubljana Stock Exchange but in June 2017 it terminated the sale procedure due to a pricing disagreement.

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The parliament appointed the members of the Fiscal Council in March 2017. This follows three failed attempts over a period of almost two years. The body is responsible for monitoring the implementation of the EU fiscal compact, which was also added to Slovenia's constitution.

A small-scale tax reform came into force. In September 2016, the Slovenian parliament adopted amendments to the Personal Income Tax Law, Corporate Income Tax (CIT) Law and Tax Procedure Law, including increasing the corporate income tax rate from 17 per cent to 19 per cent, abolishing the special zero tax rate for venture capital companies, and eliminating the recognition as an expense of the depreciation of goodwill. The reform package came into force in January 2017. The measures may have negative effects on investment and research and development activities. On the other hand, personal income tax has been reduced due to a flattening of the tax scale. Amendments to the Tax Procedure Act should facilitate tax payments, including through elimination of administrative barriers in paying social security contributions and provision of additional options for the settlement of tax debt.