ALBANIA

Highlights

- **Macroeconomic performance continues to strengthen.** GDP growth rates are on an upward trajectory and the IMF programme has been successfully concluded, contributing to enhanced fiscal stability and a falling (albeit still-high) level of public debt.
- **Construction of the Trans Adriatic gas Pipeline (TAP) section in Albania is well under way.** The TAP is a vital project for Albania as it contributes to energy diversity and regional integration.
- **Confidence is increasing in the banking sector.** The level of non-performing loans (NPLs) has started to decrease, measures to enhance governance in the sector are being introduced, and consolidation of the still-large number of banks is proceeding slowly.

Key priorities for 2018

- **EU-oriented reforms should be stepped up.** It is critical for Albania's long-term prosperity that the momentum in the EU approximation is preserved and accelerated and that everything is done in the areas of public administration reform and rule of law (among other areas) to meet EU requirements for the opening up of accession talks.
- **Further business environment reforms are needed.** The campaign against informality has yielded important results but extra efforts are needed to tackle deep-rooted problems such as getting electricity, registering property and enforcing contracts.
- **The reform momentum in the power sector should be sustained.** Steps already taken include: increased bill collections and the related lowering of distribution losses and repaid arrears to the private sector. Further improvements in governance and operational practices of the state-owned enterprises (SOEs) in the power sector are needed to make their improved financial position sustainable.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.0	1.8	2.2	3.4	3.7
Inflation (average)	1.9	1.6	1.9	1.3	2.1
Government balance/GDP	-5.2	-5.5	-4.1	-1.8	-1.2
Current account balance/GDP	-9.3	-10.8	-8.6	-7.6	-9.2
Net FDI/GDP [neg. sign = inflows]	-9.5	-8.1	-8.0	-8.7	-9.3
External debt/GDP	60.5	56.1	63.3	62.0	n.a.
Gross reserves/GDP	21.6	20.4	27.6	26.2	n.a.
Credit to private sector/GDP	39.8	39.4	37.3	33.5	n.a.

CONTINUES

Macroeconomic performance

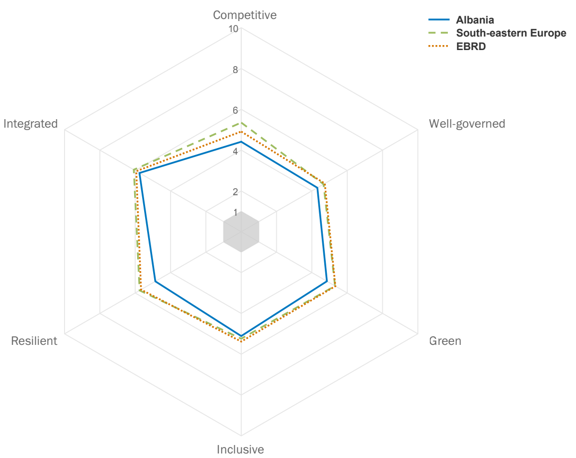
Robust economic growth is continuing. Overall GDP growth reached 3.4 per cent in 2016, compared with 2.2 per cent in 2015, on the back of strong growth in private consumption and investment. Government spending increased moderately after levelling off the year before. Net exports also had a positive contribution to growth (although small), mostly because of the good performance of services exports, such as tourism. Economic activity accelerated in the first quarter of 2017, with growth reaching 4.0 per cent year-on-year, driven mainly by the construction sector where several major infrastructure projects are advancing.

Monetary policy continues to be accommodative, but lending is still sluggish. In August 2017, the central bank announced that it would keep its key policy rate at 1.25 per cent, the same rate since November 2015. The central bank's low interest rate policy in recent years has led to the lowering of interest rates across several segments of the financial market (average lending rate as of mid-2017 was 6.6 per cent), thus stimulating private domestic demand to some extent. However, lending remains sluggish, especially for business loans. Average inflation in 2016 was 1.3 per cent, below the central bank's target of 3.0 per cent, and averaging 2.1 per cent in the first nine months of 2017.

Fiscal policy has been strengthened, putting public debt on a downward trajectory. For the past three years fiscal policy was anchored within a three-year Extended Fund Facility (EFF) programme with the International Monetary Fund (IMF). The programme successfully concluded in February 2017. Restoration of a significant degree of fiscal stability was among the major achievements of the programme, as fiscal policy has been prudent and public debt was put on a downward trajectory, peaking at about 73 per cent of GDP in 2015. At the end of 2016, public debt had fallen to 71 per cent of GDP. The Albanian parliament has endorsed the state budget for 2017 which envisions the budget deficit of 2 per cent of the projected GDP, which would be the lowest level in the last two decades. This is despite significant increases in public sector wages and the minimum wage announced in spring 2017.

The short-term outlook is positive but downside risks remain. Growth of 3.7 per cent is expected in 2017, staying at the same level in 2018, on the back of private domestic demand and major construction work on large energy-related foreign direct investment (FDI), such as the Trans-Adriatic gas Pipeline (TAP). Monetary policy is expected to remain growth-supportive, and the pass-through from lower interest rates to an increased pace of credit lending is expected to rise gradually, in line with the ongoing efforts to tackle NPLs in the banking sector. The economy would also benefit from further progress in the EU approximation process. However, significant downside risks remain, associated with the embedded structural weaknesses in public administration and infrastructure, as well as vulnerability to external shocks in Albania's main market, the eurozone.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Progress is being made in the EU approximation process. In November 2016 the European Commission (EC) recommended the conditional opening of EU accession negotiations with Albania. This came after the country adopted an important judicial reform package in July 2016. However, the recommendation remains conditional on (among other things) tangible progress in implementation of judicial reform, in particular with regard to the law on re-evaluation of judges and prosecutors, known as the vetting law. The EC has also urged the government to pursue civil service reform, including the creation of a civil servants register and a change of their recruitment model, basing it fully on candidates' professional achievements (rather than on their political orientation as is often the case). At the same time, the EC has recognised the country's steady progress towards fulfilling its key priorities within the EU accession process, namely: public administration reform, strengthening the rule of law, as well as reforms aimed at developing a functioning market economy.

Customs procedures have been improved. In June 2017 the new customs code that eases the procedures for businesses and reduces the time and costs related to customs charges entered into force. The introduction of streamlined procedures of exports and imports aims to bolster trade, and the code has been drafted in line with the EU acquis communautaire. This is an example of the business environment improvements in Albania in recent years, contributing to the country reaching 65th place in overall ease of doing business in the World Bank's *Doing Business 2018* report, compared with 85th five years ago.

Trans Adriatic gas Pipeline (TAP) construction is progressing. TAP is currently the most important infrastructure project in the country, aiming to reduce EU dependence on Russian gas and potentially diversify the energy mix and strengthen energy resilience in Albania. The TAP route through Albania is approximately 215 km onshore and 37 km offshore, out of the entire length of 878 km, starting at the Greek-Turkish border. The investment in Albania's section is expected to amount to about €1.5 billion over six years, and up to €450 million in 2017 alone. In January, the government established a new transmission system operator, Albgaz, with the task of developing and managing gas infrastructure. Meanwhile, the government has also been studying the feasibility of secondary gas infrastructure in the country and identifying priority gasification projects as part of the Gas Master Plan for Albania, for possible implementation in the period 2018-20.

Progress on energy efficiency and renewables is advancing. In November 2016 Albania transposed EU law on the energy performance of buildings, as set out in the EU's 2010 Energy Performance of Buildings Directive. According to the Energy Community Secretariat, this rectifies breaches and ensures the country's compliance with Energy Community ministerial council decisions from October 2016. The government has also issued licences for the development of wind and solar power plants, in line with plans to reduce the reliance on hydropower and increase the production of energy from renewable resources.

Transport integration with neighbouring countries is moving ahead. In August 2017 the government launched a tender procedure for the Arber motorway, connecting Tirana with the Macedonian border. Once completed, the highway will reduce transport times from Tirana to FYR Macedonia, thereby boosting trade between the two countries. This is planned to be the first project under the government's recently proposed "€1 billion for reconstruction" programme, which, if it proceeds, may use public-private partnerships (PPPs). Feasibility studies are also under way for the proposed Ionian Adriatic highway corridor as well as a detailed design for the rehabilitation of the railway line connecting Albania and Montenegro.

Governance in the banking sector is being strengthened. The central bank is currently preparing new regulations to strengthen the governance of banks and the independence of their controlling structures. According to the new regulations, the chairman of the bank's audit committee will also be a member of the Steering Council. This official should not have a private interest relationship with the bank's shareholders or executives in order to prevent conflicts of interest. Further proposed measures refer to strengthening the importance and independence of risk management units in the banks. These measures should help prevent a return of large amounts of NPLs. The NPL level remains high by regional standards but has come down to 15.6 per cent of total loans as of the end of June 2017.

CONTINUES

Albania's first private stock exchange is expected to be launched by the end of 2017. The stock exchange is expected to be operational after it was licensed by the financial supervisory authority in July 2017. Albania's Credins Bank and American Bank of Investments will own 42.5 per cent of the exchange's capital each, while the remaining shares will be held by AK Invest. The stock exchange will use the same electronic system used by the bourses in Ljubljana, Skopje, Sarajevo, Banja Luka and Podgorica, meaning that in the future it could potentially be incorporated into the regional SEE link.

ARMENIA

Highlights

- **Economic growth has regained momentum.** GDP growth accelerated to an estimated 5.9 per cent year-on-year in the first half of 2017, supported by strong export performance and a recovery in money transfers which followed three years of contraction.
- **Fiscal consolidation is under way.** The higher-than-planned budget deficit in 2016 led to budget consolidation required by the fiscal rule, and the deficit is planned to fall to under 3 per cent of GDP in 2017. At the same time, tax revenue over-performance in the first half of 2017 has created space for additional capital spending.
- **Banking sector capital buffers have improved.** Higher minimum capital requirements for the banking sector became effective in January 2017. This led to the injection of additional capital into the banking system and to a reduction in the number of banks.

Key priorities for 2018

- **Policies should be aimed at creating more fiscal space for tackling social and infrastructural challenges.** Further reforms in tax and customs administration should focus on mobilisation of revenues in a fair and equitable manner, and the fiscal rule needs to be updated to allow counter-cyclical response to exogenous economic shocks.
- **A new framework for public-private partnerships (PPPs) needs to be developed and adopted.** A framework of universal PPP legislation would help in attracting a greater number of PPP projects and managing contingent liabilities that might arise from such projects. A robust PPP framework would require, among other things, sound planning and project selection, strong budgeting, accounting and reporting practices and adequate fiscal risk analysis on a project level.
- **The operational environment in the banking sector requires further improvement.** In the wake of the recent successful recapitalisation, the banking system's ability to raise overall profitability and generate higher returns on equity has been limited. Supervision should remain vigilant to avoid a deterioration in underwriting standards.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.3	3.6	3.2	0.2	3.5
Inflation (average)	5.8	3.0	3.7	-1.4	1.9
Government balance/GDP	-1.6	-1.9	-4.8	-5.6	-3.3
Current account balance/GDP	-7.3	-7.6	-2.6	-2.3	-3.6
Net FDI/GDP [neg. sign = inflows]	-2.9	-3.3	-1.5	-2.6	-3.6
External debt/GDP	78.5	73.6	84.5	94.1	n.a.
Gross reserves/GDP	20.2	12.8	16.8	20.8	n.a.
Credit to private sector/GDP	39.5	45.3	42.0	48.0	n.a.

CONTINUES

Macroeconomic performance

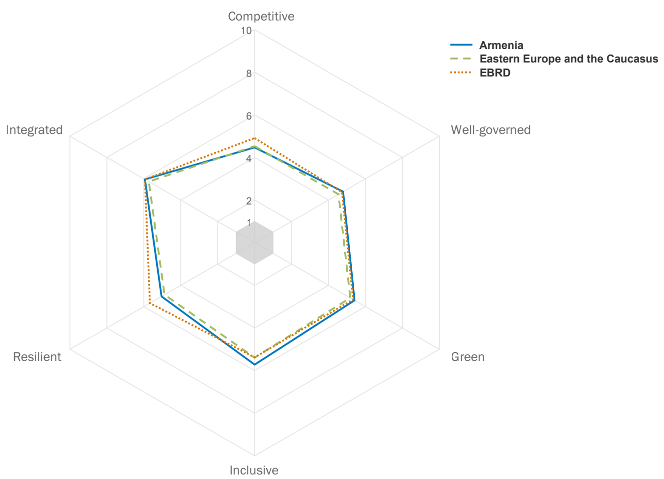
Growth came almost to a standstill in 2016 but rebounded strongly in the first half of 2017. GDP growth slowed from 3.2 per cent in 2015 to 0.2 per cent in 2016, the lowest rate since 2009. This was driven by a decline in two major sectors of the economy: construction and agriculture. Construction output shrank by 10.8 per cent in real terms and agriculture contracted by 5.8 per cent in real terms. The decline in household consumption and capital investment was offset by a 19.1 per cent increase in the volume of exports. GDP expanded by 6.5 per cent year-on-year in the first quarter of 2017 and by a further 5.5 per cent year-on-year in the second quarter. In 2016, negative inflation of 1.4 per cent reflected weak domestic demand and low import prices. In reaction to slowing growth, deflation and a stabilising exchange rate, the Central Bank of Armenia (CBA) gradually lowered the refinancing rate from 10.5 per cent in August 2015 to 6.0 per cent in February 2017. An upturn in remittances in the first half of 2017 provided a stimulus to household consumption. As a result, consumer price inflation slowly increased to 0.6 per cent year-on-year in the first nine months of 2017.

External adjustment helped to maintain a stable exchange rate. The current account deficit shrank from 7.6 per cent of GDP in 2014 to 2.3 per cent in 2016 on the back of import compression and strong exports receipts driven by the recovery in copper prices and the diversification of Armenia's exports to new markets. Favourable net foreign exchange inflows have contributed to the stability of the dram-US dollar exchange rate from the beginning of 2015. Money transfers to Armenia increased by 17.5 per cent year-on-year in the first eight months of 2017 following a contraction of close to 30 per cent in 2015-16. Gross international reserves recovered from US$ 1.26 billion in February 2015 to US$ 2.1 billion in September 2017, providing five months of import coverage.

Fiscal consolidation aims to rein in public debt. In 2016, the budget deficit widened to 5.6 per cent of GDP, beyond the initially planned 3.5 per cent. The public debt-to-GDP ratio increased to approximately 57.0 per cent at the end of 2016, triggering the deficit adjustment required by the fiscal rule. To satisfy this requirement, the authorities plan to reduce the budget deficit to around 3.0 per cent of GDP in 2017, mainly through lower capital spending, although more recently tax revenue over-performance has created room for additional spending on infrastructure. Budget revenues increased by 6.3 per cent year-on-year in the first nine months of 2017.

The growth outlook is supported by the ongoing regional recovery. Economic recovery in the main trading partners is expected to have positive spillovers into Armenia's economy, which is projected to grow by 3.5 per cent in 2017 and 3.5 per cent in 2018, but the economy remains exposed to several risks, including volatility in the commodity markets.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Armenia has successfully completed the IMF programme. The completion of the final review in June 2017 enabled the release of a US$ 22 million tranche, bringing the total disbursement under the programme to approximately US$ 112 million. The IMF assessed the programme performance as satisfactory. During the programme, the authorities enacted a financial recovery plan for the energy sector, adopted a new tax code in October 2016 and initiated improvements to the fiscal framework. Some efforts were made to develop legislative changes aimed at promoting domestic competition, improving bankruptcy procedures, and developing capital markets.

The fiscal framework is undergoing improvements. The authorities took steps to optimise planning of investment projects funded by international donor organisations. Prioritisation of these projects was carried out to ensure that loan absorption dynamics are consistent with the deficit and public debt reduction targets. The authorities initiated a revision of the fiscal rule to take into account implementation characteristics of donor-financed projects, mitigate the pro-cyclical bias and allow for more flexibility in periods of external shocks. The revised rule is expected to be submitted to the parliament by the end of 2017.

Recapitalisation of the banks was completed in an orderly fashion. The banking sector's capital buffers improved following the increase in minimum capital requirements (up from approximately US$ 10 million to US$ 60 million) which came into force in January 2017. New capital requirements led to consolidation in the banking sector, with the number of banks dropping from 21 to 17 in 2016. Progress has been made in developing a legal framework for capital markets. In October 2016, the parliament adopted laws on implementation of International Swaps and Derivatives Association (ISDA) Master Agreements, which will support the development of derivatives and hedging markets.

Measures to improve the business environment and attract investors continued. Efforts have been under way to streamline tax and customs administration, including via organisational changes. The time required for exporters to receive tax refunds has been shortened. In January 2017, the Center for Strategic Initiatives (CSI) was established to help attract foreign investments, promote PPPs, communicate key reforms and serve as a platform for cooperation between the private sector and the government. The board of trustees of the CSI involves high-level representatives of private and public sectors. Armenia ranks 47th out of 190 economies in the World Bank's *Doing Business 2018* report. Lower scores in dealing with construction permits, getting electricity, paying taxes and resolving insolvency contrast to higher scores in other areas.

The authorities have introduced a Government Reform Programme for 2017-22. Adopted in June 2017, the programme contains a list of reforms in the areas of public governance and legal system, foreign policy and defence, economic progress and social issues. Planned reforms are accompanied by implementation timelines.

Negotiations on the Comprehensive and Enhanced Partnership Agreement (CEPA) with the European Union (EU) have advanced. The negotiations were finalised on 26 February 2017, and the text of the agreement was signed off in March 2017. The CEPA will create a framework for closer political and economic cooperation between Armenia and the European Union.

AZERBAIJAN

Highlights

- **The economy is in recession but the pace of decline has slowed.** GDP declined by 3.1 per cent in 2016 but by just 0.6 per cent year-on-year in the first nine months of 2017. The modest recovery in oil prices and adjustment of macroeconomic policies are helping to stabilise the economy.
- **The International Bank of Azerbaijan (IBA) completed a voluntary debt restructuring.** This is part of the bank's broader restructuring plan that aims to clean up the balance sheet and prepare the bank for eventual privatisation.
- **The Commission on Transparency in Extractive Industries has been established and is operational.** Following Azerbaijan's withdrawal from the Extractive Industries Transparency Initiative (EITI), the authorities have pledged to continue to uphold the principles of revenue transparency and accountability.

Key priorities for 2018

- **Macroeconomic stability needs to be reinforced to improve business confidence.** Policies should be geared towards bringing down inflation while maintaining flexibility of the exchange rate and preserving the fiscal consolidation gains achieved in 2016.
- **IBA privatisation is a crucial priority.** The declared plan to privatise the IBA needs to be implemented on completion of the bank's restructuring process. This will help both to ensure the sustainability of the IBA's operations and to eschew contingent fiscal costs in the future.
- **Reform roadmaps should be implemented vigorously.** Key priorities in the short term include tax administration reforms to enhance predictability, fairness and taxpayer compliance, and decisive steps to tackle informality in the economy.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	5.8	2.8	1.1	-3.1	-0.5
Inflation (average)	2.4	1.4	4.0	12.4	12.0
Government balance[1]/GDP	1.7	2.7	-4.8	-1.1	-0.3
Current account balance/GDP	16.6	13.9	-0.4	-3.6	1.9
Net FDI/GDP [neg. sign = inflows]	-1.5	-2.9	-1.5	-5.1	-5.7
External debt[2]/GDP	11.7	14.5	18.5	20.4	n.a.
Gross reserves[3]/GDP	19.1	18.3	9.5	10.5	n.a.
Credit to private sector/GDP	26.5	31.4	40.0	27.2	n.a.

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

CONTINUES

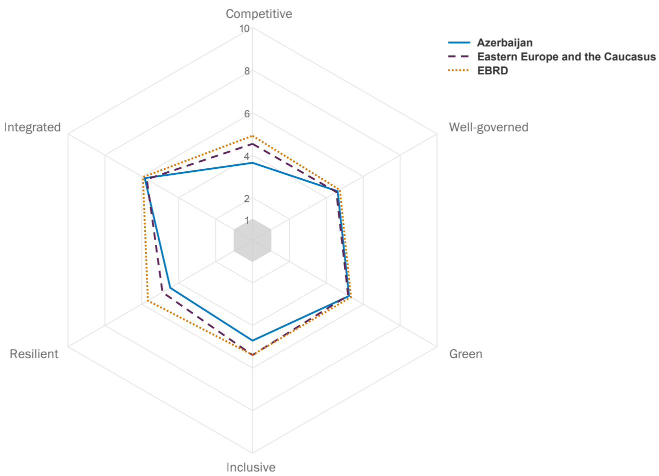
Macroeconomic performance

The economic recession is looking less severe. GDP declined by 3.1 per cent in 2016, but the pace of contraction decelerated to 0.6 per cent year-on-year in the first nine months of 2017. Non-oil GDP grew by 2.5 per cent in the first nine months of 2017 following a 4.5 per cent contraction in 2016. Last year's recession was accompanied by a major 21.7 per cent drop in capital investment, but the decline in investment has since levelled off during 2017. Macroeconomic policies have remained relatively tight to curb inflation, defuse foreign exchange pressures and safeguard liquidity buffers. However, inflation has picked up to 13.9 per cent year-on-year in the first nine months of 2017, reflecting the delayed pass-through effect of the manat devaluation in 2015-16.

Macroeconomic balances have improved. The manat devaluation in 2015-16 paved the way for increasing the competiveness of non-oil exports and for the containment of imports, but external adjustment has been slow. In the first half of 2017, Azerbaijan's current account receipts from the oil and gas sector grew by approximately 8.0 per cent year-on-year in US dollar terms, enabled by the recovery in the oil price. As a result, Azerbaijan's overall current account moved from a deficit of 3.6 per cent of GDP in 2016 to a small surplus in the first half of 2017, but the non-oil current account balance remained negative. After a brief period of volatility at the beginning of 2017, the manat-US dollar exchange rate has stabilised amid stringent monetary conditions and a recovery in the oil price. Meanwhile, the consolidated fiscal deficit declined closer to 1 per cent of GDP in 2016 after reaching approximately 5 per cent of GDP in 2015, with the improvement driven by conservative budget planning and downsizing of public investment spending. Azerbaijan has maintained sizeable liquidity buffers despite pressures arising from the low oil price environment. As of mid-2017, the combined assets of the State Oil Fund of Azerbaijan (SOFAZ) and of the foreign exchange reserves of the central bank were US$ 41 billion, which is approximately equivalent to the country's GDP.

GDP growth should rebound in 2018. A slight GDP downturn of 0.5 per cent is likely in 2017 as a whole as tight monetary and fiscal policies, necessary to safeguard macroeconomic stability and preserve liquidity buffers, weigh on the near-term growth outlook. However, the completion of landmark gas infrastructure projects (Shah Deniz stage 2, Southern Gas Corridor) is expected to provide impetus to growth from 2018 onwards, with GDP projected to rise by 2.0 per cent next year. Downside risks remain significant, associated mainly with the dependence on the resources sector and banking sector challenges.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

A series of reform roadmaps have been adopted. In December 2016, the President of Azerbaijan endorsed a set of strategic roadmaps for reforms in the key sectors of the economy, such as the oil and gas industry, agriculture, small and medium-sized enterprises, tourism, logistics and financial services among others. These roadmaps detail a short-, medium- and long-term horizon for each sector and provide action plans for 2016-20. A Center for Economic Reforms Analysis and Communication was established to promote the realisation of economic reforms and work on public outreach. However, the capacity to implement the reform roadmaps without delays remains uncertain.

Administrative requirements for doing business have been simplified. Following the streamlining of procedures for issuing licences and permits in 2016, ASAN (Azerbaijan Service and Assessment Network) introduced an e-visa portal in January 2017 which simplifies and substantially shortens the time period for issuing visas to foreigners, including business travellers. A moratorium on some of the inspections, which has been extended until January 2021, reduces the regulatory burden on businesses. A Board of Appeals introduced within ministries and under the presidential administration during the course of 2016 aims to create a dispute resolution mechanism for addressing private sector complaints, but its effectiveness remains largely untested. Improvements in customs administration as well as in other areas of government regulation have paved the way for more transparent and accurate financial reporting by companies operating in Azerbaijan. Azerbaijan ranks 57th out of 190 countries in the World Bank's *Doing Business 2018* report. Recent improvements relate to getting credit, protecting minority investors, enforcing contracts and resolving insolvency although the scores remain low in dealing with construction permits, getting electricity, getting credit and trading across borders.

The banking sector clean-up and consolidation is under way. The manat devaluation in 2015-16 negatively affected dollarised balance sheets in the banking sector, exposing capital shortfalls. Between its establishment in February 2016 and June 2017, the Financial Markets Supervisory Authority (FiMSA) closed 11 banks which failed to comply with regulatory capital requirements. Non-performing loans remain elevated, mainly reflecting foreign exchange-induced credit risks and the economic recession. Credit activity has shrunk in 2016 and in the first eight months of 2017 due to the turbulence in the banking system and the lack of credit demand from the real sector.

The authorities have initiated restructuring of the IBA. Following significant capital injections into the majority state-owned IBA in 2016-17 and transfer of some of its bad assets to a separate entity, the authorities launched a liability management operation to further de-risk and downsize the IBA's balance sheet. The IBA is the largest bank in Azerbaijan and accounted for approximately one-third of total banking assets before the debt operation. In May 2017, the IBA announced a voluntary restructuring of foreign exchange liabilities amounting to US$ 3.3 billion, offering creditors to swap the IBA's debt for new sovereign bonds and limited new IBA debt. The debt restructuring was concluded in September 2017. As part of the broader bank restructuring effort, the IBA aims to dispose of non-core foreign assets and take further steps to clean-up the balance sheet ahead of the declared plan to privatise the bank in 2018.

Establishment of the Commission on Transparency in Extractive Industries followed Azerbaijan's withdrawal from the EITI. Azerbaijan joined the EITI in 2004 at the outset of the initiative and was the first country to be validated as fully compliant with EITI standards in 2009. In March 2017, the EITI suspended Azerbaijan's membership over concerns about the enabling environment for civil society. In response, Azerbaijan decided to withdraw from the EITI. The authorities stressed that Azerbaijan would remain committed to the principles of good governance, revenue transparency and accountability in the extractive sectors. In April 2017, the President of Azerbaijan signed a decree establishing a Commission on Transparency in Extractive Industries. The Commission has become operational under the chairmanship of the executive director of SOFAZ.

BELARUS

Highlights

- **GDP is growing again in 2017.** The economy shrank by 2.6 per cent in 2016 but in the first nine months of 2017 GDP grew by 1.7 per cent year-on-year, driven mainly by a recovery in external demand and the resulting growth in export-oriented manufacturing.
- **Macroeconomic stabilisation policies are bearing fruit.** So far in 2017, the exchange rate is stable and inflation is at its lowest level, reflecting a prudent fiscal and monetary policy stance as well as weak domestic demand. Transition to fully fledged inflation targeting has advanced.
- **The authorities prepared a comprehensive package of business liberalisation measures.** Changes are designed to lower barriers for engaging in private entrepreneurship and to minimise the administrative burden on businesses including through the enhanced provision of electronic public services.

Key priorities for 2018

- **Deeper structural adjustments are required to unlock growth potential.** Reforms should aim to overhaul the state enterprise sector and to phase out directed lending that misallocates financial resources away from the organically growing private sector.
- **Further reforms are needed in the energy sector and utility services.** The ongoing adjustment of utility tariffs should continue until full cost recovery has been attained. Efforts are required to increase the cost efficiency of winter heating for residential buildings to pave the way for full cost recovery in this area. Unbundling of the electricity sector is needed to attract private investment.
- **Remaining banking sector challenges should be addressed.** The banking sector should be fully discharged from performing quasi-fiscal functions. Preparation of some banks slated for privatisation, through corporatisation measures, institutional building and balance sheet sanitisation, should proceed without delay.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.0	1.7	-3.8	-2.6	1.5
Inflation (average)	18.3	18.1	13.5	11.8	8.0
Government balance[1]/GDP	-1.0	0.1	-2.2	-3.4	-5.6
Current account balance/GDP	-10.0	-6.6	-3.2	-3.5	-5.3
Net FDI/GDP [neg. sign = inflows]	-2.6	-2.3	-2.7	-2.4	-3.4
External debt/GDP	52.4	50.7	67.5	79.1	n.a.
Gross reserves/GDP	8.8	6.4	7.4	10.4	n.a.
Credit to private sector/GDP	20.3	21.1	23.1	21.3	n.a.

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

CONTINUES

Macroeconomic performance

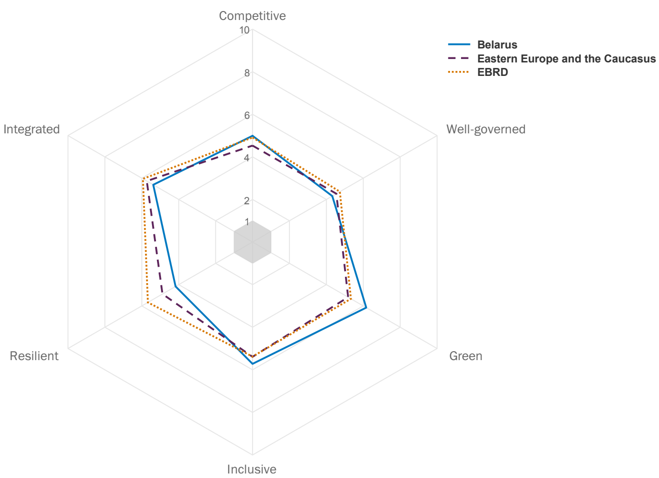
The economy is showing signs of recovery but structural bottlenecks to growth remain. GDP shrank by 2.6 per cent in 2016, the second year of recession in a row, with a broad-based output decline across major sectors of the economy. However, in the first nine months of 2017, the economy returned to low positive growth. GDP expanded by an estimated 1.7 per cent year-on-year in this period, driven by external demand and household consumption. Output in manufacturing, the economy's largest sector representing approximately 22.2 per cent of GDP, grew by 6.6 per cent year-on-year in the first nine months of 2017, mainly on the account of export-oriented industries, which are benefiting from the economic recovery in major trading partners. Agricultural output also demonstrated growth of 2.8 per cent year-on-year while construction contracted by 6.5 per cent year-on-year in the same period.

Inflation has fallen to its lowest level. Stabilisation of the exchange rate, weak domestic demand, moderation in wage growth as well as generally tight monetary and fiscal policies have helped to bring the inflation rate down to 4.9 per cent year-on-year in September 2017. This is significantly below the 9.0 per cent ceiling targeted by the National Bank of the Republic of Belarus (NBRB) in 2017, allowing for a gradual loosening of monetary policy. The refinancing rate decreased eight consecutive times in 2017 from 18.0 per cent in January to 11.0 per cent in October. Market interest rates have also declined.

The authorities made progress in unwinding macroeconomic imbalances although weaknesses remain. The exchange rate has been relatively stable since mid-2016. The current account deficit declined from 6.6 per cent of GDP in 2014 to 3.5 per cent in 2016 supported by devaluation in 2014-15 and a more flexible exchange rate regime. Proceeds from the issuance of sovereign Eurobonds in July 2017 and disbursements by the Eurasian Fund for Stability and Development (EFSD) helped to replenish foreign currency reserves. They increased to US$ 3.4 billion as of the beginning of October 2017 providing close to 1.5 months of imports coverage, which is still low relative to external liabilities. Despite the headline surpluses of the consolidated budget, the fiscal position is weakened by contingent liabilities arising from the high degree of state involvement in the economy and from directed and subsidised lending programmes.

Growth prospects depend on structural adjustments and the regional outlook. The near-term economic outlook has improved recently thanks to: (i) resolution of the gas price dispute with Russia and agreement to restore crude oil supplies to Belarus to ordinary annual volumes; (ii) resumption of disbursements by the EFSD and bilateral lending from Russia; and (iii) successful issuance by Belarus of dual-tranche sovereign Eurobonds for the aggregate principal amount of US$ 1.4 billion in June 2017. These developments have helped to mitigate short-term funding pressures. However, downside risks remain and the longer-term prospects continue to depend on the extent of structural reforms and on scaling back state interference in the economy.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Business deregulation initiatives aim to foster entrepreneurship. A comprehensive set of measures to cut "red tape" and ease administrative barriers for doing business was prepared and submitted to the President at the end of September 2017. The goal of the legislative package is to minimise the state's intervention in business activities. The package envisages, among other things, reform of the state's control functions; simplification of procedures for starting a business and conducting entrepreneurial activities in major areas of commerce; and a reduction in the number of licences and permits, as well as issuance of all licences in electronic form.

The state-dominated banking sector faces a backlog of problem assets. State-owned banks continued to dominate the market, accounting for around 65.0 per cent of sector assets at the end of the first quarter of 2017. The reported ratio of non-performing loans (NPLs) to total gross loans in the banking sector stood at 13.0 per cent as of 1 September 2017, up from 6.8 per cent at the beginning of 2016, but monitoring of the true level of problem loans is difficult due to directed and subsidised lending programmes which accounted for an estimated 40.0 per cent of all loans. The authorities have continued to reduce new directed lending, with its volume expected to decline from close to 5.0 per cent of GDP in 2013 to approximately 1.8 per cent of GDP in 2017 and an estimated 1.0 per cent of GDP in 2018. However, the stock of directed loans is expected to remain large in the medium term considering that it includes loans with long tenures and directed loans to corporates are often restructured due to their weak performance. The Development Bank of Republic of Belarus became the main administrator of directed lending programmes.

Monetary policy and regulatory frameworks are being gradually strengthened. Under the presidential decree issued in April 2017, the NBRB has switched from targeting exchange rate stability to price stability as the main monetary policy anchor. The authorities plan to move to a fully fledged inflation targeting regime by 2020. In May 2017, the NBRB adopted a resolution establishing a procedure for recognising banks as systemically important and introduced additional requirements for such banks to bolster capital buffers. The same resolution established Basel III liquidity ratios (liquidity coverage ratio and net stable funding ratio) as a functioning requirement for all banks and entitled the NBRB to apply countercyclical buffers if needed to mitigate excessive lending growth. This regulation is set to become effective from January 2018. To improve disclosure standards and transparency, from January 2017 the requirement to publish IFRS-compliant reporting has been extended to all companies whose securities are traded in a public market, banks, non-banking financial organisations and insurance companies.

Measures to prepare two state-owned banks for privatisation have advanced. Belinvestbank (BIB) made progress with commercialisation. The bank completed the inception phase of the institutional building programme in March 2017. New management was appointed and business processes were improved with the supervisory board assuming a more hands-on role. The clean-up of the balance sheet has advanced. By the end of 2016, a significant portion of the portfolio related to state programmes was transferred from the BIB's balance sheet, mostly to the Belarus Development Bank, and more of such assets are expected to be removed in 2017. Five non-core subsidiaries were divested. Meanwhile, Moscow-Minsk bank has focused on improving its commercial operations and broadening the client base as a first step towards attracting strategic investors.

Utility tariffs are adjusting gradually. As of the end of 2016, cost recovery for provision of all utilities reached an estimated 60.7 per cent. Gas, electricity, hot water and heating tariffs were further increased by an estimated 8.0 per cent as of 1 September 2017. Tariff increases have been supported by efforts to optimise costs related to generation of utility services. The pace of adjustment has been higher for utility services that allow consumption control by individual users, such as water and electricity. Raising district heating tariffs has been more challenging considering that the utilisation is centrally managed and that heating's existing cost recovery level is significantly lower compared with other utility services. The authorities introduced non-cash housing subsidies effective from October 2016 to mitigate the impact of tariff increases on vulnerable groups, that is, those whose spending on communal services is 20 per cent or more of their income in the city and 15 per cent or more of their income in rural areas.

CONTINUES

Disbursements by the EFSD advanced but programme negotiations with the IMF were put on hold. Following a brief hiatus, EFSD acknowledged that Belarus met most of the programme conditions and disbursed three tranches totalling US$ 800 million in the first 10 months of 2017. This brought total disbursements to US$ 1.4 billion out of US$ 2 billion allocated under the programme. Discussions between the IMF and Belarusian authorities about a possible programme have been under way since the beginning of 2015. More recently, the programme negotiations have stalled amid disparities related to the pace of utility tariff increases and the reform of the state enterprise sector.

BOSNIA AND HERZEGOVINA

Highlights

- **Progress on the country's reform agenda has stalled in 2017.** Key prior actions required under the existing programme with the International Monetary Fund (IMF) have been delayed for months, holding up the first review of the programme and jeopardising international funding for important infrastructure projects.
- **Macroeconomic performance has been resilient.** Growth has remained positive in recent years despite adverse shocks and a difficult investment climate, and short-term indicators in 2017 on industry and exports continue to move in a positive direction.
- **Major privatisations in the Federation remain stalled.** Although some sales have occurred in the past year, key assets remain in state hands and there appears to be little or no appetite to make substantive progress on privatisation for the two state-owned telecommunications companies.

Key priorities for 2018

- **The reform agenda needs to be kick-started again.** The main short-term priority is to get the IMF programme back on track and complete the long-delayed first review by implementing the necessary prior actions.
- **Key investment climate improvements should be targeted and implemented.** The authorities have shown a willingness to engage in reforms in this area. The challenge now is to improve the dialogue between the authorities and the private sector on investment-related issues and to deliver results in areas such as procurement reform, enhancing tax administration, and improving business registration.
- **Regional integration should be enhanced.** Bosnia and Herzegovina has belatedly agreed to join the Western Balkans Transport Community, but it will be vital to accelerate reforms in order to benefit from the international support for infrastructure projects that promote regional connectivity.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.4	1.1	3.1	3.2	2.5
Inflation (average)	-0.1	-0.9	-1.0	-1.1	1.8
Government balance/GDP	-1.9	-2.9	-0.2	0.4	-0.4
Current account balance/GDP	-5.3	-7.4	-5.5	-4.5	-4.3
Net FDI/GDP [neg. sign = inflows]	-1.3	-2.8	-1.5	-1.6	-1.6
External debt/GDP	61.7	63.7	63.7	62.8	n.a.
Gross reserves/GDP	27.6	26.3	29.7	31.1	n.a.
Credit to private sector/GDP	56.6	56.4	54.9	55.5	n.a.

CONTINUES

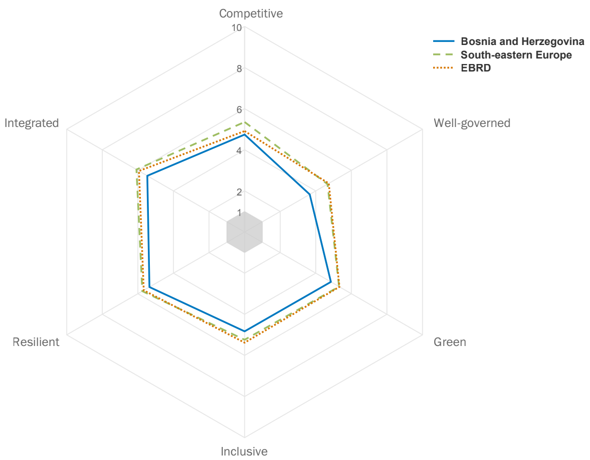
Macroeconomic performance

The economy has shown resilience in recent years. Growth in 2016 is estimated at 3.2 per cent, following a recent revision upwards, after 3.1 per cent in 2015. The economy continued to grow in the first half of 2017 albeit at a slower rate, estimated at 2.2 per cent year-on-year. The slow-down was driven by a weaker performance of the agricultural sector compared with the same period last year, as well as a levelling of the industry sector. In addition, the construction sector's performance was subdued as the implementation of some key infrastructure projects, including Corridor Vc, is delayed.

A reform slow-down in 2017 is threatening external financing. The completion of the first review of the three-year Extended Fund Facility signed with the IMF in September 2016 has been held up for many months. Staff-level agreement on the review had been reached in November 2016 but delays have occurred in implementing several prior actions (see below). As a result, further disbursements from the IMF are on hold and some financing from the European Commission and from international financial institutions (IFIs), including the EBRD and EIB, is on hold or jeopardised. However, the appropriate budgets for 2017 that fulfil IMF requirements were approved in both entities. Public debt is relatively low by regional standards at around 40 per cent of GDP, implying some room for a modest increase in borrowing in the short term.

Growth is expected to continue in the short term. In light of the delays in implementing major infrastructure projects, GDP growth is likely to be just 2.5 per cent in 2017, rising to 3.0 per cent in 2018. The economy has proven to be resilient in the past to reform slow-downs and political upheavals, but the downside risks to this forecast are still significant. The weak investment climate deters investment and the country's complex institutional structure continues to impede the implementation of reforms and holds back growth. In the medium term, however, growth prospects could be enhanced if governments at all levels step up implementation of the ambitious reform agenda and if the EU approximation process advances further.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Important reforms are on hold. The IMF programme signed in September 2016 was intended to be a complement to the country's Reform Agenda adopted in July 2015 and a strong anchor for fiscal, financial and structural reforms. The first review of the programme has been on hold since late 2016 as a result of the failure to implement a number of prior actions. These include amendments to the law on deposit insurance to strengthen oversight of the system, and amendments to the law on excise duties to raise fuel taxes to help ensure the sustainability of financing for the road sector. A further set-back occurred in July 2017 at the Western Balkans Summit in Trieste, where Bosnia and Herzegovina was the only country not to sign the Treaty on the establishment of the Western Balkans Transport Community. However, this decision was reversed by the Bosnian authorities in September 2017 and the Treaty has now been signed.

Bosnia and Herzegovina is completing the European Union's questionnaire, received in December 2016. In September 2016, the EU General Affairs Council decided to recommend to the European Commission (EC) to launch the procedure for granting Bosnia and Herzegovina candidate status. This follows the submission of an application for membership in February 2016, and the entry into force of the country's Stabilisation and Association Agreement (SAA) on 1 June 2015. The government expects to submit answers to the EC's questionnaire in the last quarter of 2017. A Stabilisation and Association Council (SA Council) between Bosnia and Herzegovina and the EU has been established and held its second meeting in July 2017. The country is also in the final stages of accession to the World Trade Organization.

Major privatisations in the Federation continue to be stalled. In March 2017, the Federation government launched a tender for the sale of its stake in the insurance company Sarajevo Osiguranje. This is the sixth attempt to sell the stake after the previous five have failed due to lack of interest. However, resistance to this privatisation and others within the Federation remains strong. There are no plans yet to commit to privatising the telecommunications companies BH Telekom and HT Mostar, and the launch of due diligence for both companies – another prior action for the IMF programme – has not started.

The Energy Community has re-introduced sanctions against Bosnia and Herzegovina. On 1 April 2017, the Energy Community re-introduced sanctions because of the country's failure to adopt necessary legislation regarding the transmission of electricity and gas at state level. Bosnia and Herzegovina has also been accused of breaking Energy Community rules over thermal power plants under construction. The Energy Community secretariat has launched a case on the environmental impact assessment of the planned Ugljevik III thermal power plant (TPP), saying that the plant's environmental impact assessment procedure was not carried out in compliance with Energy Community rules. Also, in February 2017, the Energy Community secretariat ordered Bosnia and Herzegovina to revise the permit for Banovici TPP to take account of air pollution limits, thus accepting a complaint by the Sarajevo-based environmental watchdog Ekotim against Bosnia and Herzegovina's decision to grant permission for the construction of the 350 MW Banovici TPP.

The Banja Luka bourse has joined the SEE Link. One of the country's two bourses — the Banja Luka Stock Exchange (BLSE) – has become an active member of the SEE Link network. So far, the SEE Link network has included the exchanges of Bulgaria, FYR Macedonia and Croatia, which founded the network, as well as those of Slovenia and Serbia, which became official members in December 2016. SEE Link is a project, launched in February 2016, aiming to create a regional infrastructure for the trading of securities listed on the regional markets.

The Federation has adopted a new banking system law. In January 2017, the government of Federation of Bosnia and Herzegovina adopted a new law on the banking system, aiming to improve the stability of the banking sector. In March 2017, the law was approved by the parliament. The law is aligned to EU directives, which include stronger supervision of banks, a risk management system, restructuring of banks and other provisions related to the corporate governance in banks. It is harmonised with the Republika Srpska, where the respective banking laws have already been adopted.

BULGARIA

Highlights

- **Strong growth has continued into 2017.** After growing 3.9 per cent in 2016, the economy expanded by 3.6 per cent and 3.9 per cent in the first two quarters of 2017. Domestic demand and net exports led growth in 2016, while in the first half of 2017 growth was driven by private consumption. After several years of declining prices, inflation turned positive in December 2016.
- **The government budget returned to surplus in 2016.** A mid-term fiscal framework to continue the fiscal consolidation process was approved in April 2016, which helped achieve a cash-based budget surplus of 1.6 per cent of GDP in 2016, following a deficit of 2.9 per cent in the previous year. The budget surplus continued during the first half of 2017.
- **Confidence has returned to the banking system.** The main banks have proved to be resilient in stress tests, and non-performing loans (NPLs) declined to 12.1 per cent in the first half of 2017, from 13.2 per cent at the end of the previous year.

Key priorities for 2018

- **Energy market liberalisation and integration are priorities.** Following the completion of a natural gas interconnector with Romania in November 2016, further interconnectors are planned with other neighbouring countries. The government is preparing a roadmap, to be published in late 2017, to full energy market liberalisation.
- **Further progress under the European Union's Cooperation and Verification Mechanism is needed.** In particular, the government needs to implement a newly drafted law for a special court focusing on high-level corruption, and a new money laundering law, which aligns the current framework with that of the European Union (EU).
- **Bulgaria needs to sustain efforts to reduce administrative burdens on businesses.** This is an explicit goal of the new coalition programme. Notably, a focus is needed on alleviating procedures for starting a business, getting electricity and paying taxes. At the same time, efforts are also needed to address long-term issues of governance, as well as insufficient education levels among the labour force.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	0.9	1.3	3.6	3.4	3.5
Inflation (average)	0.4	-1.6	-1.1	-1.3	1.1
Government balance/GDP	-1.8	-3.6	-2.8	1.6	-1.4
Current account balance/GDP	1.3	0.1	-0.1	4.2	2.5
Net FDI/GDP [neg. sign = inflows]	-3.6	-3.6	-5.5	-2.4	-3.4
External debt/GDP	87.9	92.0	73.6	70.7	n.a.
Gross reserves/GDP	35.6	35.6	44.1	48.0	n.a.
Credit to private sector/GDP	66.3	59.6	55.4	53.6	n.a.

CONTINUES

Macroeconomic performance

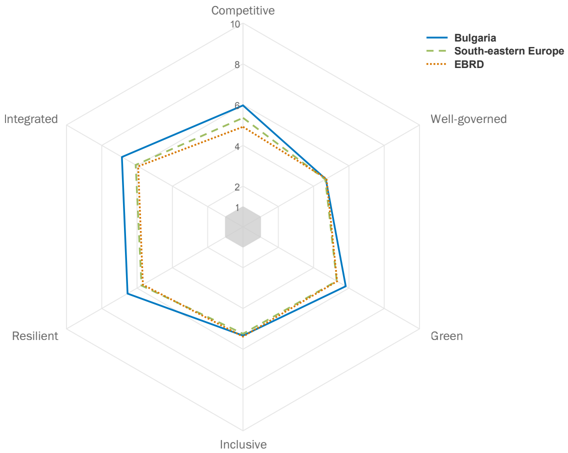
Strong economic growth has continued into 2017. The economy grew by 3.9 per cent in 2016, followed by a consumption-driven growth of 3.7 per cent in the first half of 2017. Net exports, driven by the upswing in key export markets including the EU, contributed to a current account surplus of 4.2 per cent of GDP. Private consumption also made an important contribution to growth in 2016, as unemployment fell and wages surged by a record 10 per cent year-on-year. However, investment dropped as a result of the cyclical fall in the disbursement of EU funds.

Inflation has turned positive again. In recent years, declining global oil prices and falling food prices had resulted in persistent deflation since August 2013. However, consumer prices started to rise in December 2016, driven by growing domestic demand, and year-on-year inflation averaged 2 per cent in the first half of 2017.

Fiscal performance has improved. Fiscal tightening in 2016, alongside higher tax collection, led to a cash-based budget surplus of 1.6 per cent of GDP and a primary surplus of 3.2 per cent. The budget surplus continued throughout the first half of 2017, standing at 1.8 per cent of the estimated 2017 GDP at the end of June. Public debt stood at 29.5 per cent of GDP at the end of 2016, rising slightly compared with the previous year but remaining low by regional and EU standards.

Short-term growth is likely to remain at current levels. Growth is expected to stabilise at around 3.5 per cent in 2017, with inflation of around 1.0 per cent. Domestic demand is expected to continue to drive growth, supported by improving labour market conditions and robust wage growth, with rising consumption limiting the contribution of net exports. Government consumption will remain limited due to the ongoing fiscal consolidation. Investment will strengthen as work starts on infrastructure projects financed under the EU's 2014-2020 budget. Growth is expected to remain robust in 2018, again at around 3.2 per cent. Key risks to the outlook are prolonged weakness in major trade partners and worsening of investor sentiments towards emerging markets, as well as any renewed difficulties in the financial sector. With GDP per capita (PPP) standing at 48 per cent of the EU average in 2016, convergence-based growth prospects in the medium term are positive but will require structural reforms to be reinvigorated.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Bulgaria made notable progress under the Cooperation and Verification Mechanism (CVM) in 2016, according to the 2017 report of the European Commission. Advances were noted in the implementation of judicial reforms, although the country still does not fully meet any of the six benchmarks the report monitors. At the same time, the report highlighted key challenges, including increasing the transparency of the election of the Supreme Judicial Council and ensuring that judicial appointments are transparent and merit-based. Meanwhile, the government has prepared a draft law for a special court focusing on high-level corruption and a money laundering law aligning the current legal framework with that of the EU.

Bulgaria continues to perform well compared with its regional peers in the business environment, although there remains room for improvement. According to the latest World Bank *Doing Business 2018* report, Bulgaria ranked 50th out of 190 countries in ease of doing business. Procedures for starting a business, paying taxes and getting electricity remain burdensome. Businesses surveyed in the World Economic Forum's *Global Competitiveness Index 2018* report indicate corruption and education of the labour force as the key challenges in the business environment. The new coalition programme aims at reducing the administrative burdens on businesses, which would be likely to improve the business environment if implemented.

Fiscal sustainability is being enhanced. The new government elected in March 2017 has adopted a coalition programme representing a continuation of the previous government's economic policies and fiscal framework. A three-year fiscal framework was approved in May 2017, foreseeing increases in the minimum wage and pensions. Following the approval of a pension reform package in July 2015, the retirement age has started to increase to enhance the sustainability of the state pension system. From its current levels of 63 years and 10 months for men and 60 years and 10 months for women, it will be equalised at 65 for both men and women by 2037.

Improvements in energy infrastructure have continued, strengthening energy sector integration. A natural gas interconnector with Romania was completed in November 2016, and the government plans new interconnectors with other neighbouring countries. However, there has been only limited progress in energy market liberalisation, an area that the new government has prioritised. The coalition agreement calls for the full liberalisation of the electricity and gas markets, and the government is currently preparing a roadmap to full energy market liberalisation and integration into the EU common market. The roadmap, expected to be published in late 2017, will be based on the guidelines from a 2016 World Bank study, and on EC Directives.

Confidence and resilience in the banking sector have strengthened. An Asset Quality Review (AQR) of the banking sector was completed in August 2016. The AQR showed that almost all banks comfortably meet local minimum capital adequacy requirements, with foreign-owned banks performing particularly well, while two domestic-owned banks had their capitalisation significantly trimmed, albeit still remaining above the minimum required. NPLs have continued to decline, and the first successful sale of corporate secured NPLs took place in January 2017. Nevertheless, Bulgaria's NPL levels of 12.1 per cent in the first half of 2017 remain significantly above the EU average of 5 per cent. Asset quality reviews in the insurance and pension sectors were also concluded in early 2017, with the results showing that most institutions were resilient to stress test scenarios, and no significant concerns reported.

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.

CONTINUES

Macroeconomic performance

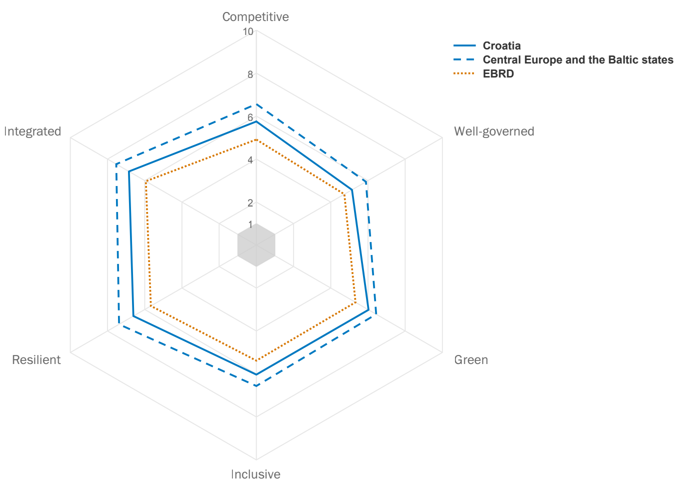
Growth accelerated in 2016, backed by several cyclical factors. After 2.3 per cent growth in 2015, the recovery continued in 2016 with 3.0 per cent GDP growth, driven by strong exports and domestic demand. The economy expanded by 2.7 per cent in the first half of 2017 on the back of strong consumption 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)



CONTINUES

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.

CYPRUS

Highlights

- **Robust growth is continuing.** A broad-based recovery is under way in 2017, underpinned by high growth in tourism, recovering investments, and rising confidence; while unemployment continues on a downward path.
- **Privatisation has come to a standstill.** Work on several flagship sales has ground to a halt, with an uncertain future, and the privatisation unit within the Ministry of Finance has been disbanded.
- **Non-performing loans (NPLs) are being reduced gradually.** The large overhang of NPLs from the crisis is being addressed by the banking sector, and one bank has partnered with a debt servicing company, but banks are missing their targets and the speed of resolution is below expectations, mostly due to limited progress in corporate reform and weak contract enforcement.

Key priorities for 2018

- **The authorities should kick-start the privatisation process.** A revitalisation could help attract fresh capital and improve the performance and governance of state-owned companies, namely in the telecommunications and energy sectors. Energy reform, including a substantial increase in renewable power production and energy efficiency improvements, depends on removing the dominance of the power monopoly company.
- **The resolution of NPLs should be speeded up.** NPLs are a major drag on the economy and the pace of dealing with them has lagged recently. A concerted effort is needed to streamline judicial procedures and facilitate the increased use of debt-service providers and loan workout packages.
- **The government should focus on further development of renewable energy sources.** Cyprus has significant potential in this area, but the current share of renewables in total consumption is below the country's 2020 target. Implementation of a long-term strategy for investments in renewables, including a well-defined regulatory framework supporting bankable investments, would help the country to reach its large and unmet potential.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	-5.9	-1.4	2.0	3.0	3.5
Inflation (average)	0.4	-0.3	-1.5	-1.2	0.8
Government balance/GDP	-5.1	-8.8	-1.2	0.5	0.9
Current account balance/GDP	-4.9	-4.3	-2.9	-5.3	-3.8
Net FDI/GDP [neg. sign = inflows]	-1.7	-8.0	48.4	5.8	-1.0
External debt/GDP	569.8	555.6	550.4	597.2	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	299.8	288.0	283.7	252.7	n.a.

*Cyprus is a member of the Euro area.

CONTINUES

Macroeconomic performance

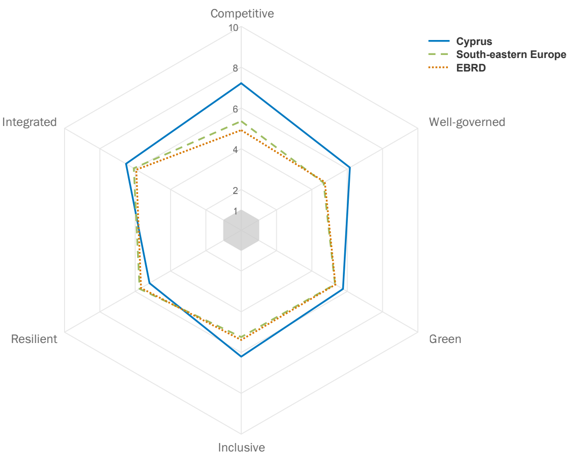
The economic recovery is continuing into 2017. After the return to growth in 2015 (2.0 per cent), following three years of contraction, the economy performed well in 2016, with GDP growth reaching 3.0 per cent, above expectations. Tourism was one of the main drivers of the economy, with arrivals last year up by around 20 per cent (almost 3.2 million tourists visited Cyprus in 2016) and virtually all hotels at full occupancy, while other sectors such as construction and professional services also contributed to the ongoing recovery. Economic growth has continued at a robust rate in the first half of 2017. The second quarter of 2017 GDP growth was 3.5 per cent year-on-year, following 3.7 per cent year-on-year in the first quarter, driven by strong performances in retail and wholesale trade, construction and manufacturing. Tourism is also having another exceptional year, continuing to benefit from instability elsewhere. In the first nine months of 2017, the number of tourist arrivals was nearly 15 per cent higher than in the same period in 2016. Unemployment remains at double-digit levels but has fallen to 10.7 per cent as of August 2017, more than two percentage points lower than a year previously.

Fiscal performance remains strong. The government is maintaining a prudent fiscal stance and delivered an overall budget surplus for 2016, at 0.5 per cent of GDP (the first one after 2008), following a fiscal deficit of just 1.2 per cent of GDP in 2015. In the first half of 2017, the general government budget remained in surplus at 0.3 per cent of GDP, with the expectation of an overall small budget surplus for 2017 as a whole. The government is able to access capital markets at favourable terms; in June 2017, the government issued a seven-year euro medium-term note (EMTN) of €850 million. Meanwhile, in July 2017 the government made a partial early payment of €0.3 billion to the IMF, thus reducing the outstanding balance to €0.7 billion.

Cyprus's credit ratings continue to improve. The country has benefited from a series of upgrades over the past year and a half, following the successful early exit from the adjustment programme with the IMF, European Commission and European Central Bank in March 2016. As of October 2017, Cyprus was rated BB+ by Standard & Poor's (after a one-notch upgrade in September 2016 and another in March 2017); BB by Fitch (also upgraded one notch in October 2017) and Ba3 by Moody's; and all three ratings agencies have a positive outlook for their ratings.

The economic recovery is expected to continue. The economy is projected to grow by 3.5 per cent in 2017, and further growth is expected in 2018 but at a more moderate rate (2.5 per cent). Banks continue to be burdened by high NPLs, which account for nearly half of total loans, notwithstanding the major reforms to the system that are under way, and the elevated levels of private and public debt are constraining private and fiscal spending. The necessary internal restructuring and reform agenda to increase potential growth rates is subject to significant implementation risks, as shown by the stalled privatisation programme which has encountered internal resistance (see below). Risks stem particularly from the ongoing drag of high NPLs, and possible negative external developments in major trading partners.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

The action plan for growth has been revised. The plan was first adopted in February 2015 and has served as a framework for a broad range of reforms across the economy. In December 2016, the Council of Ministers adopted a revised plan, and a fourth progress report on the plan was issued in January 2017. The report noted the introduction of a number of measures to improve competitiveness, including a new investment framework for 2017 that will encourage fast-track investments. At the same time, Cyprus's ranking on the World Bank's *Doing Business 2018* report remains low by EU standards. The country ranked 53rd out of 190 economies in the aforementioned report, with particular problems persisting in the areas of contract enforcement and dealing with construction permits.

Privatisation has ground to a halt. Little progress has occurred in the past year in key privatisations envisaged under the former adjustment programme (which ended in March 2016) with the IMF, European Commission and European Central Bank. The lack of progress includes the telecommunications company Cyta, which remains in majority state-owned hands, and the Electricity Authority of Cyprus, for which progress towards ownership unbundling has been minimal. In July 2017, parliament passed a bill scrapping the privatisation unit within the Ministry of Finance, illustrating the significant opposition to privatisation within parts of the political system.

Bank lending is increasing amid rising confidence and stability. In its latest bank lending survey, published in July 2017, the Central Bank of Cyprus noted that net loan demand by households and businesses increased in the second quarter of 2017, and that a further rise was expected in the third quarter on the back of the positive developments and outlook for the economy, low interest rates and rising confidence. The largest bank, Bank of Cyprus, was listed on the London Stock Exchange in January 2017.

Non-performing loans are being resolved slowly. The overhang of NPLs in the banking system remains exceptionally high by international standards. Overall non-performing exposures were still 48 per cent of gross loans as of March 2017. A new framework for insolvencies and foreclosures is in place but implementation has been slow and a number of impediments and inefficiencies remain within the insolvency service. The banking system as a whole was underperforming on several quantitative targets related to NPL resolution as of March 2017. A step forward occurred in July 2017 when the second-largest private bank, Hellenic Bank, sold its NPL and real estate management business to APS Debt Servicing Cyprus Ltd. This is the first debt servicing platform in the Cypriot market and is expected to accelerate the resolution of NPLs in the bank.

A new renewable energy agency is being created. The government announced plans in February 2017 to establish the new agency, and the relevant legislation is being prepared. Currently, the share of renewables in total energy consumption is 9.8 per cent, versus a 2020 target of 13.0 per cent. From January 2017, the so-called "green tax" on electricity bills was doubled from 0.5 to 1.0 cent per kWh, with some vulnerable groups being exempted.

EGYPT

Highlights

- **Growth has slowed amid rising inflation but the fiscal deficit has narrowed.** Fiscal reforms are anchored within a new IMF programme, and the current account deficit has remained broadly unchanged.
- **Reform progress in the past year was significant.** The exchange rate was liberalised and limits on foreign currency transfers scrapped; value-added tax (VAT) was introduced and the rate increased; several rounds of fuel, electricity and subsidy reforms were implemented; and there was progress on the industrial licensing, natural gas industry, investment and bankruptcy laws.
- **Foreign investment has increased amid rising confidence.** The approval of the IMF programme in November 2016 and the completion of the first review in July 2017, coupled with the strong reform momentum, have led to higher foreign direct and portfolio investments, increased remittances, and a heightened foreign appetite for domestic debt instruments and Eurobond issuances.

Key priorities for 2018

- **Continued fiscal consolidation, along with higher capital and social spending, is a priority.** The increase in VAT, continued energy subsidy reforms and wage restraint will reduce public debt over time and provide fiscal space for a strong social component to ease the burden of adjustment on the poor and vulnerable.
- **An immediate priority is to reduce inflation.** Inflation has reached record high levels in 2017 as a result of the currency depreciation following the liberalisation, VAT increases and subsidy cuts. As the currency starts stabilising and inflation expectations are guided by the central bank, inflation should ease.
- **Implementing and enacting executive regulations of approved laws should continue.** Legislative reforms to strengthen the business climate, attract investments, support private sector development, and promote growth are critical and should focus on, among other things, the investment law's executive regulations and investment map.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.3	2.9	4.4	4.3	4.1
Inflation (average)	6.9	10.1	11.0	10.2	23.5
Government balance/GDP	-12.9	-12.0	-11.4	-12.5	-10.9
Current account balance/GDP	-2.2	-0.9	-3.6	-6.0	-5.8
Net FDI/GDP [neg. sign = inflows]	-1.3	-1.4	-1.9	-2.1	-3.7
External debt/GDP	15.0	15.1	14.4	16.6	n.a.
Gross reserves/GDP	n.a.	5.5	6.1	9.0	n.a.
Credit to private sector/GDP	n.a.	25.4	25.7	25.6	n.a.

CONTINUES

Macroeconomic performance

Economic growth slowed and inflation sharply accelerated. Growth declined to 4.1 per cent in the fiscal year 2016-17, compared with 4.3 per cent the previous fiscal year. Meanwhile, private consumption continued to be the primary driver of growth despite eroded purchasing power as a result of inflation, and investment remained resilient. Net export performance picked up in the last two quarters following the liberalisation of the exchange rate, after being a significant drag on growth in the first two quarters. Unemployment decreased but remains elevated at 12.0 per cent in the second quarter of 2017 and youth unemployment is at 26.7 per cent. Inflation has risen, reaching 31.6 per cent year-on-year in September 2017, after having reached 33.0 per cent year-on-year in July 2017, its highest level in decades, fuelled by a new round of subsidy cuts implemented in late June.

The fiscal position improved but the deficit remains high. The fiscal deficit is estimated to have fallen to 10.9 per cent of GDP in the 2016-17 fiscal year, the lowest level in five years, down from 12.5 per cent of GDP in the previous fiscal year. The narrowing in deficit was driven by a contained wage bill and cuts in subsidies, coupled with a continued strong tax performance, especially with the introduction of value-added tax, despite increases in interest payments. The government also cleared its payment arrears to international oil companies in August 2017 from a peak of US$ 6.4 billion in 2012, which encouraged investment in the energy sector. Meanwhile, gross public debt rose to 98.4 per cent of GDP from 93.8 per cent in the previous fiscal year, with the ratio of external debt to total debt doubling to 21.8 per cent as a result of disbursements from the IMF and Eurobond issuances.

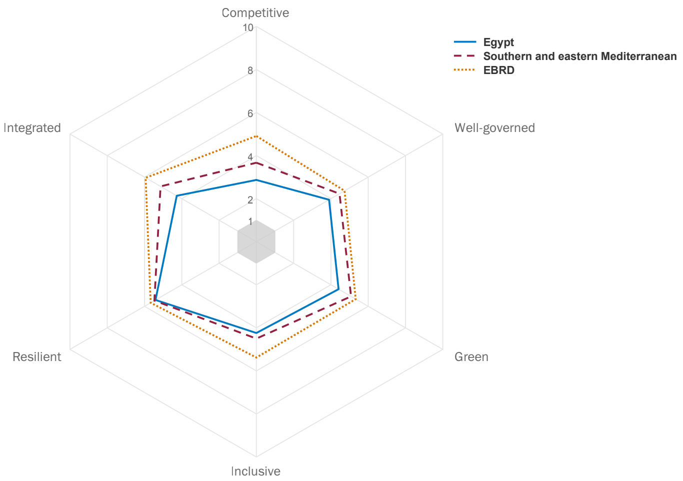
The external position remained broadly unchanged. The current account deficit increased in the third quarter of the 2016-17 fiscal year to 7.2 per cent of GDP compared with 7.0 per cent in the corresponding period the previous year, as the increase in exports and current transfers was offset by the increase in imports. The current account deficit is estimated to have declined marginally from 6.0 per cent to 5.8 per cent of GDP in 2016-17.

A new IMF programme is in place, boosting investor confidence. The programme is a three-year Extended Fund Facility of US$ 12 billion and was signed in November 2016. It was accompanied by an immediate liberalisation of the exchange rate. The first review of the programme was successfully completed in July 2017 and, coupled with strong reform momentum, boosted investor confidence. Foreign direct investment (FDI) in Egypt increased by 12.1 per cent year-on-year in the first three quarters of 2016-17, reaching 5.3 per cent of GDP compared with 3.7 per cent in the corresponding period of the previous fiscal year. Egypt attracted close to US$ 10 billion of foreign investment in domestic debt instruments in 2016-17 compared with US$ 1.1 billion the previous fiscal year. Remittances from Egyptians working abroad have also increased. International reserves have rebounded to pre-2011 levels, reaching a record high of US$ 36.5 billion in September 2017, and covering 6.1 months of imports, up from a critically low level of 3.1 months in June 2016.

Economic growth will pick up to 4.5 per cent in 2017-18, with the composition changing. High inflation will continue to adversely affect private consumption, but exports are expected to rise further. Construction will continue to be the main driver of growth, with various low-income housing projects and the construction of the new capital city. Growing confidence in the availability of foreign exchange and continued reform efforts should boost business sentiment and attract foreign investors, but significant downside risks remain, associated mainly with the adverse effect of high inflation on private sector consumption and investment, both domestic and foreign, and on competitiveness.

CONTINUES

Assessment of transition qualities (1-10)



Major structural reform developments

The central bank has implemented several bold reforms. To reduce inflation and absorb excess liquidity, the central bank increased its policy interest rate three times since November 2016; 300 basis points in November followed by 200 basis points each in May and July 2017. Inflation reached record high levels, posing a risk to macroeconomic stability and hurting the poor. The liberalisation of the exchange rate regime in November 2016 was a critical step towards restoring confidence in the economy and eliminating foreign exchange shortages. Moreover, in June 2017, the central bank scrapped limits on currency transfers abroad, signalling the easing of the foreign currency shortage, which had strangled the economy and eroded international reserves and was a major concern for foreign investors who were unable to repatriate profits.

Reforms in the energy market have advanced. The government performed several rounds of fuel and electricity subsidy reforms, the latest of which were in June 2017, where the prices of diesel and 80-octane petrol increased by 55.0 per cent, 92-octane went up by 43.0 per cent, and 95-octane rose by 5.6 per cent. The price of a canister of liquefied petroleum gas was doubled, but it remains the most heavily subsidised energy product. Moreover, the act deregulating the natural gas industry was issued and published in August 2017. The act opens the door for private sector participation in importing and trading natural gas, a move that could help end supply shortages which have hampered businesses. It also transforms the state from the monopoly manager of the distribution network into a regulator, by setting up a natural gas regulatory authority charged with licensing and devising a plan to open the gas market to competition. The strategy to settle outstanding arrears to international oil companies has already contributed to major investment pledges by two British companies, BP and BG Group, as well as Eni of Italy, which operates the Zohr gas field, the largest discovered field in the Mediterranean, potentially large enough to meet Egypt's entire domestic needs for a decade and allow for the resumption of natural gas exports.

Value-added tax (VAT) and a stamp tax on capital market transactions have been introduced. The VAT came into force in September 2016 at a rate of 13 per cent. The rate was increased in July 2017 to 14 per cent, strengthening fiscal consolidation. In the same month the authorities also introduced a new stamp tax on capital market transactions. This is a 0.125 per cent levy imposed on both sides of any capital market transaction that gradually rises to 0.175 per cent by its third year.

CONTINUES

A new investment law has been approved. Parliament approved the new law in May 2017, and the cabinet signed off on the executive regulations in August 2017. The new law will ease the process of establishing companies and obtaining licences considerably but does not resolve some of the difficulties facing investors in land acquisition procedures. As a result, although the law is an improvement on earlier versions, it is likely to undergo future revisions. Moreover, weak institutional capacity and the influence of powerful interest groups within government may pose implementation risks.

Procedures to establish a business are being simplified. A new industrial licensing law was approved by parliament in March 2017 and signed by the president in May, followed by the announcement of the executive regulations in August. The new law aims to combat bureaucracy and reduce the waiting time for new projects. Investors have long complained of lengthy processes for obtaining approvals, with Egypt ranked 128th in the World Bank's *Doing Business 2018* report, partly because of difficulties obtaining permits and licences. With the new law the waiting period for 80 per cent of industries will be reduced to one week or less, while the remaining 20 per cent, deemed more critical due to their higher risks to health, environment, safety or security, will require about one month.

Social protection measures are under way. Resolutions to protect the most vulnerable groups were announced by the president in June 2017. The main measures are: (i) increase the monetary support per capita on ration cards by 140 per cent; (ii) increase the insurance pensions by 15 per cent for 10 million pensioners; (iii) increase the value of monetary support to the 8 million beneficiaries of the two targeted social safety net cash transfer programmes which provide monthly income called *Takaful* ("solidarity" – an incentive-based system related to school attendance and making use of maternal and child health care services) and *Karama* ("dignity" – targeting the poor, the elderly and people with severe disabilities who are unable to work); (iv) approve a periodic bonus for those addressed by the Civil Service Law of 7 per cent and approve an exceptional inflation premium of 7 per cent; (v) approve a periodic bonus for those who are not addressed by the Civil Service Law of 10 per cent and an exceptional inflation premium of 10 per cent; and (vi) stop the tax on agricultural land for three years to ease the tax burden on the sector. Moreover, the school meals programme for children, which provides a daily meal and aims to address malnutrition among children in poor families and decrease the numbers of those students dropping out, has been expanded to include all public schools.

Meanwhile, some important reforms are delayed. The authorities have announced plans to offer shares in state-owned assets in the financial and energy sectors to promote competition but implementation has been delayed. The new bankruptcy law, approved by the cabinet in January 2017, is yet to be passed by parliament at the start of its autumn legislative term.

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.

CONTINUES

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.

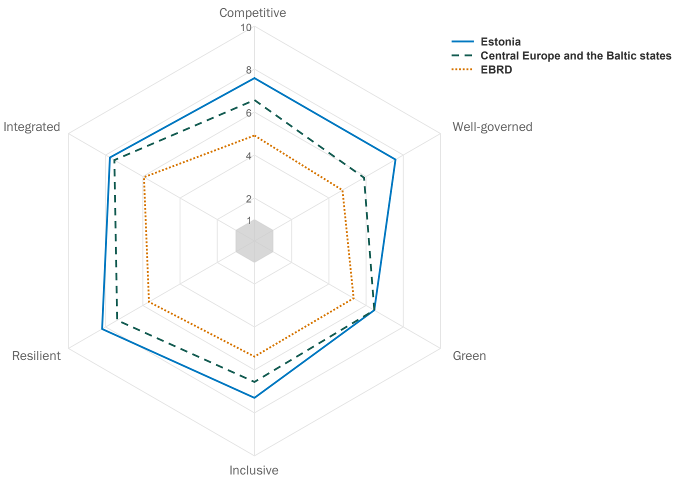
Investment growth has picked up. Investment started to recover at a rate of 17.6 per cent during the first half of 2017, after registering a cumulated contraction of above 12 per cent during 2013-16. A gradual rise in EU funds utilisation from the current EU budget is expected to boost public investment, 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)



CONTINUES

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.

FYR MACEDONIA

Highlights

- **Economic growth has slowed down.** Recorded growth in 2016 was well below the levels of the previous two years and performance so far in 2017 has been sluggish, but the political crisis has ended, which should help confidence return to the economy.
- **The new government has announced a detailed development plan.** The plan has a strong emphasis on social inclusion and support for local businesses, as well as on regional integration and advancing the country's European Union (EU) and NATO aspirations.
- **Regional transport links are being enhanced.** The southern section of Corridor X is expected to be finished soon, which will help advance the connectivity agenda.

Key priorities for 2018

- **Economic reforms should be accelerated.** The political crisis of the past two years has hampered reforms. Now that the crisis has been resolved, the new government should focus on areas needing attention such as improved fiscal management and measures to enhance social inclusion and reduce unemployment.
- **Measures to promote private sector involvement in infrastructure should be introduced.** In light of the limited fiscal space, the government should revise legislation on concessions and public-private partnerships (PPPs) to encourage private sector involvement in the transport and energy sectors.
- **Greater access to finance for SMEs is needed to encourage local businesses.** Measures that should be on the agenda to improve access to finance include: the revision of factoring legislation, reforms to improve lending in local currency, and the introduction of covered bonds legislation.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.9	3.6	3.8	2.4	1.5
Inflation (average)	2.8	-0.3	-0.3	-0.2	0.3
Government balance/GDP	-3.8	-4.2	-3.5	-2.6	-3.5
Current account balance/GDP	-1.6	-0.5	-2.1	-3.1	-2.3
Net FDI/GDP [neg. sign = inflows]	-2.8	-2.3	-2.2	-3.6	-2.8
External debt/GDP	66.1	64.9	68.1	70.0	n.a.
Gross reserves/GDP	25.2	26.4	26.4	21.8	n.a.
Credit to private sector/GDP	46.1	48.2	49.9	46.3	n.a.

CONTINUES

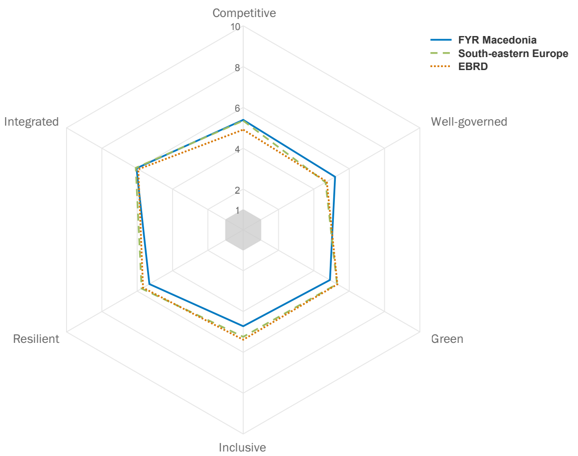
Macroeconomic performance

Growth slowed down in 2016. The robust economic performance of 2014 and 2015, when annual growth was between 3.5 and 4.0 per cent, came to an end in 2016, as the economy grew by just 2.4 per cent. The prolonged political crisis had a measurable negative impact on confidence and thus on economic performance, with a number of construction projects being delayed. The central bank reacted to currency pressures during 2016 by increasing the policy rate to 4.00 per cent, but in February 2017 it cut its long-term rate back to 3.25 per cent. Inflation stayed negative in 2016 for the third year in a row, averaging -0.2 per cent. The economy declined by 0.9 per cent year-on-year in the first half of 2017 as public and private investment levels remained depressed. The resolution of the political crisis and formation of a new government in June 2017 may pave the way for a restoration of confidence.

A slow-down in spending has kept the fiscal balance under control. The fiscal deficit in 2016 was just below 3.0 per cent of GDP, lower than expected. The budget was amended twice in 2016, first in July 2016 raising the planned deficit target to 3.6 per cent of GDP from the previous 3.2 per cent, and the second time in August, raising the expected deficit close to 4.0 per cent of GDP. However, the better-than-expected outcome was driven by a freeze in some spending categories in the period before the parliamentary elections in December 2016. Meanwhile, public debt has been rising steadily from below 30.0 per cent of GDP in 2010 to 46.5 per cent of GDP as of the first quarter of 2017. In August 2017, the parliament approved a 2017 budget revision, planning the budget deficit at 2.9 per cent of GDP, slightly down from the previous 3.0 per cent.

Growth is likely to stay modest in the short term. Both public and private investments have been delayed by uncertainty about the political situation, but short-term prospects are improving. As a result, the 2017 forecast for growth is 1.5 per cent, with a moderate increase to 2.5 per cent growth in 2018 on the assumptions of political stability, the unblocking of further reforms and the arrival of much-needed investments. Downside risks have been mitigated by the improved political situation this year but the country is vulnerable to regional shocks and any resumption of political tensions.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

The government is advancing reforms in line with EU recommendations. Soon after it took office in June 2017, the government announced a so-called "3-6-9" reform plan. The first part of the plan involves a set of reforms within three months, aimed at advancing reforms in key areas identified by the European Commission as priorities, including in public administration and the judiciary. This three-month package was completed before the October 2017 local elections. The six-month reform package, which should be completed before the December 2017 European Council meeting, aims to convince the EU that the country has improved its position as an EU candidate. The government also plans a third, nine-month reform package, which should be completed before the release of the new European Commission progress report in spring 2018.

The government has presented a development plan for 2017-20. Some of the major development priorities include: (i) acceleration of EU and NATO integrations, including by making institutions more transparent and efficient; (ii) better social protection – by increasing the minimal wage and lowering the poverty rate; (iii) stronger support for local companies – by allowing domestic firms to invest in the country's free industrial zones, which so far have been mostly occupied by foreign investors; and providing a series of employment and other incentives for local firms; (iv) introduction of a more egalitarian tax system; (v) a boost to the country's investments in road and railway infrastructure; and (vi) lower energy imports, by relying on better energy efficiency, and diversifying gas imports by connecting the country to the Trans Adriatic Pipeline (TAP) gas project, as well as to gas connections with Greece and Bulgaria.

FYR Macedonia continues to score exceptionally well in the World Bank's Doing Business report rankings. The country was ranked 11th overall (out of 190 countries) in the World Bank *Doing Business 2018* report, the second-best position among all EBRD countries and far above all other Western Balkans peers. This is one place lower compared with last year. However, corruption perceptions have worsened significantly; according to the latest Transparency International Corruption Perceptions Index, the country is now ranked at 90th position globally (out of 176 countries) compared with 66th in the previous year.

The Energy Community closed a dispute settlement with FYR Macedonia in January 2017. The decision follows successful participation of the country's transmission operator MEPSO in regionally coordinated capacity auctions.

Finalisation of the southern section of the pan-European Corridor X is expected soon. The construction of the Demir Kapija-Smokvica motorway section in the southern part of the country, leading to the Greek border, is expected to be completed by the end of 2017. The pan-European Corridor X runs between central Europe and Greece via Serbia and FYR Macedonia. The project, worth €257 million, is being financed with loans provided by the EBRD and the EIB, and grants from the EU's Instrument for Pre-Accession Assistance funds. It is an important part of FYR Macedonia's integration agenda and should facilitate enhanced cross-border trade.

The new government has cancelled a gasification tender. The tender for the construction of the secondary and tertiary gas network through a PPP valued at around €150 million was called in March 2017 by the previous government. The concession was set for a period of 30 years. However, as only one company submitted documents, the new government has decided to call a fresh tender. With regards to the primary gasification network, so far only the construction of the Klecovce-Stip connection has been completed (August 2016), while works on the Stip-Negotino, Negotino-Bitola and Skopje-Tetovo-Gostivar sections are ongoing. The total investment in the gas network is estimated at €350 million. Around 70 per cent of the gasification process in FYR Macedonia is expected to be completed by 2022.

Non-performing loans have declined to single-digit levels. The non-performing loan (NPL) ratio fell to 6.5 per cent as of June 2017, after stagnating for the past three to four years at around 10.0 to 11.0 per cent of total loans. This reflects recent measures to write off NPLs that are fully provisioned for more than two years. Overall the banking sector is well capitalised, with the capital adequacy ratio at 15.8 per cent.

GEORGIA

Highlights

- **Economic growth is accelerating.** In the first half of 2017, strong export performance and burgeoning tourism helped to lift GDP growth to an estimated 4.9 per cent year-on-year, up from 2.7 per cent in 2016.
- **The banking sector demonstrated resilience in the face of exchange rate volatility.** Despite volatility in the lari-US dollar exchange rate and high dollarisation of the economy, non-performing loans remained under control and efforts to incentivise usage of the local currency for economic transactions continued.
- **The government has adopted a new reform agenda.** A Four Point Reform Plan is in place, and measures to accelerate economic growth and implement well-coordinated macroeconomic policies are important priorities under the programme, which is also supported by a new IMF arrangement.

Key priorities for 2018

- **Public investment needs to be stepped up without compromising fiscal sustainability.** Scaling up implementation of competitiveness-enhancing public infrastructure projects will help to realise Georgia's potential as a regional hub economy and to reap greater benefits from its business-friendly environment and extensive network of free trade arrangements.
- **Public-private partnerships (PPPs) should be structured in line with the new PPP framework.** A new PPP law has been developed in conformity with modern PPP best practices and internationally accepted standards. Adoption of this law by the parliament will promote fiscally responsible implementation of the PPP structures for infrastructure projects.
- **Commercial dispute resolution capacity should be enhanced.** The ability of the judiciary system to mediate commercial disputes in a competent and impartial manner needs to be strengthened. Steps should be taken to rebuild investor confidence in the judiciary and improve the qualifications of judges dealing with business disputes.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.4	4.6	2.9	2.7	4.5
Inflation (average)	-0.5	3.1	4.0	2.1	6.0
Government balance[1]/GDP	-2.6	-3.2	-3.7	-4.2	-4.1
Current account balance/GDP	-5.8	-10.7	-12.0	-12.8	-11.9
Net FDI/GDP [neg. sign = inflows]	-5.1	-8.2	-9.1	-9.3	-9.4
External debt/GDP	81.7	83.8	107.8	108.1	n.a.
Gross reserves/GDP	17.5	16.4	18.0	19.2	n.a.
Credit to private sector/GDP	39.0	44.5	50.4	55.7	n.a.

[1] According to the definition by the Ministry of Finance (GFS 1986).

CONTINUES

Macroeconomic performance

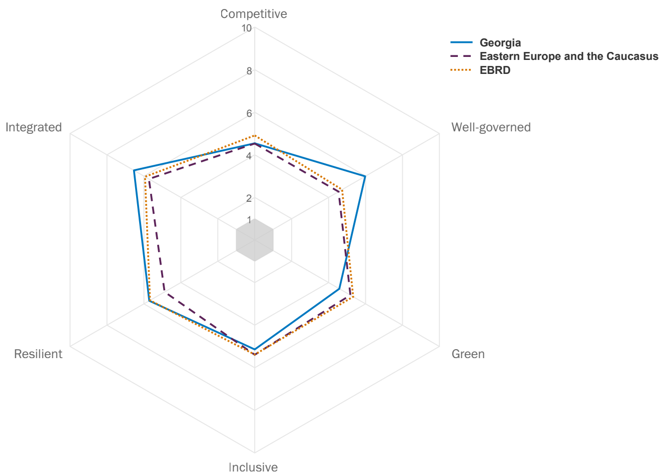
Output growth has accelerated in 2017 on the back of an improving external environment. GDP growth averaged close to 6.0 per cent in 2010-14, but then fell below 3.0 per cent in 2015 and 2016 mainly due to a difficult external environment and a slow-down in key trading partners. In 2016, robust growth in the hospitality industry, construction and financial intermediation bolstered the economy. Growth picked up to an estimated 4.9 per cent year-on-year in the first half of 2017, supported by a 30.1 per cent year-on-year increase in exports and a 15.1 per cent increase in tourist arrivals in the same period.

The exchange rate volatility persists. Following in the footsteps of other regional currencies, the lari depreciated by approximately 34.4 per cent against the US dollar between 2014 and 2016. This exchange rate trajectory was reversed in the first nine months of 2017, with the lari appreciating by approximately 6.9 per cent against the US dollar. This was supported by foreign exchange inflows from increased merchandise exports, tourism receipts, tightening of monetary policy, and a recovery in remittances which increased by approximately 19.7 per cent in the first nine months of 2017. The exchange rate pressures have since reemerged. Between the beginning of October and mid-November the lari lost approximately 6.7 per cent of its value against the US dollar. Inflation accelerated to 6.2 per cent year-on-year in September 2017 from an average of 2.1 per cent in 2016 reflecting earlier depreciation of the lari, a spike in excise taxes and higher commodity import prices. The National Bank of Georgia (NBG) increased the refinancing rate two consecutive times from 6.5 per cent in September 2016 to 7.0 per cent in May 2017.

External and fiscal deficits are sizeable but sustainably financed. The high current account deficit, at 12.8 per cent of GDP in 2016, remained mostly financed by an inflow of net foreign direct investment which stood at approximately 9.3 per cent of GDP in 2016. Official international reserves remained steady in the first nine months of 2017, providing approximately three and a half months of import coverage (US$ 3.0 billion at the end of September 2017). The fiscal deficit widened to 4.2 per cent of GDP in 2016 and is planned at 4.1 per cent of GDP in 2017, reflecting high infrastructure spending supported mainly by borrowing from international financial institutions on favourable terms.

Growth is set to remain vigorous. A recovery in consumption, investment in infrastructure and strong performance of the hospitality sector are expected to fuel short-term growth. The free trade agreement signed with China in May 2017, which abolishes approximately 95 per cent of import taxes on Georgian goods, and realisation of DCFTA benefits in the medium term are expected to stimulate exports. GDP growth is forecast at 4.5 per cent of GDP in 2017 and 2018. Weaker-than-expected regional recovery and geopolitical tensions could, however, affect growth on the downside.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Georgia has introduced a new Reform Plan. The Four Point Reform Plan, introduced in February 2017, aims to improve the investment climate and generate higher and more inclusive economic growth. The plan's structural reform agenda focuses on, among other things, upgrading the education system, streamlining implementation of infrastructure projects to leverage Georgia's position as a transit and tourism hub, increasing efficiency and improving governance in the public administration, and further improving the business environment.

A new IMF programme is supporting fiscal and monetary discipline. A three-year US$ 285 million Extended Fund Facility was approved by the IMF Board in April 2017, providing additional shock absorption capacity against exogenous economic risks. The main policy areas under the new programme include fiscal consolidation and improvements in public financial management, pension reform, development of a new PPP law with an emphasis on minimisation of contingent fiscal risks, measures to enhance the NBG's liquidity management framework, and financial sector reforms to strengthen banking regulation and supervision, improve the bank resolution framework and enhance overall resilience of the financial sector. Staff-level agreement between the IMF and Georgian authorities for completion of the first programme review was reached in October 2017.

Fiscal reforms are creating more space for growth-enhancing public infrastructure projects. Efforts were made in the past year to increase revenues and to shift fiscal resources from current expenditures to public investment spending. The tax model introduced in 2016 applies corporate income tax only to distributed profits, and to offset the resulting shortfall, the authorities raised excise taxes on tobacco, gambling, cars and fuels effective from January 2017. Current expenditure optimisation measures include reduction of the wage bill through rightsizing the headcount in public administration and reforms to the remuneration system. Universal healthcare insurance, launched in 2013, was modified to apply only to more vulnerable groups whose income is below the specified threshold. Legislative amendments were made to allow better state control over local government spending in order to ensure compliance with general government deficit limits. Work has also been initiated on designing a new pension system.

Incentives to use local currency are in place but with limited impact so far. A 10-point "larisation" plan was developed jointly by the NBG and the government of Georgia and rolled out in January 2017. As part of the plan, the authorities offered one-time subsidised conversion of dollar-denominated mortgage loans (issued before January 2015 and up to approximately US$ 40,000 per loan) into local currency at the beginning of 2016. Only a quarter of eligible loans participated in the conversion opportunity. Small new loans (up to approximately US$ 40,000) have been required to be issued in local currency only since January 2017. Other measures under the larisation plan include regulatory incentives to issue local currency corporate bonds, preferential treatment of local currency under the NBG's prudential regulations and the requirement to quote all prices in lari, including for real estate. As of August 2017, these measures have had limited cumulative impact. Dollarisation decreased somewhat but remained high with 57.6 per cent of loans and 66.0 per cent of deposits denominated in foreign currency as of 1 October 2017.

Safeguards have been added to the banking sector. Despite lari depreciation, non-performing loans remained low at approximately 3.1 per cent of total loans in the third quarter of 2017. In May 2017, the NBG increased the minimum capital requirement for Georgian banks more than four times, to approximately US$ 20.4 million. Banks are expected to increase their capital in three stages until 2018. In May 2017, the parliament adopted a Law on Deposit Insurance System which provides for setting-up mandatory insurance for deposits up to 5,000 lari (US$ 2,000), starting from January 2018. The scheme is to be fully funded by banks providing insurance contributions to the Deposit Insurance Fund, which will be governed by high-ranking officials from the ministries, NBG and independent members.

GREECE

Highlights

- **Modest economic growth has returned.** After marginally negative growth in 2016, the economy is on a modest upward path in 2017, boosted by strong performances in the industrial and export sectors and improved confidence following progress in the Economic Adjustment Programme and completion of the second review of the latter.
- **Privatisation and business-friendly reforms are advancing.** Several flagship privatisations have been achieved, a new privatisation fund has been established, and product and labour markets have been further liberalised.
- **Banking sector health is improving as non-performing loans (NPLs) are being tackled.** The level of NPLs remains exceptionally high but the systemic banks are implementing an action plan for their reduction, profitability has returned to the sector as a whole and banks are gradually regaining access to capital markets.

Key priorities for 2018

- **The authorities should ensure a strong commitment to completing the economic adjustment programme.** Remaining on course with the programme until its completion in August 2018 will help bolster investor confidence and remove lingering fears about a return to recession and possible delays in debt repayments.
- **Privatisation should be advanced.** Prompt sales of key assets could bring vital investment to the country and help exploit its potential as an energy and logistics hub.
- **The country's energy potential should be further exploited.** Substantial progress has been made in this area in recent years and further measures should proceed to develop renewable energy sources, promote energy efficiency and continue with implementation of important cross-border pipeline projects and development of liquefied natural gas (LNG) facilities.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	-3.2	0.7	-0.3	-0.2	2.0
Inflation (average)	-0.9	-1.4	-1.1	0.0	1.2
Government balance/GDP	-13.2	-3.6	-5.7	0.5	-1.7
Current account balance/GDP	-2.0	-1.6	0.1	-0.6	-0.2
Net FDI/GDP [neg. sign = inflows]	-1.5	0.1	0.5	-1.9	-1.6
External debt/GDP	244.9	221.3	246.1	233.8	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	117.6	116.2	112.8	107.7	n.a.

*Greece is a member of the Euro area.

CONTINUES

Macroeconomic performance

The economy stagnated in 2016 but a modest upturn is under way in 2017. After a very difficult year in 2015, the economy shrank marginally in 2016 (growth of -0.2 per cent). Signs of a recovery have emerged in the first half of 2017. Growth in the first quarter was 0.5 per cent quarter-on-quarter (and 0.4 per cent year-on-year) and growth in the second quarter was 0.5 per cent quarter-on-quarter (and 0.8 per cent year-on-year), driven mainly by growing exports and strong industrial sector growth, especially in the electricity sector. Confidence indicators are edging upwards as a result of the improved economic performance and the completion (in June 2017) of the second review of the Economic Adjustment Programme (EAP). Prices were stable during 2016 but have been increasing gradually in 2017, with inflation reaching 1.0 per cent in September. Unemployment remains a major problem but is on a downward trend, reaching 21.0 per cent in July 2017.

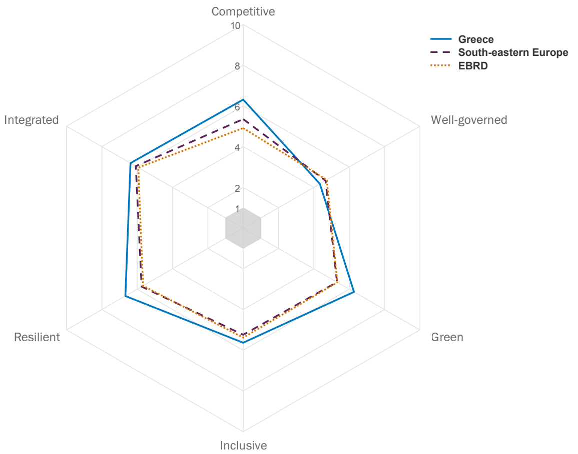
Fiscal targets have been exceeded. In 2016, the government achieved a primary surplus of 4.2 per cent of GDP, well above the target of 0.5 per cent agreed under the programme with creditors. The achievement reflects the impact of austerity measures introduced in recent years but also some one-off measures, including the liquidation of a number of state-owned enterprises. In July 2017, Greece exited EU's Excessive Deficit Procedure, as the government delivered a 0.5 per cent of GDP overall budget surplus in 2016 (in European System of Accounts 2010 terms). However, public sector arrears have been rising again, reaching around €7 billion by mid-2017. Achieving the annual primary surplus target of 3.5 per cent of GDP in the period 2018-21 will be a major challenge.

Public debt remains exceptionally high. Overall public debt is around 180 per cent of GDP and is judged by the IMF to be highly unsustainable. However, differences between the European institutions and the IMF on how to deal with Greece's debt have narrowed during 2017. The completion of the second review of the programme enabled a new disbursement from the European Stability Mechanism and allowed Greece to meet its large debt repayments in July 2017. In that month the IMF Executive Board approved "in principle" a €1.6 billion, 14-month, stand-by arrangement for Greece. The arrangement, which supports the authorities' economic adjustment programme, will become effective only after the Fund receives assurances from Greece's European creditors on further debt relief measures, and provided that Greece's economic adjustment programme remains on track. A second executive board decision is needed to make the arrangement effective. Meanwhile, the Eurogroup has committed in principle to a second set of medium-term debt relief measures (in addition to those agreed in May 2016) to be implemented at the end of the programme in August 2018, but only to ensure the annual gross financing needs (GFN) remain below 15 per cent of GDP in the medium term and below 20 per cent of GDP thereafter.

Positive growth is likely in the short term, but long-term prospects remain uncertain. Growth is expected to pick up in the second half of 2017, with overall growth of 2.0 per cent for the year, rising to 2.2 per cent in 2018. Major downside risks to the forecast remain. The economy remains in a very difficult position, with current levels of investment well below depreciation, implying a constant deterioration of the capital stock. Further short-term austerity measures are in the pipeline, including tax increases and pension cuts. Potential growth drivers in the short term included disbursement of EU structural funds, the reduction and eventual clearance of public arrears to the private sector, further progress in NPL resolution, and some resumption of private sector investment.

CONTINUES

Assessment of transition qualities (1-10)



Major structural reform developments

Fiscal reforms are advancing. Some important medium-term fiscal measures were introduced in mid-2017 in order to complete the second review of the programme, including pension cuts (1 per cent of GDP in net savings) and income tax reform (another 1 per cent of GDP in net savings) starting from 2019 and 2020, respectively. Other measures are being put in place to combat endemic tax evasion. In March 2017, the Finance Ministry announced the enforcement of a new informational system to aggregate taxpayers' deposit and income data speedily and cross-check those with tax returns to spot potential tax evasion. Taxpayer arrears to the state stood at €95.4 billion in June 2017, accounting for 53 per cent of GDP and up by €5.5 billion from the end of 2016.

Progress is occurring on privatisation. A new privatisation fund was established in 2016 and the appointment of the board of directors and supervisory board occurred in February 2017. Several important privatisations have been successfully carried out in the past year. A flagship deal in 2017 was the completion of the sale (by concession) of 14 regional airports to Fraport of Germany. Important sales have also taken place in the past couple of years in the port sector, with the latest being the acquisition in April 2017 by a DIEP-led consortium (Deutsche Invest Equity Partners) of a 67 per cent stake in the Thessaloniki port OLTH for €232 million. The government has relaunched a tender to sell a majority (66 per cent) stake in the natural gas grid operator DESFA. This time, six potential bidders have expressed an interest.

Greece is becoming an international energy hub. Important projects under way include the Trans-Adriatic Pipeline, which should be in operation by 2020, transferring 10 billion cubic metres of natural gas per year from Azerbaijan to Europe through Greece, Albania and Italy. The investment totals €5.6 billion, of which €2.3 billion is in Greece. Other projects under way include an LNG terminal in Alexandrouli by DEPA and Gastrade and the IGB pipe between Greece and Bulgaria. In addition, a number of wind energy parks are currently under construction, with a cumulative value of €1 billion.

Further business environment reforms have been introduced. A number of measures were legislated in May 2017 in order to complete the second review of the programme. These include the streamlining of bankruptcy procedures, a relaxation of procedures surrounding collective dismissals, and further liberalisation of trading hours and over-the-counter prices in line with OECD recommendations. However, Greece is ranked 67th out of 190 economies on the World Bank's *Doing Business 2018* report, lower than all other OECD countries.

CONTINUES

Non-performing loans are being tackled. The levels of NPLs and NPEs (non-performing exposures, which include restructured loans) are still exceptionally high by international standards, standing at €75.2 billion (36.7 per cent of total loans) and €103.9 billion (50.6 per cent of total exposures), respectively at the end of the first quarter of 2017. Banks are addressing the problem under an action plan agreed with the Bank of Greece (BoG). The target for NPEs was exceeded in the first quarter of 2017 whereas that for NPLs was marginally undershot. The BoG and the four systemic banks are targeting for NPEs to decrease to €66.7 billion (33.9 per cent NPE ratio), and NPLs to €40.2 billion (20.4 per cent NPL ratio) by the end of 2019, and coordinated work is under way among the four banks to speed up the process. The market for the sale of NPLs was improved following the amendments to the law on licensing and operation of banking receivables' servicing platform adopted in May 2017. To date, the BoG has granted four licences.

The government has further relaxed capital controls. Among other measures, as of September 2017, the monthly withdrawal limit for individuals has risen to €1,800 cumulatively per month, rather than a €840 limit per two weeks. Also, the government has relaxed the withdrawal limits for funds coming from abroad electronically to 50 per cent, up from the current 30 per cent withdrawal allowance. In May 2017, the government promised the full lifting of capital controls by year-end, but the exact timetable remains uncertain.

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.

CONTINUES

Macroeconomic performance

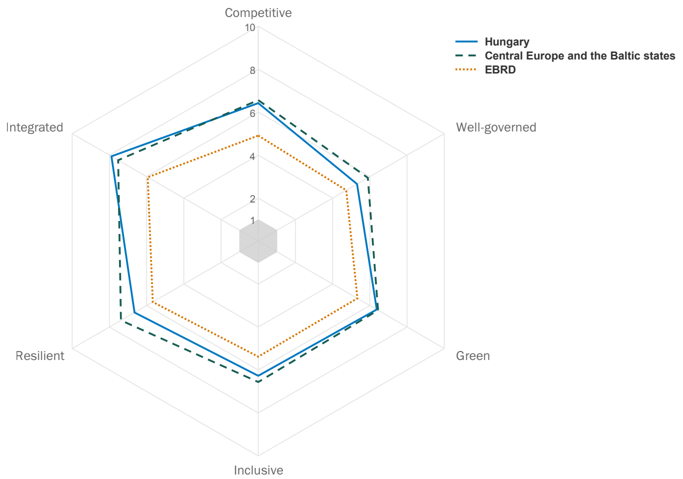
Robust private consumption has supported recent growth. GDP growth slowed to 2.2 per cent in 2016 as investment decreased by 10.6 per cent, mostly explained by the low utilisation of EU funds. In contrast, private consumption remained strong, underpinned by rising employment and wages. Household disposable 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)



CONTINUES

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.

JORDAN

Highlights

- **Growth continued to decline in 2016.** It dropped to 2 per cent in 2016, which reflects the slow-down in agriculture, construction and mining, although a slight upturn is evident in the first half of 2017. Unemployment rose sharply to 18 per cent in the first half of 2017, its highest level in 25 years.
- **The pace of fiscal consolidation was strong, although slower than initially envisaged.** This is due to weaker nominal growth and tax revenues and refugee-related spending pressures. Moreover, the composition of expenditures has worsened, and public debt increased, also the result of continued Water Authority of Jordan (WAJ) losses.
- **Structural reform continued.** Key developments include: the adoption of the electricity tariff adjustment mechanism and the action plan to reduce the water sector's losses; the elimination of general sales tax (GST) and customs duty exemptions on a large number of products; the compilation of credit reports by the credit bureau to assess borrower creditworthiness; and the launching of the new "one-procedure one-form" registration process and standardised business classifications.

Key priorities for 2018

- **Continued fiscal consolidation is needed.** The main reforms should: broaden the tax base through amending the income tax law and removing additional GST and customs duties exemptions; tackle tax evasion and strengthen tax compliance, while containing non-priority current expenditures and wage bill growth, better targeting transfers, and preserving social and capital expenditures.
- **Much-needed legislative reforms to improve the business environment should be prioritised.** These include submitting to parliament the draft inspection law, enacting the secured lending and insolvency laws, and ratifying amendments to the insurance and deposit insurance laws.
- **Reforms to strengthen inclusive growth should continue.** The government's strategy consists of three measures: (i) facilitating access to finance; (ii) active labour market policies and reforms; and (iii) improving the business environment and governance. These reforms should be complemented by the implementation of the Jordan Compact initiative to create jobs for Jordanians and Syrian refugees in special economic zones.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.8	3.1	2.4	2.0	2.3
Inflation (average)	4.8	2.9	-0.9	-0.8	3.3
Government balance/GDP	-5.5	-2.3	-3.5	-3.2	-2.5
Current account balance/GDP	-10.4	-7.3	-9.1	-9.5	-8.4
Net FDI/GDP [neg. sign = inflows]	-5.3	-5.8	-4.3	-4.0	-3.8
External debt/GDP	30.3	69.4	70.0	70.5	n.a.
Gross reserves/GDP	35.7	39.3	37.7	33.3	n.a.
Credit to private sector/GDP	76.3	73.0	72.8	77.6	n.a.

CONTINUES

Macroeconomic performance

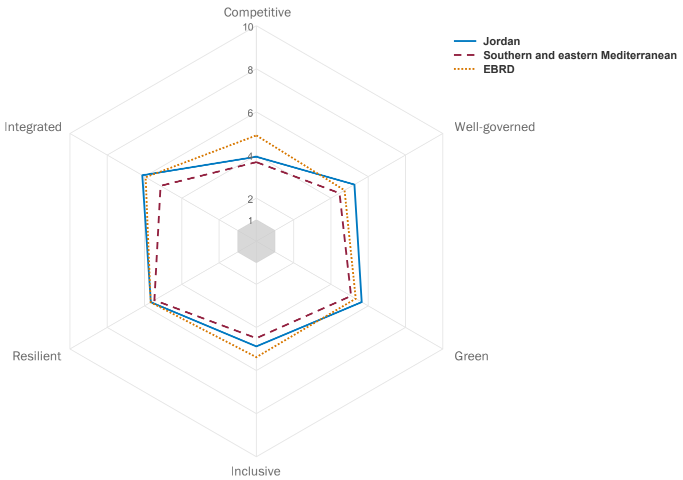
The decline in growth, which started in 2014, continued in 2016. GDP growth fell from 3.1 per cent to 2.0 per cent between 2014 and 2016. This deterioration was driven by slowing agriculture and construction, and contracting mining activity, which shrank by 12.1 per cent in 2016 due to temporary shutdowns in production. Transportation and financial services were the main positive drivers of growth. During the first half of 2017, growth recorded 2.1 per cent year-on-year, with strong rebounds in mining and agriculture, despite the continued decline in construction. Data for the first eight months of 2017 show a recovery in tourism, increasing 8.1 per cent relative to the same period in 2016. Labour market conditions deteriorated further; the unemployment rate rose sharply to 18 per cent in the first half of 2017, its highest level in 25 years, partially reflecting some methodological changes. Female and youth unemployment rates are double the overall rate.

The pace of fiscal consolidation was strong, but slower than planned. The central government's deficit declined to 3.2 per cent of GDP in 2016 from 3.5 per cent in 2015, reflecting stronger non-tax revenues and flat expenditures, despite declining grants. Nevertheless, the composition of expenditures worsened, with lower capital expenditures offsetting higher defence and security spending. Moreover, the decline in the deficit was lower than envisaged, owing in part to weaker nominal growth, continued refugee-related spending pressures, and limited success in increasing tax revenues. As a result, and with continued Water Authority of Jordan (WAJ) losses, public debt reached 95.1 per cent of GDP at the end of 2016.

The current account deficit widened and reserves declined. A decline in energy imports as a result of lower oil prices and the National Electric Power Company's (NEPCO) shift to liquefied natural gas as its primary energy source were counterbalanced by lower exports, tourism receipts, grants and remittances. As a result, the current account deficit reached 9.5 per cent of GDP in 2016, slightly higher than the 9.1 per cent deficit in 2015. International reserves declined in August 2017 to US$ 13.2 billion but remained at comfortable levels, at 6.9 months of imports.

The outlook remains broadly unchanged. Growth is expected to remain low at 2.3 per cent in 2017, as regional turmoil continues to weigh on tourism and investment, and following lower-than-expected 2016 growth and lower reserves. In 2018 growth will pick up slightly to 2.5 per cent, supported by the implementation of structural reforms and fiscal consolidation. The outlook is subject to considerable risks from additional refugee inflows and a surge in the US dollar undermining Jordan's competitiveness. Moreover, any slippages in implementing reforms under the IMF-supported programme would undermine prospects for a strong rebound in economic performance.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

The credit bureau has expanded its activities. The bureau had started operating in January 2016 to help expedite credit decisions, notably for small and medium-sized enterprises (SMEs), which make up about 95 per cent of the corporate sector. It has been receiving data since October 2016 from banks, as well as from other financial institutions such as insurance and leasing companies, microfinance institutions, public utilities and telecommunications companies. It has started compiling credit reports to assess borrower creditworthiness and expediting credit risk assessment decisions for borrowers. The bureau should be able to assign credit scores to borrowers by early 2018 after compiling three years of historical data.

The electricity tariff adjustment mechanism and the action plan to reduce the water sector's losses were adopted. The authorities published in December 2016 the final version of a study on cross-subsidisation and options for electricity tariff reform. Based on the findings of the study, a new automatic tariff adjustment mechanism was adopted in October 2016 and came into effect on 1 January 2017. The mechanism considers the system's overall costs, including power plants, NEPCO and distributors, and shelters NEPCO from oil price fluctuations, helps its operational cost recovery and reduces its vulnerability to exogenous shocks. The authorities also reduced cross-subsidies by lowering tariffs on high-end consumers. At the same time, an updated action plan on ways to reduce the water sector's losses was adopted by the government and published in April 2017.

The authorities continued with labour market reforms to strengthen job prospects. A bylaw on flexible working hours was issued by Royal Decree in March 2017, and implementation guidelines are being prepared in the second half of 2017 by the Ministry of Labour in consultation with other stakeholders. To promote female employment, the authorities require large companies to provide childcare facilities within their premises. Most recently, they have submitted to parliament amendments to the labour law to allow companies to pool their resources and set up joint nurseries, while increasing penalties for companies not complying with the law, and have started establishing new nurseries in the special economic zones.

A decree establishing a central Public Investment Management (PIM) unit at the Ministry of Planning and International Cooperation was adopted in June 2016. The government is already managing all investments according to standards set by the new PIM framework adopted in 2015 to strengthen the design, assessment, prioritisation and implementation of public investment and public-private partnership projects. Moreover, in May 2017 the government conducted a comprehensive Public Investment Management Assessment (PIMA), to ensure that public investment spending was well assessed and efficient enough to promote growth while minimising future risks to the budget, given the limited fiscal space.

Reforms to strengthen the business environment have advanced. Recent efforts have focused on reducing the cost of starting and operating a business. The authorities addressed shortcomings in the investment-window procedures by automating and integrating the services provided by Jordan Investment Commission to make it fully operational by the end of June 2017. The authorities have also launched the new "one-procedure one-form" registration process and standardised business classifications to eliminate all duplicate procedures and introduce a fast track approval mechanism. Jordan is ranked 103rd out of 190 countries in the *Doing Business 2018* report, ahead of the Middle East and North Africa average and of Egypt and Lebanon, but behind Morocco and Tunisia. The areas where Jordan is ranked the lowest are getting credit (159th), and protecting minority investors and resolving insolvency (146th).

CONTINUES

The authorities conducted a medium-term debt management strategy (MTDS) analysis. Based on the findings of the analysis, the debt management strategy for 2016-20 covering the central government and its agencies, including NEPCO and WAJ, was prepared and published in September 2016. An action plan to build capacity in the middle and front offices of the Public Debt Directorate (PDD) was prepared ahead of schedule. The authorities started in January 2017 to publish the central government indicative bond issuance plan for 2017 to enhance transparency, communication and predictability. A quarterly financing plan for the central government and its agencies was prepared to ensure that the issuance schedules of the central government and public agencies are coordinated in a way that improves overall borrowing terms, lengthens the average maturity of debt, improves the debt profile of the central government and its agencies, and reduces total public debt over the medium term.

The removal of GST and customs duties exemptions was less ambitious than initially envisaged. Revenues from these measures amounted to 0.4 per cent of GDP instead of the planned 1.1 per cent of GDP, as many non-basic goods and services remain exempt. GST exemptions generally contribute to lower efficiency and revenue with limited offsetting benefits.

Several much-needed laws have been delayed. Delays included are submitting to parliament the draft inspection law, enacting the secured lending and insolvency laws, and amendments to the income tax, insurance, and deposit insurance laws. In addition, the publication of a study assessing the key issues and challenges to promote financial inclusion has not yet been completed.

KAZAKHSTAN

Highlights

- **Growth is accelerating.** GDP growth accelerated to 4.3 per cent year-on-year in the first nine months of 2017, from 1.1 per cent in 2016, primarily supported by the recovery in oil exports and stronger activity in the construction, agriculture and transport sectors.
- **Banking sector consolidation is advancing.** In July 2017, Halyk Savings Bank, Kazakhstan's largest bank, finalised the purchase of Kazkommertsbank (KKB), the second largest, after the state allocated US$ 6.4 billion to clean the balance sheets of banks with large shares of non-performing loans (NPLs). The merger of two other large banks, Tsesnabank and Bank CenterCredit is expected.
- **The Kashagan oilfield restarted in September 2016.** Production reached 180,000 barrels per day as of June 2017, about 10 per cent of Kazakhstan's total production. This is a marked development for the field, which had suffered from long delays and cost overruns owing to logistical and technical challenges.

Key priorities for 2018

- **Implementation of the government's structural reform agenda is a key priority.** Priorities include continuing efforts for a successful privatisation of state-owned entities, tariff reform in regulated sectors, development of the Astana International Financial Center (AIFC), banking sector reforms and the establishment of the framework for a green economy transition.
- **The role of the state in the economy should be further reduced.** Work needs to continue towards a better balance between the respective roles of the public and the private sectors, by supporting the growth of private enterprises, including small and medium-sized enterprises (SMEs), in agribusiness and other non-extractive sectors, as well as public sector reform and the commercialisation and privatisation of state-owned enterprises (SoEs).
- **The banking sector should be further strengthened.** The National Bank of the Republic of Kazakhstan (NBK) should continue its work on the reduction of legacy problem loans, as well as to further strengthen banking sector regulation and supervision, by taking more robust action regarding banks that fail to adjust their activities.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	6.0	4.3	1.2	1.1	3.8
Inflation (average)	5.8	6.7	6.7	14.6	7.3
Government balance/GDP	4.8	1.7	-2.2	-0.3	-2.9
Current account balance/GDP	0.5	2.8	-2.8	-6.5	-5.3
Net FDI/GDP [neg. sign = inflows]	-3.4	-2.1	-1.5	-9.8	-5.8
External debt/GDP	63.4	71.2	83.2	119.3	110.1
Gross reserves/GDP	10.4	13.2	15.1	21.5	n.a.
Credit to private sector/GDP	31.4	30.5	31.0	27.1	n.a.

CONTINUES

Macroeconomic performance

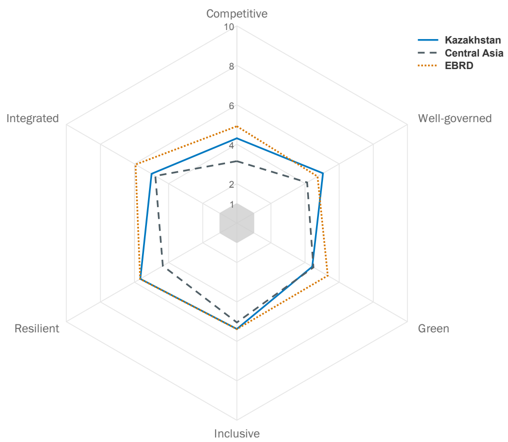
The economy is recovering. Real GDP growth accelerated to 4.3 per cent year-on-year in the first nine months of 2017, primarily driven by the rebound in oil exports and strong performance in the agriculture, construction and transport sectors. This follows a significant slow-down during 2014-16, due to the plunge in oil prices, weaker domestic demand and the recession in Russia. Exports rose by 32.2 per cent in the first eight months of 2017 in US dollar terms, mainly due to higher metal and stable oil prices, after falling 20 per cent in 2016 and 42 per cent in 2015. Imports increased by 17.9 per cent in the same period of 2017 after a drop of 17 per cent in 2016 and 26 per cent in 2015. Foreign exchange buffers have remained strong at combined net international reserves of the NBK and National Oil Fund foreign assets of about US$ 90 billion in September 2017, or 27 months of imports of goods and services.

Monetary conditions have normalised. Monetary policy has been effective at anchoring inflation expectations despite inflation spikes following the abrupt change in the exchange rate regime back in 2015. Inflation has returned to the 6.0 to 8.0 per cent NBK target corridor, reaching 7.1 per cent in September 2017 year-on-year. Following 46 per cent depreciation in 2015, the tenge has stabilised since March 2016. The NBK has gradually lowered its monetary policy rate from a high of 17.00 per cent at the beginning of 2016 to 10.25 per cent in August 2017. After lack of liquidity in the period of exchange rate pressure, there is excess short-term liquidity in tenge now, which is being sterilised by the central bank. However, sources of long-term tenge remain concentrated in a few institutions such as the Unified Pension Accumulation Fund that is managed by the central bank.

NPLs continue to weigh on the banking sector, but there is a new momentum towards resolution. The NPL ratio increased to 10.7 per cent in June 2017, from 6.7 per cent at the end of 2016, partly as a result of growth in overdue accrued interest. While this is around the 30 per cent level that persisted over 2008-13, the underlying asset quality remains a concern given the presence of not fully transparent off-balance sheet structures. However, steps have been taken to strengthen the NBK's supervisory mandate, dollarisation is declining, and banking sector consolidation is taking place with the injection of state funds.

Growth is expected to reach 3.8 per cent in 2017 and remain strong at 3.5 per cent in 2018, driven by increasing crude production, including from the restarted Kashagan oilfield, favourable oil prices and a recovery in real incomes growth, which turned negative in the second quarter of 2017. Inflation is expected to remain within the 6.0 to 8.0 per cent range set by the NBK currently, but might be shifted to 5.0 to 7.0 per cent in 2018.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Key structural reforms are moving forward gradually. The country's policy response to the oil price drop and the difficult economic environment in 2014-16, which focused mainly on counter-cyclical government spending and the move to a flexible exchange rate and inflation targeting regime, has created a more conducive environment for economic growth and further structural reforms. Key reforms include the development of the AIFC, which is taking shape. The Astana International Exchange is to be launched in early 2018. In June 2017, the Shanghai Exchange and the AIFC signed an agreement under which the Shanghai Exchange became a strategic cooperation partner of the AIFC and owns 25.1 per cent of the Astana Exchange. In other developments, the government amended the regulatory framework governing renewable energy development in 2017 in order to reduce the foreign exchange risk for investors. A framework for tariff reform in regulated sectors has been developed, although social issues make the immediate application challenging. Legislation concerning subsoil use is being amended with the objective to implement international standards for minerals and hydrocarbons extraction.

Kazakhstan ranks 36th of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2018* report. The country made progress in three components of ease of doing business: the transfer of a property was streamlined by improving registration transparency and the land administration system's dispute resolution mechanisms; investor protection was improved by strengthening minority shareholder rights and their role in major corporate decision making, by requiring greater corporate transparency and allowing better access to corporate information during trial; enforcing contracts was made easier by introducing tighter time standards for key court events – they are respected in the majority of cases.

A new development strategy has been unveiled. In January 2017 the President announced the new development strategy, "Third Modernization: Global Competitiveness". It aims to accelerate the modernisation and digitalisation of key sectors of the economy, increase productivity, diversify the economy away from hydrocarbons (in particular by boosting manufacturing), address banking sector weaknesses, reduce impediments to the private sector, increase the effectiveness of the civil service and reduce the role of the state in the economy by accelerating privatisation efforts.

Banking system consolidation and recapitalisation is taking place. In July 2017, Halyk Savings Bank, Kazakhstan's largest bank, finalised the purchase of Kazkommertsbank (KKB), the second largest, after the state allocated US$ 6.4 billion to clean the balance sheet of banks with the largest shares of the sector's NPLs. It is assumed that large banks will be the major recipient of the government fund injection, while the smaller banks will be expected to rely mostly on capital injections from their shareholders. In February 2017 the NBK also supported KKB via its liquidity line to repay its sizeable €400 million Eurobond in a timely manner. The merger of two other large banks, Tsesnabank and Bank CenterCredit is expected.

Steps are being taken to strengthen NBK's supervisory mandate. More robust actions against banks that fail to adjust their activities have been taken. The banking licence of Kazinvestbank was suspended due to the systematic failures to fulfil payment obligations. On 22 May 2017 NBK repeatedly suspended Delta bank's licences for accepting deposits from individuals and legal entities until November 2017. There are upcoming stress tests and an Asset Quality Review (AQR) of large banks planned for late 2017. In August 2017, the NBK adopted a programme to improve the financial stability of the banking sector and introduce a risk-oriented approach to the financial supervision process. The NBK will spend around tenge 500 billion (US$ 1.5 billion) on the implementation of the programme.

Fiscal policy is being stepwise adjusted to the continued lower level of oil prices. The draft 2018 budget envisages further adjustment through reduction of stimulus spending and higher non-oil revenues from growth and improved administration. A new draft tax code has been prepared, which focuses on changes in natural resources taxation and VAT improvements and making the tax system more progressive. An expansion of public-private partnerships (PPPs) is also being considered.

CONTINUES

The government is making progress with its ambitious privatisation programme. Between mid-2016 and mid-2017, 53 small companies owned by the state-holding-company Samruk-Kazyna (SK) were sold. SK has been actively working on the pre-privatisation preparation of blue-chip companies, and it mobilised international advisers with the objective to attract strategic investors that can bring know-how and improve governance. SK also held a privatisation workshop at the London Stock Exchange in April 2017, showcasing initial public offering candidates, particularly Air Astana. Under the privatisation programme 2016-20, adopted in December 2015, assets singled out for privatisation include 782 entities in total, with 216 assets under the SK umbrella representing the most important strategic part. The SK assets have been divided into two parts, with 44 core assets and 172 smaller assets. The plan is to privatise the small non-core assets during 2016-17 and the large blue-chip companies during 2018-20. Air Astana and KazAtomProm are expected to be privatised in 2018-19.

The Kashagan oilfield restarted in September 2016. In November 2016 the field achieved a commercially viable level of production with sustained output at 75,000 barrels per day (b/d). In June 2017, production reached 180,000 b/d. The government expects that Kashagan will reach its first-stage full output capacity of 370,000 b/d before the end of 2017, with overall annual oil output at around 8.9 million tonnes. This will mark a milestone in the development of the field, which has suffered from long delays and cost overruns owing to logistical and technical challenges, and will help it meet its growth targets.

KOSOVO

Highlights

- **The economy is growing robustly.** The main drivers of growth continue to be private consumption and strong investment figures, which in turn are driven by public investments in infrastructure. The IMF programme expired in August 2017.
- **Some investment climate measures have been introduced.** These include a new law on strategic investments, which is designed to simplify the process for investors and boost foreign direct investment (FDI), and progress in the areas of contract enforcement and public procurement.
- **Cross-border integration is being enhanced.** In the past year, measures have been taken to facilitate trade between Kosovo and Albania, and the regional transport connectivity agenda has also advanced.

Key priorities for 2018

- **Further investment climate reforms are needed.** Key areas needing attention include enhancing the impact and effectiveness of the National Economic Development Council, strengthening the capacity of the Competition Authority, and supporting the implementation of the bankruptcy law and other commercial laws.
- **Cross-border transport infrastructure should be further enhanced.** This should include progress towards the rehabilitation and improvements of major cross-border road and rail routes and improved capacity for the country's air navigation services agency.
- **Fiscal stability should be preserved.** Kosovo has built up an enviable record of fiscal prudence, contributing to the low level of public debt, and it will be important to preserve these achievements in order to bolster investor confidence.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.4	1.2	4.0	3.4	3.7
Inflation (average)	1.8	0.4	-0.5	0.3	1.4
Government balance/GDP	-3.1	-2.6	-1.9	-1.4	-3.4
Current account balance/GDP	-3.6	-7.0	-8.5	-9.8	-11.0
Net FDI/GDP [neg. sign = inflows]	-4.9	-2.2	-4.7	-4.2	-5.2
External debt/GDP	30.2	31.2	33.3	34.2	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	33.0	33.6	34.5	36.6	n.a.

*Kosovo uses the euro as its legal tender.

CONTINUES

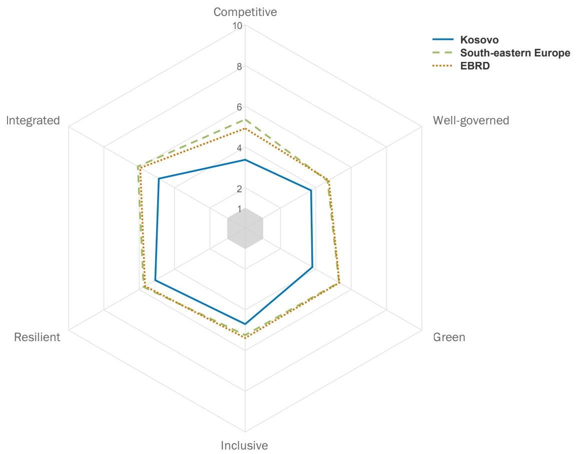
Macroeconomic performance

The economy continued to perform well in 2016. Economic growth in 2016 is estimated at 3.4 per cent, slightly smaller compared with 4.0 per cent in 2015, but continuing the strong recovery from the slow-down in 2014. Drivers of growth in Kosovo continue to be robust private consumption, helped by major inflows of remittances, and strong investment figures including public investments in infrastructure, such as the 65 km section of the highway connecting Pristina to the Macedonian border. On the other hand, government consumption and net exports made negative contributions to growth, with the latter reflecting the country's weak production base and low competitiveness. Kosovo's economy continued to perform well in the first half of 2017, with an estimated growth rate of 4.2 per cent year-on-year, primarily driven by rising investment but with positive contributions also from net exports and private consumption.

The IMF programme expired in August 2017. A 22-month, €185 million stand-by arrangement (SBA) was approved in July 2015. In March 2017 it was extended until August to facilitate policy continuity and to allow sufficient time for ongoing structural reforms to progress. However, the IMF shelved the programme's final reviews, as well as the final disbursement of around €15 million, because of the absence of a new government following the early general elections in June. Fiscal performance under the programme was strong, with a budget deficit in 2016 of 1.4 per cent of GDP, well within the 2.0 per cent of GDP fiscal rule. The government plans to boost capital expenditure in the next period and to run a wider deficit. It is possible that some extra fiscal space would be needed for the planned new Kosovo thermal power project (Kosovo C) (which, if it goes ahead, is expected to cost over €1 billion, or more than 20 per cent of the country's GDP), depending on whether private sources of finance are sufficient to cover the entire cost.

Short-term growth is likely to remain robust. The economy is projected to grow by 3.7 per cent in 2017 and 3.5 per cent in 2018, supported once again by remittance inflows and critical investment in transport and energy infrastructure. Downside risks remain significant. The recent political uncertainty may have an adverse effect on investor and consumer confidence and could delay key infrastructure projects, which are crucial for the country's long-term development.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Key reforms are being anchored within the framework of the Stabilisation and Association Agreement (SAA). In February 2017, Kosovo and the EU held the first SAA sub-committee meeting on transport, environment, energy, climate and regional development. The talks were within the framework of the SAA, which entered into force in April 2016. Among other topics, the European Commission (EC) stressed the need to continue the development of projects to help establish the core transport network for the Western Balkans. There was agreement on the need for continuing reforms, including strengthening the independence and capacities of the transport sector's regulatory institutions and taking concrete measures to improve road safety. The EC also highlighted the need for enhanced efforts on renewable energy and energy efficiency, including the establishment of a supporting financial mechanism for financing energy efficiency.

Procurement procedures are being progressively digitised. In an effort to promote transparency and good governance, the government has made electronic procurement ("e-procurement") compulsory for all central government procurement agencies from September 2016, and for municipalities from January 2017. Kosovo ranked 40th out of 190 economies in the World Bank's *Doing Business 2018* report, 20 places up from last year. A particular improvement was made in the area of resolving insolvency as the country has introduced a legal framework for corporate insolvency, making liquidation and reorganisation procedures easier.

Integration between Kosovo and Albania is advancing. The two countries have agreed to open a joint customs point in the Albanian port of Durres for goods that are destined for Kosovo. This means that any Kosovan business may be inspected and cleared in the port, rather than at the border. Establishing a facility of the Kosovo customs office at the port of Durres, harmonisation of excise duties and creating a "green corridor" for the export and import of agricultural seasonal products are all steps towards further economic cooperation and integration between the two countries.

A new law on strategic investments is in place. The law was signed by the President in February 2017. The law targets the reduction of bureaucratic procedures and other barriers to investment. In future, if a project is classified as strategic, investors should be able to obtain all the necessary licences and permits within 15 days. However, privatisation revenues have been negligible in recent years and FDI in 2016 was around €250 million, or just 4 per cent of GDP.

Kosovo has transposed EU law on the energy performance of buildings. In December 2016 Kosovo adopted national legislation transposing the 2010 EU Energy Performance of Buildings Directive. This rectifies breaches and ensures the country's compliance with Energy Community ministerial council decisions from October 2016.

The central bank has launched a new credit registry system. The new system, operational since June 2017, was developed according to the latest standards and technology in the credit reporting field. It provides more information on lending activity, as new reporting fields have been added following requests from the Kosovo Credit Guarantee Fund (KCGF), financial institutions and various central bank departments. New information also enables credit institutions to gain a clearer picture on their clients' ability for repayment and the responsibility for financial obligations, and it allows users to instantly research a large volume of credit reports.

Lending activity is recovering. Average monthly year-on-year growth of credit to the private sector in 2016 was 9.2 per cent, speeding up to an average of 10.6 per cent over the first half of 2017. Nevertheless, private sector credit accounts for just 36 per cent of GDP. The average lending rate in 2016 was 7.2 per cent and is on a downward trend, while the average deposit rate in 2016 was 1.2 per cent. Kosovo's banking sector comprises 10 active, private banks, of which eight are majority foreign-owned. The sector is highly concentrated, with the top four banks, Austrian Raiffeisen, Slovenian NLB, Turkish TEB and German ProCredit Bank, accounting for more than 80 per cent of the total banking assets. Capitalisation remains strong with a capital adequacy ratio of 18 per cent at the end of 2016, with each individual bank being in compliance with the minimum regulatory requirement of 12 per cent. Asset quality remains good, as non-performing loans, which, according to Kosovo's central bank, do not include sub-standard loans, dropped to 5 per cent as of March 2017, and are among the lowest in the central and south-eastern Europe region.

KYRGYZ REPUBLIC

Highlights

- **The economy is growing strongly.** Real GDP growth reached 5.0 per cent year-on-year in the first nine months of 2017, reflecting partly the low base effect as well as strong gold production and the stabilisation of remittances inflows.
- **The currency has stabilised after significant depreciation during 2014-15.** The som appreciated by around 10.8 per cent from the beginning of 2016 to the end of October 2017, reflecting the rebound in remittances and improvements in the external environment.
- **Banking sector vulnerabilities remain significant.** The weakening of the currency and overall economic slow-down in 2015 and the first half of 2016 contributed to an increase in classified loans to 8.8 per cent by the end of 2016, up from 4.5 per cent in 2014. Dollarisation in the banking sector remains high, but is declining as a result of the National Bank of the Kyrgyz Republic (NBKR)'s policies.

Key priorities for 2018

- **Simplifying tax administration and other interaction with the government for small and medium-sized enterprises through more efficient public services continues to be of high importance to improve the business climate.** This would also help to move more businesses from the informal to the formal sector.
- **Efforts to strengthen the banking sector should continue for a more resilient financing base for the economy.** Prudential banking rules should be enforced more rigorously.
- **Public utilities should be strengthened through commercialisation and stronger private sector participation.** This would help municipal utilities improve their financial standing, operating practices and governance, and enhance the reliability of the power sector by rehabilitating assets and developing a more attractive institutional framework for private investment.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	10.5	4.0	3.9	3.8	4.4
Inflation (average)	6.6	7.5	6.5	0.4	3.1
Government balance/GDP	-3.7	1.0	-1.2	-4.5	-3.0
Current account balance/GDP	-13.3	-16.0	-16.0	-9.7	-11.6
Net FDI/GDP [neg. sign = inflows]	-8.5	-3.1	-15.1	-6.6	-6.7
External debt/GDP	71.9	75.6	85.2	84.4	73.1
Gross reserves/GDP	30.5	26.2	26.6	30.0	n.a.
Credit to private sector/GDP	15.4	19.6	21.8	20.4	n.a.

CONTINUES

Macroeconomic performance

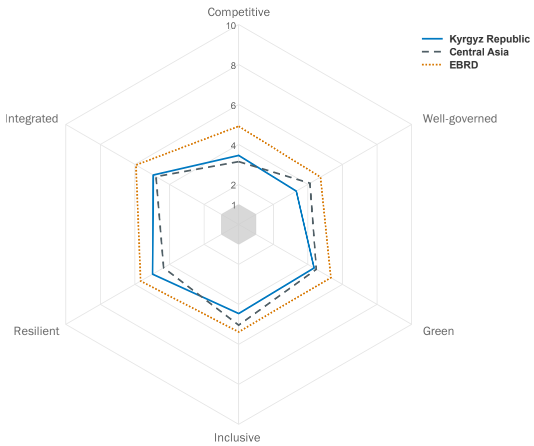
The economy is growing strongly. GDP growth reached 5.0 per cent year-on-year in the first nine months of 2017, continuing the strong rebound in the second half of 2016. Excluding the Kumtor gold mine, GDP growth reached 3.6 per cent, slightly lower compared with 2016, when the economy grew by 3.8 per cent. The better 2017 GDP figures not only reflect the significant increase in gold production, but also the low base effect and strong remittances inflows, which increased by 25.4 per cent in US dollar terms and 22.5 per cent in local currency terms year-on-year in the first eight months of 2017.

The currency has stabilised since 2016. The som appreciated by around 10.8 per cent from the beginning of 2016 to mid-October 2017, reflecting the rebound in remittances and the stabilisation of the external environment. Currency appreciation and lower fuel prices reduced inflation to only 0.4 per cent in 2016, but the rate accelerated to 3.3 per cent year-on-year in September 2017, mainly due to higher services prices. The NBKR gradually lowered its refinancing rate from 10.0 per cent in 2015 to 5.0 per cent in December 2016. Gross international reserves remained stable, close to US$ 2.1 billion (covering five months of imports of goods and services) as of September 2017.

External and fiscal positions remain under pressure. The fiscal deficit widened to 4.5 per cent of GDP in 2016 from 1.2 per cent in 2015 as a result of weak budget revenues and large infrastructure spending. The government is targeting a deficit of 3.0 per cent of GDP in 2017 as the economy has begun to recover. The current account deficit narrowed to around 9.7 per cent of GDP in 2016 from 16.0 per cent in 2015, reflecting the recovery in external transfers in the second half of the year and a further decline in imports as a result of weak investment and household demand. The deficit will likely further decline this year, but nevertheless remain sizeable.

Real GDP growth is expected to reach 4.4 per cent in 2017 and 4.2 per cent in 2018, on the back of strong growth in mining and higher gold exports, as well as continued growth in remittances, boosting household demand. Infrastructure spending from China will likely remain significant. However, the fiscal loosening in the run-up to the presidential election will have to be reversed in order to continue with the IMF programme.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Business environment and investment climate challenges remain despite improvements in recent years. The Kyrgyz Republic ranked 77th out of 190 countries in terms of ease of doing business, according to the World Bank *Doing Business 2018* report. The country performs well in areas such as starting a business, registering property, getting credit and dealing with construction permits, but poorly in paying taxes, resolving insolvency, getting electricity, enforcing contracts and trading across borders. Efforts to boost investment are hindered by low state capacity, political volatility and concerns over foreign ownership of economic assets.

Progress has been made to resolve the long-standing Kumtor gold mine dispute. At the beginning of September 2017 Canadian mining company Centerra Gold Inc. announced that an agreement had been reached with the Kyrgyz authorities to settle all disputes over the Kumtor gold mine. As a result all environmental claims and court orders against Kumtor will be dropped and Centerra will be able to freely transfer its funds worth US$ 299 million out of the country, which earlier had been frozen by the Kyrgyz government. Following the deal, there will be no restrictions on Kumtor's ability to distribute funds to Centerra and all restrictions of movement on Kumtor's employees will be lifted. The settlement follows a dispute during which Centerra took the Kyrgyz government to international arbitration in 2016 over a disagreement on profit sharing.

Banking sector vulnerabilities remain, but are not so significant to sharply constrain credit growth. The weakening of the currency and the overall economic slow-down in 2015 and the first half of 2016 contributed to an increase in classified loans (overdue and non-performing loans) to 8.8 per cent by the end of 2016 from 4.5 per cent in 2014, falling only marginally to 8.4 per cent as of June 2017. The dollarisation in the banking sector has remained rather high at 48 per cent in deposits and 42 per cent in loans as of June 2017. However, as economic growth has accelerated the banking sector has begun to show signs of recovery with credit to the private sector increasing.

The Kyrgyz Republic again needs to find a new partner for the Naryn project. The government approved a contract in August 2017, under which Liglass Trading, a Czech photovoltaic and hydropower investment company, agrees to construct and operate two large hydropower plants in the Upper Naryn cascade and 10 other smaller plants with a capacity of 280 MW. However, after Liglass announced in September 2017 that it would be unable to fulfil obligations to pay US$ 37 million to RusHydro, the government decided to cancel the contract with the company. The contract for the development of these hydropower plants had previously been awarded to RusHydro, a Russian hydroelectric company. The contract with the Russian company was terminated in 2015 because of the government's concerns regarding the ability of the Russian government to follow through on proposed investments in the project. The successful completion of the Upper Naryn project would be a good sign for other significant endeavours such as the proposed Karambata-1 dam, which will require investment on an even larger scale.

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.

CONTINUES

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.

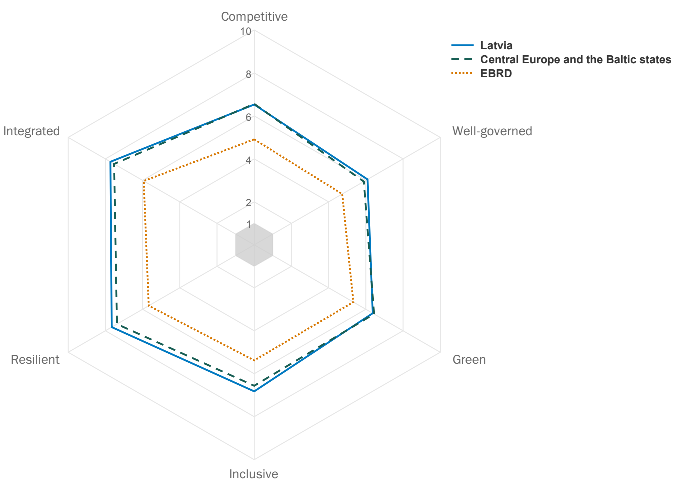
EU co-financed investment is rebounding slowly. Following a dramatic drop of 15.0 per cent in 2016, investment growth recovered to 17.5 per cent during the first half of 2017. Two factors are behind this improvement. First, the already substantially delayed investments co-financed by the EU funds have 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)



CONTINUES

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.

LEBANON

Highlights

- **The macroeconomic position is challenging as a result of the political situation and regional instability.** Growth remained low in 2016 at an estimated 1 per cent, fiscal performance deteriorated and the external position remains difficult.
- **The debt burden in Lebanon is among the highest in the world.** This puts a strain on public finances as interest payments account for half of revenues, leaving limited space for capital and social spending.
- **Policy-making improved and reforms progressed after the resolution of the political deadlock.** Once the new government was appointed in December 2016, reforms advanced, including decrees regulating oil and gas exploration (approved by the Cabinet in January 2017), and an electricity reform plan and draft 2017 budget in March 2017.

Key priorities for 2018

- **A sustained and balanced fiscal adjustment is essential.** Without further adjustment, Lebanon's public debt burden will continue to rise, adding to existing vulnerabilities and ultimately crowding out essential public spending.
- **Lebanon's infrastructure deficit needs to be addressed.** The current situation is the result of protracted under-investment and is exacerbated by the refugee presence. Slow internet speeds are a major burden for firm operation and growth, and strengthening infrastructure would help the development of a knowledge economy.
- **There is a critical need for electricity reform.** The electricity sector has been identified as the most pressing bottleneck for doing business and for competitiveness. Reforming this sector has been long-delayed, resulting in large fiscal implications.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.50	2.0	0.8	1.0	2.3
Inflation (average)	4.8	1.9	-3.7	-0.8	3.6
Government balance/GDP	-9.0	-6.3	-7.6	-9.3	-9.9
Current account balance/GDP	-26.7	-26.4	-18.7	-18.6	-18.0
Net FDI/GDP [neg. sign = inflows]	-1.6	-3.5	-3.5	-4.6	-4.5
External debt/GDP	170.4	175.0	175.8	183.9	n.a.
Gross reserves/GDP	73.7	78.0	74.3	84.6	n.a.
Credit to private sector/GDP	136.9	143.8	147.4	147.1	n.a.

CONTINUES

Macroeconomic performance

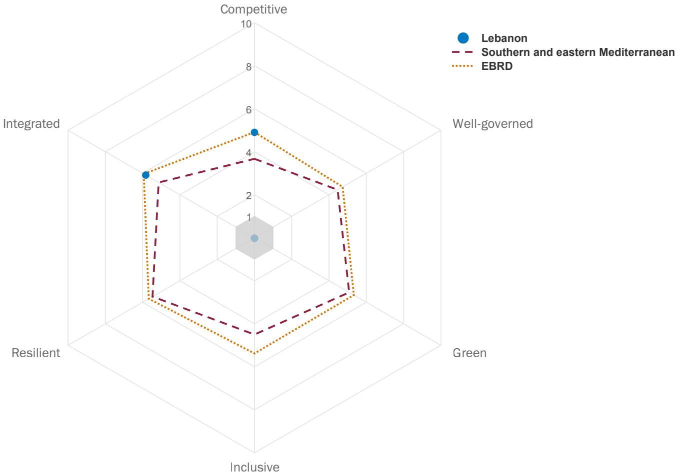
Growth remains sluggish. The economy grew by just 1 per cent in 2016, the same rate as in 2015. Lebanon has been in a protracted period of low growth since the start of the Syrian conflict in 2011 and the collapse of Syria's economy. In 2016, tourism, real estate and construction, traditionally the main drivers of growth, continued to be weak, reflecting regional insecurity and the political situation in Lebanon. In 2017, growth is still subdued despite positive political developments, as external imbalances remain wide.

Fiscal performance deteriorated in 2016. The fiscal deficit reached 8.1 per cent of GDP in 2016, up from 7.4 per cent of GDP in 2015, as a result of several factors. On the positive side, transfers to Electricité du Liban (EdL) decreased as a result of the global drop in oil prices, and tax revenues were stronger supported by higher excise tax collection, a steady increase in income and property taxes, and higher treasury receipts. However, interest payments, hospital spending and capital expenditures also increased, as did transfers to municipalities. Moreover, wages for military personnel represented two-thirds of the total wage bill as the deterioration in the security situation at the borders led to the hiring of additional troops. Interest payments consumed around 48 per cent of total revenues, the highest level since 2007, crowding out more productive forms of public expenditures. The large number of Syrian refugees, representing almost one-third of the total population, is placing further pressure on the economy's public finances and infrastructure, straining local communities, and adding to poverty and unemployment. Gross debt increased to 143.4 per cent of GDP, the third-highest level in the world, as a result of persistent fiscal deficits and moderate growth.

The external position remains challenging. The current account deficit is estimated to have widened to 18.9 per cent of GDP in 2016 from 16.3 per cent in 2015, owing to the impact of regional conflict on key trading partners and routes. Exports of goods and services declined in 2016, partly offset by decreases in imports. Remittances from the large diaspora increased by 9.0 per cent in 2016 to 7.5 per cent of GDP and supported growth through private consumption, which constitutes around 90.0 per cent of GDP. Gross remittances, which also include non-resident deposits, reached 14.6 per cent of GDP in 2016, with remittance flows from the Gulf Cooperation Council (GCC) accounting for almost 25.0 per cent of the total. The reliance on GCC countries for remittances and trade mitigates the growth benefit from lower oil prices to the extent that GCC countries' growth and fiscal accounts are affected by lower oil prices. Net foreign direct investment (FDI) increased to 3.8 per cent of GDP from 3.4 per cent in 2015, while net portfolio investment increased five-fold to reach 5.1 per cent of GDP. As a result, international reserves have remained high and stable and amounted to US$ 40.2 billion as of May 2017, over 14 months of imports, bolstering confidence in the peg and the financial system despite weak public finances.

Growth is expected to rebound but remains subdued at 2.3 per cent. A recovery in the construction and financial sectors, thanks to renewed political stability and the continuation of reforms, is expected to boost confidence, increase inflows and help debt dynamics. Meanwhile, sizeable vulnerabilities and risks remain, including from regional turmoil and increased spending pressures.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Lebanon's economy suffers from a number of structural weaknesses. In 2017, The World Economic Forum ranked Lebanon 101st out of 138 countries in its Competitiveness Ranking, due to poor macroeconomic conditions, infrastructure and electricity, and institutions. Corruption, government instability and inadequate infrastructure were identified as the most problematic factors for doing business. The World Bank's *Doing Business 2018* report ranked Lebanon 133rd out of 190 countries, down from 126th in the 2017 report. According to the assessment, the lack of investment in infrastructure has eroded the country's competitiveness.

Progress was made in setting up public-private partnerships in the energy sector. The electricity sector remains a key bottleneck to improved competitiveness and a large drain and source of uncertainty on the budget because of ageing infrastructure, unpaid consumption and low tariffs. Efforts to reform the national electricity company, Electricité du Liban (EdL), have been hindered for years. A chronic electricity crisis has existed since the end of the Civil War in 1990, with successive governments failing to make large investments to improve the ailing sector and its outdated infrastructure. The electricity reform plan announced in March 2017 calls for the lease of power barges aimed at improving power supply in the summer.

Decrees regulating oil and gas exploration have been approved. In January 2017, the cabinet approved decrees that would allow the start of offshore oil and gas exploration, by setting out both the exploration blocks that it will offer and the terms and conditions for exploration and production agreements. Lebanon is the last country in the eastern Mediterranean region to explore its hydrocarbon reserves, which are shared with Cyprus, Israel and Egypt. After passing a hydrocarbon law in 2010, Lebanon fell behind neighbouring countries in exploring the Levant Basin owing to internal political strife. The authorities in Lebanon expect to open five new offshore gas blocks for exploration in 2017. The government is now pushing to receive bids by mid-September to speed up the process.

Efforts to reform taxes and public sector wage scales face legal barriers. In July 2017, parliament passed a series of laws to raise taxes and ensure funding for the long-awaited new public-sector wage scale. Parliament voted to approve 38 separate measures to provide the funding for increased public-sector salaries and an 85 per-cent increase in public-sector pensions, to be delivered over three years. The changes included a tax on bank profits, a fine on those encroaching on public maritime properties, and a new fee on foreigners entering the country, among others. The package was supposed to pave the way for parliament to ratify the country's first budget since 2005. However, in August, the constitutional council suspended the implementation of the law, and in September it annulled the law in its entirety. It is worth noting that the passage of a new wage scale has been delayed for five years and the latest revenue measures to be passed were a decade ago.

Spending plans are still formulated ad hoc but progress is being made in improving the situation. Political deadlock has resulted in parliament not formally approving a budget for the past 12 years, with spending plans formulated on an ad hoc basis. In March the cabinet approved the 2017 draft budget, and parliament approved it during an extraordinary session in October and is set to begin drafting the 2018 budget. Parliamentary ratification of an annual budget going forward would improve the transparency and predictability of public finances, allow further reforms and facilitate donor funding. The World Bank recently agreed to new loans and grants for two separate road projects totalling more than US$ 400 million, conditional on Lebanon passing a budget. The absence of an approved budget continued to impede the formulation and implementation of debt-stabilising reforms. While the agreement on a budget within the cabinet raises the prospect of one now being passed by parliament, its likely impact is unclear and the associated delays increase fiscal risks.

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.

CONTINUES

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.

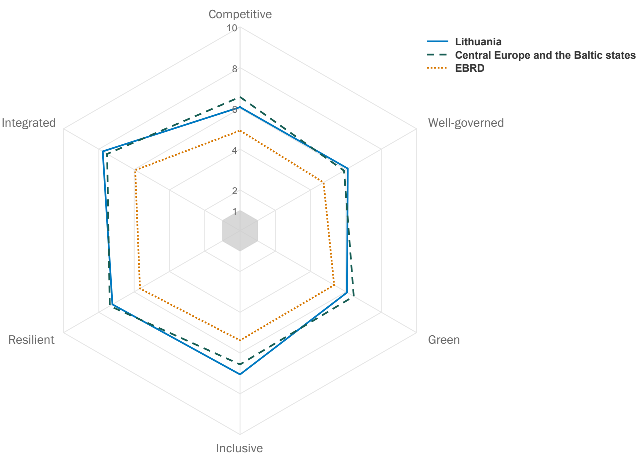
Investment has the potential to rebound sharply. After registering a drop of 0.5 per cent in 2016, investment growth recovered by 5.7 per cent during the first six months of 2017. Some turnaround in EU funds absorption at the beginning of this year has lifted public investment, while the historically 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)



CONTINUES

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.

MOLDOVA

Highlights

- **The economy is growing again after the recession in 2015.** GDP increased by 4.3 per cent in 2016, supported by a bumper harvest, a recovery in household consumption and exports of goods and services, and further growth has occurred so far in 2017.
- **A new IMF programme is in place.** The three-year programme was approved in November 2016, on completion by the Moldovan authorities of prior actions mainly focused on the banking sector.
- **Banking sector vulnerabilities are being tackled.** The regulatory and supervision framework has been overhauled to provide the National Bank of Moldova (NBM) with tools for the identification of banks' ultimate beneficial owners and related party lending.

Key priorities for 2018

- **Key commitments under the IMF programme should be met.** The IMF programme is a crucial anchor for reforms and is essential to catalysing further international support and implementation of structural reforms.
- **Banking sector cleansing should be completed.** The new regulatory and supervision framework needs to be thoroughly implemented, and non-transparent shareholders still present in the ownership structure of some of the largest banks should be replaced with fit and proper investors.
- **Further business environment and governance reforms are needed.** Key priorities should include judiciary reform, simplification of the regulatory framework, an overhaul of the tax and customs administration, and improvement of governance in public institutions.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	9.4	4.8	-0.4	4.3	3.0
Inflation (average)	4.6	5.1	9.7	6.4	6.5
Government balance/GDP	-1.9	-1.9	-2.3	-2.1	-3.7
Current account balance/GDP	-6.2	-7.1	-7.2	-4.2	-4.0
Net FDI/GDP [neg. sign = inflows]	-2.7	-3.8	-3.2	-1.1	-2.2
External debt/GDP	86.4	81.4	93.7	92.1	n.a.
Gross reserves/GDP	35.5	27.0	27.0	32.6	n.a.
Credit to private sector/GDP	42.1	36.4	31.2	25.8	n.a.

CONTINUES

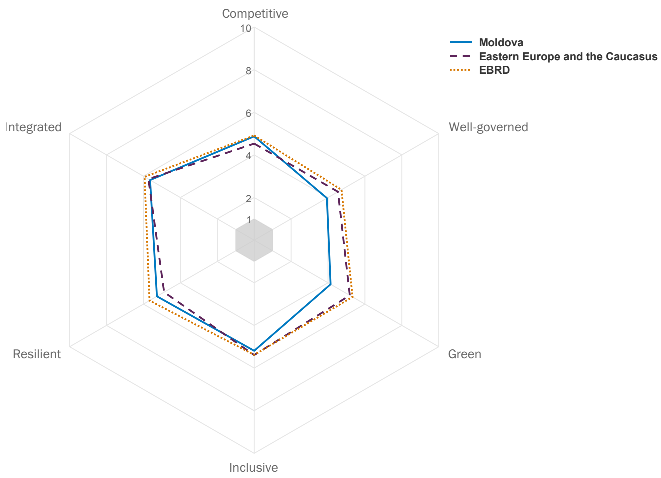
Macroeconomic performance

Economic growth has resumed. Following a 0.4 per cent economic contraction in 2015, real GDP grew by 4.3 per cent in 2016 on the back of a good agricultural season. Agricultural output increased in real terms by 18.0 per cent in 2016 after declining by 13.0 per cent in 2015. In 2016, household consumption rose by 3.6 per cent and the real volume of export of goods and services increased by 9.3 per cent, driven by higher export flows to the European Union (EU) countries. On the other hand, gross fixed capital formation contributed negatively to GDP growth, falling by 2.8 per cent in real terms in the same period. GDP continued to grow by 2.8 per cent year-on-year in the first half of 2017.

External and inflationary pressures have eased. The Moldovan leu stabilised in 2016 after depreciating by 33.6 per cent against the US dollar in 2014-15. Supported by strong export performance and recovering remittances, the leu appreciated by 13.5 per cent in relation to the US dollar in the first nine months of 2017. In the same period, inbound money transfers returned to growth of 9.5 per cent year-on-year after a decline in the previous two years. The current account deficit fell from 7.1 per cent of GDP in 2014 to 4.2 per cent of GDP in 2016. Official reserve assets increased from US$ 1.8 billion at the end of 2015 to US$ 2.6 billion in September 2017, lifting import coverage to approximately six months. Amid monetary tightening and a stable leu, inflation decelerated from 13.6 per cent year-on-year in December 2015 to 6.3 per cent year-on-year in the first nine months of 2017. General government gross debt increased from approximately 25.0 per cent of GDP in 2014 to close to 40.0 per cent of GDP in 2016, mainly due to the recognition of public debt arising from the emergency assistance provided by the NBM to the three failed banks.

The short-term growth outlook is positive but significant vulnerabilities remain. The new IMF programme has eased funding pressures and helped to stabilise Moldova's economy. Current projections for growth are 3.0 per cent in 2017 and 3.5 per cent in 2018, driven by macroeconomic stabilisation and an improved external environment. However, the forecast is subject to uncertainty due to a narrow economic base concentrated in agriculture. Vulnerabilities in the financial sector remain despite recent steps to improve banking supervision and the regulatory framework.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Moldova's entry into an IMF programme has catalysed reforms. A three-year IMF arrangement for Moldova of US$ 179 million was approved in November 2016. The programme has a strong focus on the banking sector and on addressing debt accumulated by the energy companies, setting utility tariffs at cost recovery levels and developing a sound medium-term budget framework for 2017-19. To satisfy prior actions and secure the agreement, the authorities undertook reforms in the financial and energy sectors, amended the 2016 budget law and converted state guarantees to the NBM into marketable government securities. In April 2017, the IMF completed the first programme review and released a US$ 21.5 million tranche. Approval of the programme unlocked international budget assistance from the European Union, the World Bank and Romania.

The authorities made progress in tackling long-standing vulnerabilities in the banking sector. Legislative amendments adopted in 2016 equipped the NBM with stronger legal powers and the enforcement capacity to identify banks' ultimate beneficial owners (UBOs) and related-party lending. Under the new rules, the NBM has acquired statutory powers to deem any person to be a bank's related party on the basis of objective criteria, unless the bank is able to prove otherwise. Changes to the Banking Law approved in the course of 2016 imposed more severe sanctions on managers, administrators and shareholders of banks for misconducts. The new Bank Recovery and Resolution Law was enacted in October 2016 to provide adequate crisis management capacity to NBM by introducing new resolution and intervention tools. A Central Securities Depository was created in April 2017 to reinforce financial infrastructure and increase protection against raider attacks.

As of the end of August 2017, two of the three largest banks remained under special supervision, and the third under special administration, of the NBM. These banks together account for approximately 65 per cent of Moldova's banking sector assets. Full external diagnostic reviews were launched in these three banks focusing on exposure to related parties. Full-scope onsite inspections were conducted in the two banks under special supervision. The NBM blocked the shares of non-transparent shareholders in two banks and re-offered them for sale with a view to attracting fit and proper strategic investors. The Board of Directors of Victoriabank, one of the three largest banks, became operational again in October 2016.

Some reforms were undertaken in the energy sector. Energy tariffs have been increased closer to operating cost recovery levels, but they remain insufficient to address the accumulated debts of energy companies and to facilitate the requisite investments into energy infrastructure. To further the laws on electricity and natural gas promulgated in 2016, the parliament of Moldova adopted a new law on energy in July 2017 as an important step towards approximation with the EU's Third Energy Package. The new law supports the strengthening of the institutional set-up and independence of the energy regulator (ANRE) via, among other things, improved procedures for the appointment of its directors and establishing clear performance indicators. A new renewable energy law, approved in February 2017 and entering into force in 2018, transposes the EU directive and is expected to create an enabling framework for renewable energy projects.

A plan to restructure the government apparatus has been approved. In July 2017, Moldovan parliament supported a government restructuring plan that targets enhanced efficiency of public administration. Under the plan, the number of ministries was reduced from 16 to 9. Downsizing of public administration staff aims to generate savings on administrative expenses. According to the plan, deputy ministers are to be replaced with permanent state secretaries to foster a separation between political and administrative functions and to ensure continuity and stability in the work of ministries. The reorganisation is expected to take several months.

CONTINUES

Pension system sustainability was improved. The new pension law entered into force from the beginning of 2017. It is set to gradually increase the retirement age to 63 by 2019 for men and by 2028 for women. The new pension system introduces basic pension coverage and requires that all public sector employees are subject to the same contribution and benefit rules. The link between contributions and benefits was strengthened to make the system more equitable and to stimulate compliance.

Steps were taken to ease the regulatory environment for businesses but significant obstacles remain. In 2016, the total number of authorisations, permits and licences required for starting a business decreased by approximately a quarter. The authorities approved an action plan to implement one-stop-shop solutions and procedures for orderly liquidation of businesses were simplified. The reporting burden on businesses is to be lowered, effective from January 2018, by unifying five reports on payroll and payroll taxes and on mandatory social and insurance contributions into one report deliverable to a single public institution.

A moratorium on inspections was introduced and work initiated on a new mechanism for performing state controls and on reforming and reducing the number of institutions with control functions. Measures were also taken to simplify procedures for obtaining construction permits, but implementation of reforms to address the remaining regulatory hurdles, improve customs administration and overhaul the judiciary is lagging behind. Moldova ranks 44th out of 190 countries in the World Bank's *Doing Business 2018* report with lower scores in dealing with construction permits, getting electricity, enforcing contracts and resolving insolvency compared with better rankings in other doing business indicators.

MONGOLIA

Highlights

- **The economy is recovering well.** Growth reached 5.3 per cent in the first half of 2017, significantly up from 1.0 per cent in 2016, largely reflecting the base effect, high fixed investment in the mining sector and a recovery in household consumption.
- **A new IMF programme is in place.** This is part of a broader US$ 5.5 billion package supported by China, Japan, Korea, the Asian Development Bank (ADB) and the World Bank. Disbursements are conditional on fiscal consolidation, monetary policy and banking sector reforms as set out in the new programme.
- **Significant fiscal reforms have been passed.** Progress has been made on legislation that strengthens tax administration, tax policy and budgetary controls, including through the establishment of a fiscal council.

Key priorities for 2018

- **Reforms under the IMF programme need to be implemented effectively.** Critical pillars of the programme are fiscal consolidation, strengthening the banking system, financial market reform, restoring debt sustainability and rebuilding international reserves.
- **Banking sector reforms need to advance.** A forthcoming Asset Quality Review should be followed by recapitalisation and restructuring of banks as needed. It will be key to improve the supervisory and regulatory framework, and strengthen the governance and independence of the Bank of Mongolia.
- **An environment conducive to large mining sector projects needs to be secured.** The natural resources sector requires further reform, including the promotion of transparency of the licensing process, further improving the effectiveness of the implementation of existing legislation, and strengthening the independence and technical capacity of the regulatory bodies.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	11.6	7.9	2.4	1.0	2.6
Inflation (average)	8.6	12.9	5.9	0.6	4.5
Government balance/GDP	-6.8	-1.2	-5.0	-15.4	-10.4
Current account balance/GDP	-25.4	-11.5	-4.8	-6.3	-4.9
Net FDI/GDP [neg. sign = inflows]	-16.7	-2.3	-0.9	37.8	-8.8
External debt/GDP	151.2	171.7	184.4	248.3	247.4
Gross reserves/GDP	17.8	13.5	11.3	11.8	n.a.
Credit to private sector/GDP	56.2	56.2	50.5	52.0	n.a.

CONTINUES

Macroeconomic performance

Mongolia's economy is recovering. Economic growth slowed to just 1.0 per cent in 2016, as domestic demand declined and investment struggled to recover from the downturn in previous years. However, a strong recovery has taken hold since late 2016 thanks to growing investment in the mining sector and higher coal prices and exports. Real GDP growth reached 5.3 per cent year-on-year in the first half of 2017, following a 9.8 per cent rise in the fourth quarter of 2016. Household consumption also improved. External trade turnover increased by 33.4 per cent year-on-year in the first nine months of 2017. Exports rose by 37.5 per cent year-on-year in US dollar terms, led by coal exports, while imports rose by 27.9 per cent in the same period.

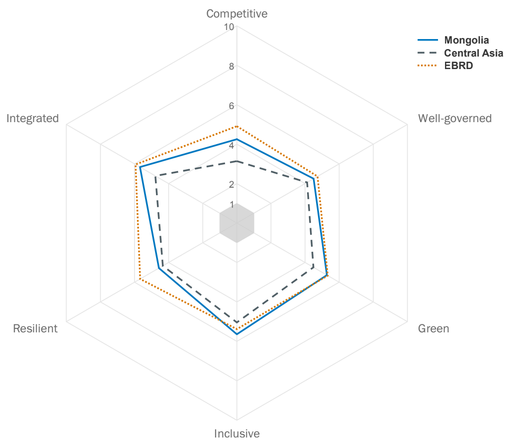
Currency pressures eased in 2017. This reflects the effect of the new IMF programme, the accompanying fiscal reforms, and higher exports. The tugrik modestly appreciated against the US dollar in the first 10 months of 2017, following a 20 per cent depreciation over 2016. This allowed the central bank of Mongolia (BOM) to lower its policy rate to 12.0 per cent in June 2017 from the 14.0 per cent rate established earlier. Upward pressure on inflation has been gradually building from low levels in 2016. Inflation reached 5.8 per cent in September 2017 year-on-year, after averaging 0.6 per cent in 2016.

Public finances have remained a challenge, although liquidity pressures have been overcome. The budget deficit widened to 15.4 per cent of GDP in 2016, versus an initially budgeted 4.0 per cent, partly as a result of including into the budget spending programmes previously undertaken by the central bank. For 2017, the budget deficit is expected to narrow to a still-significant 10.4 per cent of GDP, reflecting substantial reductions in the spending on state-funded programmes. Short-term liquidity pressures have abated since the government refinanced an external bond due in March 2017 by issuing a new seven-year maturity bond. This demonstrated solid market access in light of the new programme with the IMF, which unlocks a US$ 5.5 billion financial package from multilateral and bilateral lenders over the next three years to maintain the economic stability of the country.

In October 2017 the government of Mongolia issued US$ 800 million in a 5.5-year bond with a 5.625 per cent coupon. Proceeds from the bond will be used to repay debts from the government's previous bonds, including the Chinggis and Dim Sum bonds. Major public debt repayments will thus not be due before 2021.

The economy is projected to grow by 2.6 per cent in 2017, rising to 3.0 per cent in 2018, as mining investment and exports accelerate driven by the expansion of the second phase of the Oyu Tolgoi mine. Public spending will by contrast remain subdued in 2017-18, given the government has remained committed to the significant fiscal tightening envisaged under the IMF programme.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Mongolia is quite advanced towards its transition to a market economy. The country has the highest average transition quality score compared with other Central Asian countries and ranks 23rd among the 37 EBRD countries. Mongolia ranked 62nd out of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2018* report, with large gaps remaining in the areas such as getting electricity and trading across borders. In the mining sector, issues surrounding the share of state ownership, the rules governing the allocation of risks and rewards between the state and private investors, and the tax regime have all been subject to change and uncertainty.

Structural reforms are anchored within the new IMF programme. The programme – a three year US$ 434 million extended fund facility signed in May 2017 – focuses on economic reforms to: (i) tighten fiscal policy; (ii) improve the central bank's independence, governance and focus on core responsibilities; (iii) strengthen the financial sector; (iv) foster economic diversification and inclusive growth; and (v) protect the most vulnerable in society. The approval of the programme unlocked an additional US$ 5.2 billion financial support package, with the ADB, the World Bank, Japan and Korea, providing around US$ 3 billion budgetary and project support, and China extending an around US$ 2.2 billion swap line to BOM for the next three years.

The structural reform agenda has advanced. Staff-level agreement on the first and second review of the IMF programme was reached in October 2017. The rehabilitation and strengthening of the banking system is under way: the results of the comprehensive Asset Quality Review are expected in mid-December; important legal reforms are being drafted to strengthen the financial system; and improvements to the regulatory and supervisory framework are under way. On the fiscal side, progress has been made in strengthening the tax administration, tax policy and budgetary controls including through the establishment of a fiscal council and a high-level working group on tax policy.

Significant fiscal reforms have been passed. Legislation passed in April 2017 focused heavily on revenue-side reforms. Changes include a progressive personal income schedule that replaces the flat rate of 10 per cent applied previously and the taxation of interest on personal savings. Under the new progressive schedule, individuals with earnings exceeding tugrik 1.5 million (US$ 70,000) will be liable to additional marginal tax rates of 15 to 25 per cent. Other important amendments include the raising of retirement ages, which will be increased by six months every year from 2018 to reach the target pension-drawing ages of 65 years for men and women by 2028 and 2038, respectively. A 10 per cent tax will be levied on all savings accounts, effective from May 2017. Also, increases were adopted on fuel taxes, a vehicle tax schedule targeting larger vehicle engine capacities. Tariffs on imported cigarettes were also increased from 5 to 30 per cent, and higher excise taxes were imposed on alcoholic beverages and cigarettes, to be phased in during 2018-20. Mandatory social insurance fund contributions will also be increased gradually from 2018.

The strategic Oyu Tolgoi II mining project is gathering pace. Rio Tinto, the operator of Mongolia's biggest mine, Oyu Tolgoi (OT), is making progress on the second phase of the project, which was launched in 2016. A sum of US$ 6 billion has been invested so far in OT, and another US$ 5 billion could be invested under the new phase. Significant structural changes were made earlier to support mining activities in the country, which included the amendments to the Foreign Investment Law that clarified applicable tax regimes and permitted most foreign private investors to invest in a range of strategic sectors without seeking government approval. The amendments also stipulated that foreign-invested projects are governed by the rules in place when the contracts were signed. However, restrictions remain on foreign state-owned enterprises acquiring control of key mining assets.

MONTENEGRO

Highlights

- **Montenegro has joined NATO and steady progress is being made on EU accession negotiations.** NATO membership is an important milestone in the country's Euro-Atlantic integration. In the EU negotiations, Montenegro has opened 28 out of 33 negotiating chapters, and has provisionally closed three.
- **Construction of a major motorway project has advanced.** The government has issued almost all necessary construction permits, and plans to invest €200 million in 2017. The construction of the priority section of the highway was launched in 2015 and is expected to be finished by mid-2019.
- **Progress on large-scale privatisation has been sluggish.** Most of the economy is in private hands but some key companies are still publicly owned. Investor appetite for these assets is limited, judging by the lack of interest in recent attempts to sell them.

Key priorities for 2018

- **Competitiveness in the private sector needs to be enhanced.** Montenegro should focus on key sectors with high potential, including the development of value chains in the agribusiness sector and the promotion of backward linkages in tourism.
- **Cross-border transport and energy links are crucial for further growth and investment.** In addition to the major highway project under way, the authorities should take steps to improve the standard of regional roads and to strengthen the functioning of the regional energy market.
- **Fiscal policy needs further strengthening.** Recent measures to rein in spending are welcome but the country's rising public debt and heavy capital spending needs warrant greater efforts to control non-productive spending and put public debt on a downward path.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.6	1.8	3.4	2.9	3.7
Inflation (average)	2.2	-0.7	1.5	-0.3	2.1
Government balance/GDP	-4.5	-0.7	-5.9	-6.0	-6.4
Current account balance/GDP	-14.5	-15.2	-13.3	-19.0	-20.2
Net FDI/GDP [neg. sign = inflows]	-9.6	-10.2	-17.1	-9.8	-10.3
External debt/GDP	153.5	163.1	163.1	166.8	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	56.4	54.1	53.1	54.7	n.a.

*Montenegro uses the euro as its legal tender.

CONTINUES

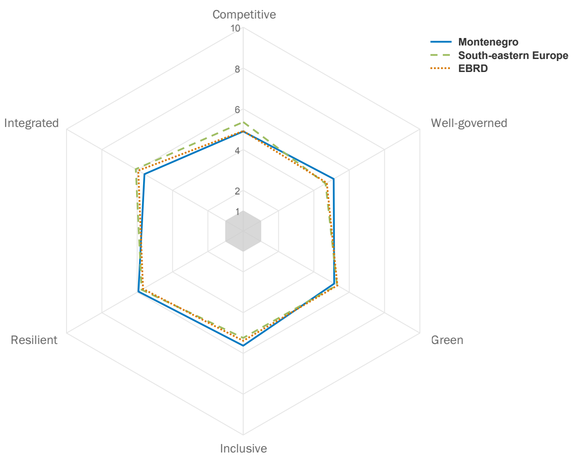
Macroeconomic performance

The economy performed below expectations in 2016. GDP growth in 2016 was 2.9 per cent, compared with 3.4 per cent in 2015, and was lower than expected, despite high pre-election spending and increases in public sector wages, pensions and social benefits. High imports related to the major highway project, as well as to the construction of the wind power plant, fuelled the trade deficit and caused a significant drag on growth, almost offsetting the positive gross capital contribution. The tourism sector, on which the economy depends heavily, as receipts from foreign tourist arrivals account for about one-fifth of annual GDP, has continued to perform well. The country experienced a record year for tourism in 2016 and is heading for another record in 2017. The number of foreign tourist arrivals in 2016 increased by 7.0 per cent, reaching 1.7 million (almost three times the size of the country). The economy accelerated in the first half of 2017, and the growth in this period is estimated at 4.2 per cent year-on-year.

The government is tackling growing fiscal pressures. The estimated 2016 fiscal deficit was 6 per cent of GDP, smaller than expected but only because capital spending was just 5 per cent of GDP instead of a previously projected 12 per cent, due to delays in the highway investment project. To combat growing fiscal pressures, a new Fiscal Strategy was adopted in June 2017. It contains a number of measures, including: (i) a VAT increase from the current 19 per cent to 21 per cent as of January 2018 (the lower 7 per cent rate remains in place for certain essential goods and tourism services); (ii) an increase in excise duties on cigarettes, alcohol, sugary drinks and coal; and (iii) a reduction in the salaries of senior public employees (by 8 per cent). The main goal of the strategy is to achieve a budget surplus from 2019 onwards. This should put public debt, which has been rising rapidly in recent years to 67 per cent (of projected 2017 GDP) as of mid-2017, on a downward trajectory. The government has also reduced benefits to mothers of three and more children by 25 per cent, reversing a measure introduced the previous year. In addition, with the aim to improve tax collection, the government has given the opportunity to companies to ask for tax debt reprogramming: 5,500 requests were submitted for €185 million.

Growth is expected to continue in the short term. The near-term growth rates, projected at 3.7 per cent in 2017 and 3.3 per cent in 2018, are expected to be mainly investment-driven and supported by public investment in transport and energy infrastructure, where the construction of the motorway is the key project, and flagship foreign direct private investments, particularly in the tourism sector. However, the downside risks remain significant, associated both with potential cost overruns on the highway project as well as the country's vulnerability to external shocks.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Montenegro became a NATO member in June 2017 and steady progress is being made on EU accession negotiations. On 5 June 2017 Montenegro became the newest, and the 29th, NATO member. This is a major milestone, as every eastern European country that has so far joined the EU had first joined NATO. Accession talks with the EU are progressing and, as of September 2017, Montenegro had opened 28 negotiating chapters (out of 33), and had provisionally closed three: Science and Research; Education and Culture; and External Relations. Initial benchmarks for the opening of four of the five remaining chapters have already been met and their opening is expected by the end of 2017. The one remaining chapter, on Competition Policy, may be opened once the Law on State Aid Control and the Law on Protection of Competition are passed.

Progress on large-scale privatisation remains sluggish. The 2017 Privatisation Plan envisaged the privatisation of the country's key transport companies – the Port of Bar and the rail freight operator, Montecargo. In addition, the privatisation of some major tourism assets still in state hands was also planned, such as the Institute Igalo, as well as preparation of tenders for Hotel Group Budvanska Rivijera and Ulcinjska Rivijera. Progress to date has been minimal. In October 2016 the government launched the sale of its 30 per cent stake in the Port of Bar and 51 per cent stake in Montecargo. However, this process for both companies was cancelled at its final stage in April 2017 as the government rejected the offer of the only bidder – the Polish OTL group. Also, a tender for the 30-year lease of Ucinjska Rivijera was launched in June 2017, but only one offer was received, from Karisma Hotels Adriatic Montenegro. Meanwhile the tender preparation for the concession of the shipyard's port – the Port of Bijela – is in the final phase. The consortium, which is comprised of the Dutch company Damen and the Adriatic Marinas, a company which operates the country's flagship investment Porto Montenegro, had expressed interest in obtaining concessions for the port for a period of 30 years, aiming to create a place for yacht building and repair.

The construction of the highway Bar–Boljare is advancing. The construction of the 42-km long priority section (Smokovac–Matesevo) of the highway Bar–Boljare, connecting the Adriatic Port of Bar to the border with neighbouring Serbia, was launched in 2015. The section is the most challenging part of the total highway, as it almost entirely consists of bridges and tunnels. The Chinese company CRBC is in charge of the construction of the priority section for a cost of US$ 1.1 billion. The investment is financed from a loan by the Chinese Export-Import Bank for US$ 944 million. Some €216 million had been spent on the construction by the end of 2016 and the government plans to spend €200 million in 2017. The priority section is set for completion in 2019.

An important renewable power project has been completed. The project is a commercial 72MW wind power plant, the first in the country. The investor, Akuo Energy of France, began constructing the plant in 2015 and completed the project (which is also financed by loans from the EBRD and KfW) in the first quarter of 2017. The wind farm represents 8 per cent of the total installed capacity and 6 per cent of total electricity production in Montenegro. In May 2017, the wind farm started its four months of final tests on all 26 wind turbines, after which it should be operational once tests are successfully completed. The launch of the project will help the country to achieve its target to raise the share of renewable energy to 36 per cent of its energy mix by 2020. The consortium is also interested in building Krnovo 2, which would mean installing more wind turbines at the same location.

CONTINUES

An electricity power market has been established. In June 2017 Montenegro's power firms signed an agreement on the establishment of a power bourse that would allow competition in its electricity supply market. Under the agreement, signed by power company EPCG, grid operator CGES and the Montenegro Electricity Market Operator (COTEE), the three firms are setting up a joint company that will have the status of a power exchange. Currently, EPCG is the only active electricity supplier in the country. The launch of the electricity exchange will help improve the competitiveness of the power market in Montenegro. Electricity will be traded more transparently and the stronger competition should lead to lower prices for consumers. The EU has called on the Western Balkans states to establish a regional energy market through the establishment of local power bourses. Currently only Serbia and Croatia have one. The EU aims to eventually integrate the regional power market into the single EU market. Also, Montenegro improved the reliability of electricity supply over the course of the previous year as CGES started to implement the Supervisory Control and Data Acquisition (SCADA) automatic energy management system, which improved significantly this area of doing business, moving the country's overall ranking in the World Bank's *Doing Business 2018* report up by nine places to 42nd out of 190 economies.

Banking sector stability and profitability have improved. The average growth of credit activity in 2016 was 3.7 per cent year-on-year, an increase from 1.6 per cent in 2015, and further accelerated to 6.9 per cent in the first half of 2017. The credit recovery has been helped by a reduction in non-performing loans from 25 per cent of all loans in 2011 to 11 per cent as of June 2017. The sector posted a net profit of €7.4 million in 2016, turning from a revised €3.3 million loss a year earlier. The banking sector is well capitalised. The capital adequacy ratio improved from 15.5 per cent in 2015 to 16.1 per cent in 2016, much higher than the regulatory minimum of 10.0 per cent.

MOROCCO

Highlights

- **Growth remained sluggish in 2016.** The economy remains sensitive to volatile agricultural output, and non-agricultural activity has been subdued. Fiscal and current account deficits are above 4 per cent of GDP but reserve coverage has strengthened in the past year.
- **The six-month political gridlock, which started in October 2016, ended with the appointment of a new coalition government.** The coalition is broader and more fragmented, which may slow policy-making. However, policy priorities do not differ from those of the previous administration, implying a continuation of sound policies and strong reforms.
- **Important fiscal and public sector reforms are advancing.** In the past year pension system and civil service reforms have continued, the implementation of the organic budget law (OBL) came into effect, steps to address risks related to state-owned enterprises were taken, and the authorities implemented tax reforms.

Key priorities for 2018

- **Fiscal policy reforms should continue.** The focus should be on continuing fiscal consolidation and decentralisation, civil service reform and strengthening the oversight of state-owned enterprises.
- **Financial policy framework reforms would make the financial sector more resilient.** Critical measures include adopting the central bank law, continuing to implement the joint IMF-World Bank Financial Sector Assessment Program recommendations, and moving towards a more flexible exchange rate regime.
- **Further measures are needed to improve the business climate and enhance competitiveness.** Access to finance would be improved by enacting the draft law on collateral and aligning the insolvency regime with international best practices. It is also important to make the Competition Council operational by appointing all its members, and to implement the recently adopted national strategy to fight corruption.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	4.5	2.7	4.5	1.2	4.2
Inflation (average)	1.9	0.4	1.6	1.6	1.2
Government balance/GDP	-5.6	-5.2	-4.5	-4.1	-3.5
Current account balance/GDP	-7.6	-6.0	-2.2	-4.4	-4.0
Net FDI/GDP [neg. sign = inflows]	-2.8	-2.8	-2.6	-1.6	-1.6
External debt/GDP	29.3	33.3	33.9	34.6	n.a.
Gross reserves/GDP	17.1	19.8	22.8	24.9	n.a.
Credit to private sector/GDP	84.3	83.9	80.2	81.3	n.a.

CONTINUES

Macroeconomic performance

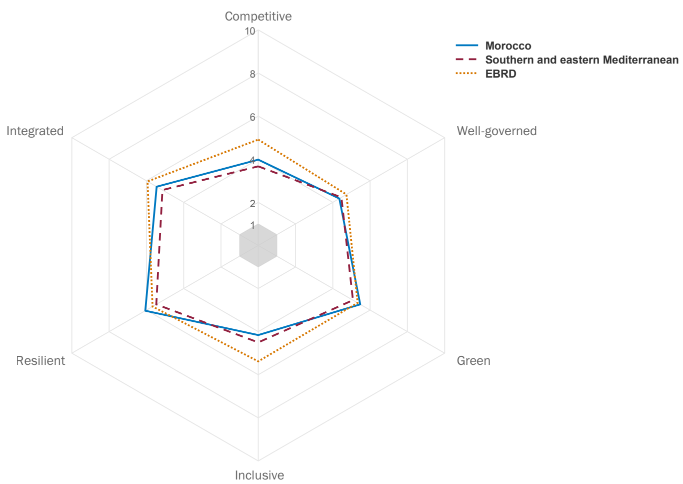
Growth slowed significantly in 2016 but picked up in the first half of 2017. GDP growth declined to 1.2 per cent in 2016, from 4.5 per cent in 2015, due to a sharp slow-down in agriculture and subdued non-agricultural activity. The 12.8 per cent contraction in agriculture was due both to a drought and a negative base effect following record agricultural production in 2015. The disappointing 2.7 per cent growth in non-agriculture was due to slowing industry. In the first three quarters of 2017 growth picked up to 3.9 per cent, driven by the rebound in agriculture. The unemployment rate increased to 9.3 per cent in the second quarter of 2017 from 9.1 per cent in the same quarter of 2016, while youth unemployment increased to 22.5 per cent in 2016.

Fiscal developments were positive, although less favourable than envisaged. For 2016, the deficit was 4.1 per cent of GDP, down from 4.5 per cent in 2015, but higher than the authorities' objective of 3.5 per cent. This was primarily due to a revenue shortfall related to lower-than-expected growth and to accelerated VAT reimbursements (to ease SME financing constraints), while increased capital spending (to support growth) was offset by lower current spending. For the first half of 2017, fiscal performance improved and the deficit narrowed to 1.2 per cent of GDP, compared with 2.4 per cent in the same period of 2016, due to strong tax revenue performance.

The external position remained strong in 2016, as international reserves increased. The current account deficit widened to 4.4 per cent of GDP in 2016, from 2.2 per cent in 2015, and by more than expected. This was due to stronger capital equipment and food imports, and to the impact of lower phosphate prices that offset strong export growth in emerging sectors such as automobiles. In the first half of 2017 the deficit increased further to 7.3 per cent of GDP compared with 4.8 per cent in the same period of 2016. Meanwhile, steady foreign direct investment inflows, international bond issuances and trade credit supported the capital account. As a result, international reserves reached 6.3 months of imports at the end of 2016 and 5.9 months of imports in September 2017.

Growth is expected to rebound to 4.2 per cent in 2017. This reflects the pick-up in agricultural output, but is subject to steadfast reform implementation, including agricultural sector modernisation and reforms to improve the business climate and boost productivity. The outlook remains subject to downside risks, including from social unrest, weak growth in Morocco's main trading partners, geopolitical risks and global policy uncertainty.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Pension system and civil service reforms have continued. Parliament passed draft laws to reform the pension system run by the Moroccan Pension Fund (CMR) in July 2016 and gradual implementation began in September 2016. This reform gradually raises the retirement age, increases the rate of employer and employee contributions, and introduces new rules for calculating benefits. It will extend the sustainability of the pension system managed by the CMR and lower the deficit of the system. Moreover, to keep the public payroll below 10.5 per cent of GDP over the medium term, several reforms have been pursued, including the recent introduction of contractual employment and increased personnel mobility across ministries.

Implementation of the 2015 OBL started in 2016 and steps to reform the governance of state-owned enterprises (SOEs) have advanced. The OBL was adopted in 2015 and took effect in 2016, with most of its provisions implemented. The provision establishing the limiting nature of personnel appropriations to limit the risks of exceeding those appropriations entered into force on 1 January 2017, and the regulatory measure limiting the carry-forward of investment appropriations was renewed, pending the introduction of the relevant OBL provisions on 1 January 2018. A draft law to strengthen the governance and auditing of public enterprises and establishments in order to further improve their performance was submitted to the General Secretariat of the Government in 2017, with a view to finalising and submitting it to the Government Council. The authorities have also taken steps to address potential SOE-related fiscal risks, for which specific provisions are missing from the OBL.

The authorities are implementing tax reforms. The reforms are in line with recommendations from the 2013 national tax conference. Key measures implemented since then include: the taxation of self-employed and liberal professions; the introduction of corporate tax brackets in the 2016 budget, rather than a unique 30 per cent corporate income tax rate; the introduction of VAT deductions in some agro-industrial inputs; and improvements to the VAT refund system. Revisions were also introduced on excise tax rates, and the social contribution for the public sector increased in September 2016 with the implementation of the new pension law. Lastly, the government has simplified various administrative procedures related to compliance and settlement of tax disputes.

Plans to introduce greater exchange rate flexibility and inflation targeting have been delayed. While the central bank had plans to gradually introduce a floating exchange rate starting in the second half of the year, it is now unclear when this will take place. Currently, the dirham is pegged to a two-currency basket weighted 60 per cent to the euro and 40 per cent to the US dollar. By delaying, the government may be missing a good opportunity, given the current strong economic health due to the improvement in fiscal and external buffers, the resilience of the financial sector, the alignment of the exchange rate with fundamentals, and the gradual diversification of the economy.

The business environment has improved but some reforms are lagging. Efforts have been made recently to simplify administrative procedures (such as for customs transactions, property rights and enterprise creation), and to reduce payment delays from the public to the private sector. Morocco's 2018 World Bank Doing Business ranking remained broadly the same at 69, against 68 in 2017, but an improvement compared with 75 in 2016. However, other key reforms are lagging, including the appointment of all members of the Competition Council (which would make it operational), and determined implementation of the recently adopted national strategy to fight corruption.

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.

CONTINUES

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.

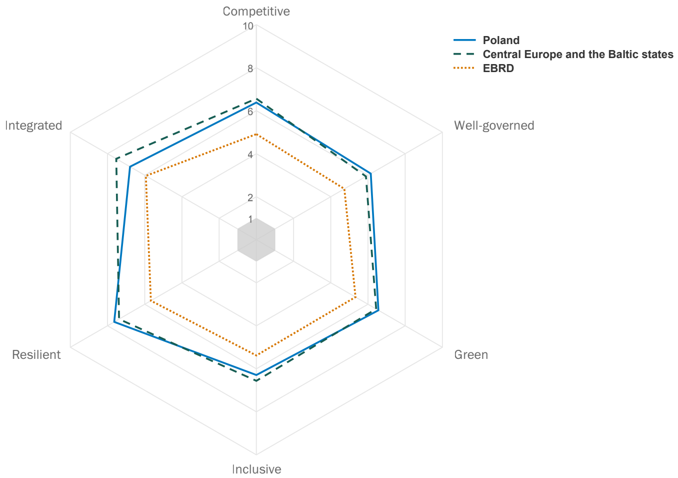
The EU co-financed investment is set to rebound. In 2016 investment dropped by 7.9 per cent. Weak public investment was largely affected by the delays in moving towards the new regulatory and operational requirements of the EU 2014-20 budget, whereas private investment was largely hit by legislative 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)



CONTINUES

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.

CONTINUES

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.

ROMANIA

Highlights

- **The economy is growing strongly.** Output grew by 4.8 per cent in 2016 and 5.8 per cent in the first half of 2017, driven by private consumption and supported by a pro-cyclical fiscal policy. However, the fiscal deficit has risen and there is a risk that the 3.0 per cent of GDP budget deficit limit will be breached in 2017.
- **Structural reforms have been hindered by the unstable political environment.** However, progress continues to be made under the European Union's Cooperation and Verification Mechanism, particularly in the fight against corruption, and a new anti-corruption strategy for 2016-20 was adopted.
- **Non-performing loans (NPLs) continue to decline, but remain above the EU average.** NPL sales of around €4 billion have been achieved since the adoption of loan resolution measures in late 2014, and the NPL ratio has declined to 8.2 per cent from a peak of 22.0 per cent at the end of 2013.

Key priorities for 2018

- **Efforts need to be made to address business environment impediments.** These include the low efficiency of public administration, and the complexity of procedures and corruption, which are holding back infrastructure development. Urgent action needs to be taken to improve transport infrastructure, which constitutes one of the weakest areas of the business environment, and is vital for the country's development. Similarly, the government needs to address the "red tape", legal uncertainty and judicial inefficiency, which inhibit corporate investment.
- **Reforms to fight corruption should continue.** Romania has made major strides in judicial reform and the fight against corruption, following the adoption of a new anti-corruption strategy for 2016-20. However more action is needed in order to sustain the momentum and consolidate previous successes.
- **Privatisation plans should be re-invigorated.** Proposals for partial privatisations and initial public offerings of state-owned enterprise (SOEs) including Bucharest Airport, Hidroelectrica power company and Oltchim chemical company have seen some progress but are currently stalled, and the future of such privatisations is unclear in the context of the planned establishment of the Sovereign Wealth Fund for Development and Investment (FSDI).

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.5	3.1	3.9	4.8	5.3
Inflation (average)	4.0	1.1	-0.6	-1.6	1.1
Government balance/GDP	-2.5	-1.9	-1.5	-2.4	-3.3
Current account balance/GDP	-1.1	-0.7	-1.2	-2.3	-3.0
Net FDI/GDP (neg. sign = inflows)	-2.0	-1.9	-2.4	-2.9	-2.9
External debt/GDP	64.7	56.1	54.1	49.7	n.a.
Gross reserves/GDP	25.5	21.6	21.8	21.4	n.a.
Credit to private sector/GDP	33.9	31.1	30.0	28.2	n.a.

CONTINUES

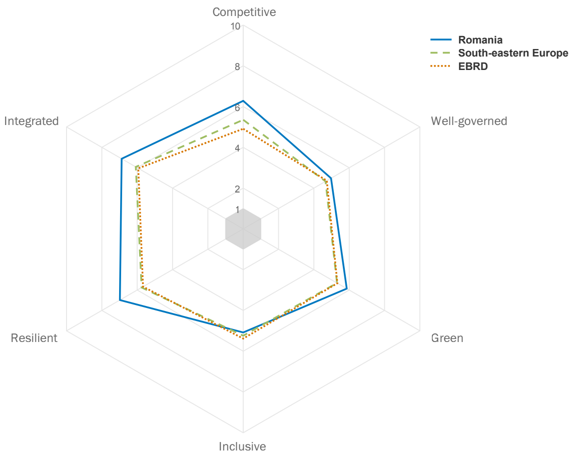
Macroeconomic performance

Romania was one of the best-performing economies in the EU in 2016, growing by 4.8 per cent. This strong performance has continued in 2017, with first-half growth of 5.8 per cent. Private consumption has been the main driver of growth, supported by a pro-cyclical fiscal policy including cuts in VAT and other consumer taxes. Alongside fiscal policies, strong wage growth and low unemployment at a seasonally adjusted rate of 5.3 per cent in June 2017, also influenced consumption growth. However, despite a historically low central bank policy rate of 1.75 per cent supporting private investment, overall investment growth was negative in 2016 as a result of the government's difficulties in absorbing the 2014-20 EU funds. Net exports also constituted a drag on growth in 2016 as rising domestic demand drove up imports. After 19 consecutive months of deflation, consumer prices started to rise in January 2017 and have subsequently continued their upward trajectory, as the base effect of VAT cuts the previous year dropped out and private consumption increased.

External vulnerabilities are increasing and the fiscal position is deteriorating. Rising imports, profit repatriation and falling remittances have resulted in an increased current account deficit of 2.3 per cent of GDP in 2016. Recent declines in foreign direct investment (FDI) mean that the deficit is no longer covered by FDI inflows, as had typically been the case previously. On the fiscal side, falling revenues and hikes in public wages and pensions caused the budget deficit to increase to 2.4 per cent of GDP in 2016, and it may exceed 3.0 per cent of GDP in 2017 on the back of continued loose fiscal policies, potentially giving rise to the European Commission (EC) introducing an Excess Deficit Procedure (EDP). On the positive side, general government debt is low by regional standards, at 37.6 per cent of GDP.

GDP growth is likely to remain robust in the short term. A growth rate of 5.3 per cent is expected in 2017 as continued strong domestic demand is supported by the increases in minimum and public sector wages, and investment is boosted as absorption of EU funds increases. In 2018 growth is expected to slow to around 4.2 per cent as policy stimulus weakens. Downside risks, including prolonged weakness in the eurozone, changes in global investor sentiment and domestic political and reform uncertainty, may hamper growth prospects in the near term. In the longer term, the diversified economy, large market size and scope for convergence within the EU (GDP per capita, purchasing power parity-adjusted, is only 59 per cent of the EU average) should allow growth rates of around 4 per cent to be sustained, provided structural reforms are undertaken in the areas of privatisation, infrastructure and local capital market deepening.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Romania continues to make progress under the Cooperation and Verification Mechanism (CVM). The government adopted a new anti-corruption strategy for 2016-20 in August 2016, and approved a Code of Conduct for government members. Some progress was made in amending the Criminal Code to align with Constitutional Court rulings. The 2016 Report of the European Commission on progress under the CVM noted that the positive trend of the previous three years has continued. At the same time, the report reiterated that a number of key issues remain outstanding and urged the authorities to focus on the “irreversibility” of the results on anti-corruption.

The investment environment has improved, although challenges remain. Romania ranks better than the regional average (Europe and Central Asia), but lower than most of the EU comparator economies as regards ease of doing business. In the World Bank *Doing Business 2018* report, Romania ranks 45th out of 190 countries. According to the EC, public service delivery is hampered by low efficiency of public administration, complexity of procedures and corruption, while red tape, legal uncertainty and judicial inefficiency remain challenging for companies.

Privatisation of key enterprises remains stalled. State-owned enterprises (SOEs) remain dominant players in the energy and transportation sectors. Plans for the partial privatisations and initial public offerings (IPOs) of major SOEs such as Bucharest Airport and Hidroelectrica, the country’s biggest electricity producer, have been under discussion for some time but are currently stalled. The prospective establishment of the Sovereign Wealth Fund for Development and Investment (FSDI) in late 2017, into which it is proposed that the state’s participation in profitable SOEs will be transferred, and which would invest in projects in various priority areas, may have further adverse impact on privatisation plans. As of the third quarter of 2017, the structure and objectives of the FSDI – aside from funding public investment – have not yet been clearly determined.

Challenges in infrastructure remain. According to the Global Competitiveness Report 2017-2018, Romania ranks 102nd (out of 137) in the quality of transport infrastructure, which constitutes one of the weakest areas of its business environment. Similarly, the country has the second lowest ranking in the European Union in the World Bank’s Logistics Performance Index. During 2016, secondary regulations regarding the newly updated public procurement laws were introduced, with a goal to transpose EU directives into national legislation. The new public-private partnership (PPP) law, approved in November 2016, is currently under revision and a new draft law (including secondary legislation) is expected to be adopted later in 2017. However, a lack of coordination and strategic planning hampers public investments in infrastructure, while perceptions of corruption and fraud in procurement limit private investments.

The corporate segment of the energy market is fully liberalised, but liberalisation in the household segment is slow. The electricity and gas market for corporates is competitive, as liberalisation for this segment was completed in 2014 and 2015. However, liberalisation for the household segment is not set for completion until 2018 for the electricity market and 2021 for the gas market. The sector requires significant investment to diversify its energy sources and enhance cross-border interconnections. The sector also suffers from the dominance of SOEs and delays in aligning national energy efficiency legislation with EU legislation.

NPLs continue to decline, but remain above the EU average. Banks are continuing to clean their balance sheets, with NPL sales reaching around €4 billion by the end of 2016 since the adoption of loans resolution measures in late 2014. The NPL ratio declined to 8.2 per cent in July 2017 (European Banking Authority definition), from a peak of 22.0 per cent at the end of 2013. NPLs are expected to further decline over the coming year, although remaining above the EU average of 5 per cent. Meanwhile, banks continue to make efforts to restructure their loan portfolios.

Confidence in the banking sector has been enhanced. Following the recommendation of the European Systemic Risk Board, Romania set up a National Committee for Macro-Prudential Supervision in March 2017, which will work to ensure financial stability. The risks posed by the newly adopted debt discharge law for mortgage-backed loans, which allows debtors to discharge their debt obligations by transferring the collateral to creditors, were limited by a Constitutional Court decision to restrict its applicability. Meanwhile, the authorities have pledged to perform an asset quality review and stress test for the banking sector in 2018.

RUSSIA

Highlights

- **Russia's economy is emerging from recession.** GDP fell by 0.2 per cent in 2016, but growth returned in the first half of 2017, with GDP rising by 1.5 per cent year-on-year, on the back of stronger activity in the trade, mining and transport sectors.
- **A new fiscal rule has been adopted.** As a result of a counter-cyclical fiscal policy, the budget deficit surged to 3.7 per cent of GDP in 2016, from 1.1 per cent in 2014. The new fiscal rule, to be applied fully from 2019, is intended to reduce the effect of oil prices on the federal budget.
- **Inflation has fallen close to the Central Bank of Russia's target.** The disinflation has been supported primarily by weak domestic demand and rouble appreciation, allowing the Central Bank of Russia (CBR) to continue cutting the key policy rate.

Key priorities for 2018

- **Economic diversification away from extractive industries should stay high on the agenda.** Dependence of the economy on oil and gas has increased in the past two decades, creating significant economic volatility and suppressing private investment. More focus on the development of non-extractive tradeable industries and services, especially those with higher value added, would be desirable.
- **Compliance with the newly adopted fiscal rule would help reduce economic volatility.** The high correlation between oil prices and economic growth makes the economy particularly vulnerable to external shocks. The new fiscal rule could enhance resilience through smoothing the impact of oil price volatility on the budget and domestic demand.
- **Reducing state presence in the economy would support productivity and economic growth.** Russia has made steps forward in recent years in improving business and administrative procedures but the state's footprint has increased in the past decade. Faster and more transparent privatisation of state assets, and a reduction in the size and influence of public administration are needed.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.8	0.7	-2.8	-0.2	1.8
Inflation (average)	6.8	7.8	15.5	7.0	4.2
Government balance/GDP	-1.2	-1.1	-3.4	-3.7	-2.5
Current account balance/GDP	1.5	2.8	5.0	2.0	2.7
Net FDI/GDP [neg. sign = inflows]	0.8	1.7	1.1	-0.8	-0.7
External debt/GDP	31.7	29.1	38.0	40.1	n.a.
Gross reserves/GDP	22.2	18.7	27.0	29.4	n.a.
Credit to private sector/GDP	49.4	53.5	54.7	50.8	n.a.

CONTINUES

Macroeconomic performance

Russia's economy is growing again. After a recession in 2015 (when GDP dropped by 2.8 per cent) driven mainly by the fall in oil prices, GDP fell by just 0.2 per cent in 2016, which was much better than expected. The slow recovery of consumption has been supported by strengthening real wages and low unemployment (at around 5 to 6 per cent), but investment activity is still weak due to economic uncertainty and relatively high financing costs. The contribution of net exports to GDP growth stayed positive as exports benefited from a relatively stable external demand, while imports continued to fall (albeit at a slower pace due to strengthening of the rouble and emerging signs of a recovery in economic activity). GDP rose by 0.5 per cent year-on-year in the first quarter, primarily on the back of consumption recovery, and reached 2.5 per cent in the second quarter of 2017.

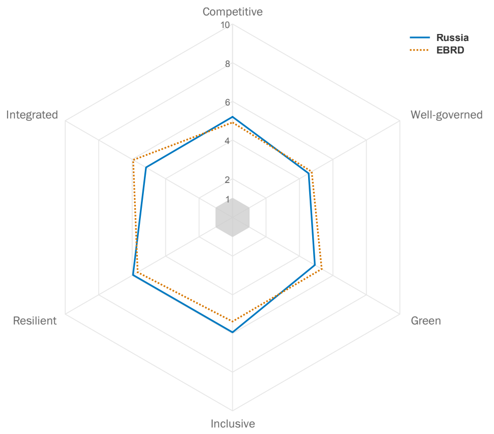
The exchange rate has strengthened as a result of the recovery of oil prices. The rouble depreciated from below 50 roubles to one US dollar in May 2015 to above 80 in January 2016 on weakening oil prices. Depreciation pressures have eased since then following the increase in oil prices, and the rouble recovered to around 60 roubles to one US dollar in August 2017.

With inflation falling towards the target rate, monetary policy has been eased further. The CBR cut the key policy rate by 1.0 percentage points in 2016 and a further 1.5 percentage points, from January to September, to 8.5 per cent. Supported by weak domestic demand, the strengthening rouble, a strong food harvest and base effects, inflation fell to 3.0 per cent in September 2017, from a peak of 16.9 per cent in March 2015. According to a Bank of Russia survey, inflation expectations have declined significantly. However, at 9.6 per cent in September 2017 they remain elevated.

Fiscal policy has acted counter-cyclically. The general government deficit surged to 3.7 per cent of GDP in 2016, from 1.1 per cent in 2014. Although budgetary plans for 2017-19 set out fiscal consolidation at one percentage point of GDP annually, the pace is somewhat uncertain due to the government's conservative oil price assumption of US$ 40 per barrel on the one hand (upside risk) and the need to sustain social spending in the run-up to the elections on the other (downside risk). The new fiscal rule, adopted in July 2017, is intended to reduce the effect of oil prices on the federal budget. Expecting that fiscal and monetary policy frameworks will further improve macroeconomic stability, Fitch upgraded its outlook on Russia's sovereign rating (BBB-) to positive in September 2017.

Short-term growth will continue but long-term growth prospects are weak and remain heavily dependent on oil price developments. Growth is expected to pick up in 2017 to 1.8 per cent, driven by higher oil prices, recovering private consumption and investments, and stay at a similar level in 2018 (1.7 per cent). Although risks to the 2017 projection are tilted to the upside, without significant reforms, long-term growth may remain stuck at around 1 to 2 per cent annually due to outdated production capacities and low investments, as well as less favourable internal structural factors (weak demographics, outdated infrastructure and unfavourable institutional characteristics of the economy).

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Russia's competitiveness has improved over the past year. The country moved up five places, to 35th (out of 190 countries) in the World Bank's *Doing Business 2018* report, with advances in registering property, trading across borders and getting credit. It ranks particularly high in getting electricity (10th), registering property (12th) and enforcing contracts (18th), while sizeable obstacles are present in trading across borders (100th) and dealing with construction permits (115th), despite the improvements acknowledged in the former recently. Russia's rating improved by five positions (to 38th out of 137 countries) in the World Economic Forum's Global Competitiveness Report 2017-2018, mostly on the back of an improving macroeconomic environment. Financial market development and institutions remain the weakest links, while corruption, tax rates and access to finance persist as the most problematic factors for doing business.

Banking sector stability has been maintained despite the recession but asset concentration at state-owned banks is rising further. The overall capitalisation rate of the Russian banking sector (at 12.9 per cent in June 2017) remains above the regulatory minimum, with some banks facing capital constraints. The CBR continued for the fourth year to close banks that were performing weakly and had poor corporate governance. In September 2017, there were 574 banks operating in Russia, around 380 fewer than in mid-2013. Bank closures have led to the depletion of the deposit insurance fund, which is now mostly financed by CBR loans, while asset concentration at state-owned banks has increased somewhat due to deposit outflows from private banks to large, mainly state-owned banks. The four largest banks in Russia (all state-owned) account for over 50 per cent of total assets in the sector. After moving in the negative zone from July 2015, household loan growth turned slightly positive in late 2016, while non-performing loans (NPLs) are relatively low in both the corporate and household sectors (at 6.1 and 7.5 per cent, respectively, in September 2017). On the other hand, the Russian rating agency, ACRA, estimates the (more broadly defined) NPL ratios at 12 to 15 per cent, with private banks recording the highest levels.

Two large banks are to enter receivership under the new bank resolution legislation. The new rules, effective from mid-June 2017, envisage the CBR operating the framework instead of the Deposit Insurance Agency (DIA). Previously, the CBR provided cheap loans to problem banks chosen by the DIA to rehabilitate them. Under the new framework, the newly established Bank Consolidation Fund (BCF), to be financed and managed by the CBR, is providing resolution funding, but only after the controlling shareholders' claims are bailed-in. The first Russian banks to enter receivership under the new regulations are Otkritie and BinBank, both among the top 10 banks in terms of assets, which created some market uncertainty.

A new fiscal rule should enhance government savings and reduce volatility. The new rule, adopted in July 2017 and coming into effect in 2019, is expected to ensure higher fiscal savings and reduce the impact of oil price volatility on the economy. The rule limits budget expenditures to the sum of oil revenues at the reference oil price, non-oil revenues, interest expenses on sovereign debt, and carryover budget balances. The transition period effectively allows a 1 per cent primary budget deficit at the reference oil price in 2018. The oil windfall will be saved into the Reserve Fund and the fund will be used when the oil price is below the reference price, but it will not be used to compensate for lower non-oil revenues, as was the case previously. The Reserve Fund and the National Wealth Fund will be merged, as the government plans to fully deplete the Reserve Fund by the end of 2018 amid low oil prices. The merged fund's main goals include ensuring financing for the pension system, deficit financing for the federal budget, and co-financing for private pension saving plans.

The privatisation programme for 2017-19 was scaled down as fiscal pressures abated. The 2016 privatisation revenues were at a record high of RUB 407 billion (€6 billion), which included revenues from the sale of Bashneft to Rosneft at RUB 330 billion (€4.8 billion) in October 2016. In 2017, the privatisation proceeds are projected at only RUB 42 billion (€0.6 billion), down from RUB 138 billion (€2 billion) in the previous version of the budget, due to the postponement of the sale of a 10.9 per cent stake in VTB Bank. The 2017-19 privatisation plan envisages, among other smaller deals, the sale of minority stakes in the diamond producer Alrosa, the Novorossiysk port and Sovkomflot fleet operator. The privatisation of VTB Bank has been postponed until Western sanctions are lifted.

SERBIA

Highlights

- **Growth is slowing down in 2017.** Investments and exports had supported a growth rate of 2.8 per cent in 2016 but both have decelerated significantly in the first half of 2017. On the production side, unfavourable developments in agriculture, mining and electricity are also contributing to the weak growth performance this year.
- **Fiscal adjustment has over-performed.** This reflects consistent application of spending cuts introduced earlier as well as rising revenues in 2016. However, significant contingent fiscal risks still stem from large, unreformed state-owned enterprises (SOEs) while the "rightsizing" of the public administration is progressing slowly.
- **Non-performing loans (NPLs) have started to decline but corporate over-indebtedness may still limit lending.** NPLs have dropped significantly in the past two years but remain high by regional standards while long-term debt of over-indebted companies is around 25 per cent of GDP.

Key priorities for 2018

- **Deepening of public sector reforms is needed.** Key measures that need to be advanced include privatisation and SOE restructuring, and improved efficiency of public administration. A new IMF programme, after the end of the present one in February 2018, could underpin the reform momentum.
- **The still-low level of investment calls for a more business-friendly environment.** Higher predictability of the business environment, lower para-fiscal charges, and an easier access to finance would support entrepreneurs and small and medium-sized enterprises (SMEs) the most.
- **Strengthening resilience needs non-performing loan (NPL) sales and further de-euroisation.** With the NPL resolution strategy serving as a good basis for bringing NPLs down, the focus now should be on more efficient judicial processes, improved out-of-court restructuring, and an easier access to NPLs for a broader range of potential investors. Despite the recent increase in dinar deposits and household dinar loans, Serbia is still among the most euroised countries globally.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.6	-1.8	0.8	2.8	1.8
Inflation (average)	7.7	2.1	1.4	1.1	3.3
Government balance/GDP	-5.5	-6.6	-3.7	-1.3	0.0
Current account balance/GDP	-6.1	-6.0	-4.7	-4.0	-4.5
Net FDI/GDP [neg. sign = inflows]	-3.8	-3.7	-5.4	-5.5	-4.8
External debt/GDP	74.8	77.1	78.3	77.8	n.a.
Gross reserves/GDP	32.7	29.7	31.0	29.9	n.a.
Credit to private sector/GDP	43.6	43.4	43.4	44.1	n.a.

CONTINUES

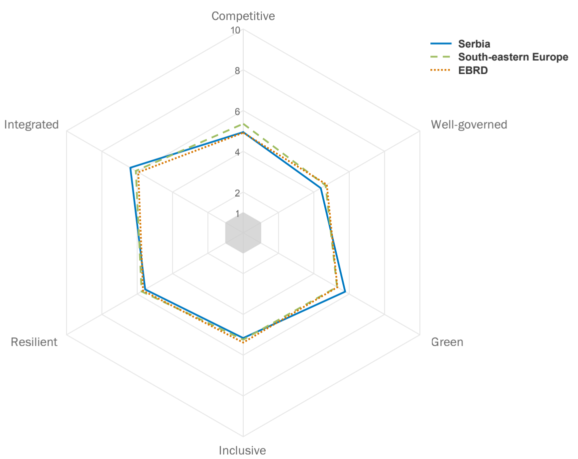
Macroeconomic performance

Growth in 2016 accelerated, but a slow-down is occurring in 2017. GDP grew by 2.8 per cent in 2016, up from 0.8 per cent in 2015. Growth was driven by investment and exports amid stronger external demand and an improved investment environment, but was also helped by supply-side factors, including relatively low oil prices and interest rates, and a very good agricultural season. However, growth slowed to 1.2 per cent year-on-year in the first half of 2017 and may reach only around 1.8 per cent for the year as a whole, due to faster imports growth and weaker investments. On the production side, the main contributors to the growth slow-down have been agriculture as well as mining and electricity generation. Despite relatively high foreign direct investment (FDI) inflow (above 5 per cent of GDP in 2015 and 2016), the total investment remains below 20 per cent of GDP which is significantly lower than needed to support faster convergence.

Fiscal performance has continued to be better than envisaged. The budget deficit narrowed from 6.6 per cent of GDP in 2014 to 1.3 per cent in 2016, while public debt (72.9 per cent of GDP at the end of 2016) started falling one year earlier than expected. The decline in public debt continued in 2017, due to lower financing needs given the fiscal surplus in the first eight months of the year but also thanks to the dinar strengthening against the euro and the US dollar. The good fiscal performance reflects measures taken earlier, including public wage and pension cuts and continuation of attrition rules, but also stronger revenues and some one-offs (for example, payment of the central bank's profit). In view of the achievements so far, the government has decided on a gradual relaxation of austerity measures. This includes a one-off assistance of RSD 5,000 (around €40) to pensioners in November 2016, a general 1.5 per cent rise in pensions, and a targeted increase of public sector wages from 3 to 6 per cent for the police, army, judiciary, scientific, cultural, social and health care institutions from January 2017. On the other hand, a ban on new hiring, introduced in 2013, has been extended until the end of 2017. In October 2017, the government announced another RSD 5,000 one-off bonus to be paid to pensioners the next month, as well as a rise in pensions (5 per cent) and public sector wages (5 to 10 per cent) as of 1 January 2018.

Monetary easing has slowed from previous years. On the back of weak domestic demand and the decline in global commodity prices, inflation continued to move below the central bank's previous target (4 ± 1.5 per cent until the end of 2016) and at the end of 2016 reached 1.6 per cent year-on-year. Reflecting the decrease in inflation expectations and lower expected growth of regulated prices, the National Bank of Serbia (NBS) lowered the inflation target to 3±1.5 per cent as of 1 January 2017. Inflation has picked up in 2017, mainly on the back of food and beverage prices as well as a gradual increase in domestic demand and foreign inflation (notably in the euro area), but it is for now staying within the tolerance band. In 2016, the NBS cut the key policy rate by 50 basis points to 4.0 per cent, 7.75 percentage points down from the peak in 2013. Monetary easing was put on hold throughout most of 2017, to be reinstated in September and October by a total 50 basis points cut. More favourable terms of financing contributed to lending activity picking up over the past year.

Assessment of transition qualities (1-10)



CONTINUES

After a disappointing rate in 2017, economic growth may accelerate again to 2.9 per cent in 2018. Faster growth may be supported by the low base effect, and strengthening consumption and investment activities, with offsetting effects from higher imports. On the other hand, slowing down or discontinuing fiscal and structural reforms represent the main downside risks to the projection. Long-term convergence requires further business environment reforms and less state involvement in the economy.

Major structural reform developments

The business environment continued to improve, but more needs to be done. Serbia ranked 43rd (up four places from the previous year) out of 190 countries in the World Bank's *Doing Business 2018* report. The improvement was mainly the result of making it easier to start a business (by reducing the signature certification fee and cutting the time for business registration), to register property (by improving the reliability of the land administration system) and to enforce contracts (by adopting a new enforcement law that broadens and clarifies the responsibilities of enforcement agents and powers of the courts during the enforcement process). Room for further improvement still remains in several areas, most notably in protecting minority investors, resolving insolvency, getting credit and electricity, as well as in enforcing contracts. Serbia has also improved its standing in the World Economic Forum's *Global Competitiveness Report 2017-2018* (up 12 places from the previous one), primarily on account of improvements in the macroeconomic environment, but its score still remains quite low (78th out of 137 countries) due to weak market efficiency, business sophistication, institutions and innovation capacity. As the "top five" most problematic factors for doing business in Serbia, respondents continue to identify tax rates, access to financing, inefficient government bureaucracy, corruption and policy instability.

Privatisation and resolution of SOEs have progressed slowly. Over the past year, out of around 180 enterprises in the portfolio of the Privatisation Agency, around 30 have been resolved, mostly by going into bankruptcy. Eleven strategic enterprises (out of 17 initially) were still not resolved by December 2016. These include drug-maker Galenika for which a new privatisation tender is under way and opening of the financial offer of a sole bidder is expected at the end of October 2017; copper mine RTB Bor for which the government is trying to find a strategic investor or privatise it; Komercijalna Banka for which the completion of privatisation was expected by the end of 2017 but due to the continuing corporate governance concerns the sale is more likely to be completed in 2018; chemical producer MSK; and fertiliser plant HIP Azotara. In March 2017 the Ministry of Economy invited interested investors to submit letters of intent for the sale of the petrochemicals producer Petrohemija. The privatisation method for Petrohemija is still to be decided on. In February 2017 the government also launched the procedure for a 25-year concession of the Belgrade Nikola Tesla airport, with five consortia allowed to proceed to the second stage. On the request of qualified bidders, the government twice extended the deadline for submission of binding bids in the second phase of the concession tender – first in August 2017, until 23 October, and then again in early October, until 23 November 2017.

Public administration reforms have progressed slowly. Tax collection has improved but reforms underlying the operation of tax administration (such as risk analysis of tax evasion, keeping and recruiting qualified staff, upgrading training and IT, as well as services to taxpayers) have been delayed. The rightsizing process of public administration continued, resulting in 22,000 people leaving from the end of 2014 to the end of 2016, close to the envisaged level of 25,000 to 30,000 in 2015-17. However, the current civil service framework still does not guarantee the neutrality of the public administration, merit-based recruitment, promotion and dismissal procedures. According to the European Commission, political influence plays a key role in choosing senior managers, and turnover of senior civil servants remains particularly worrisome. Capacities in capital investment management are still weak due to inefficiencies in budgeting, planning and contract oversight. A recently adopted Bylaw on Selection, Preparation, Evaluation, Monitoring and Reporting on Capital Projects may help public investment management to be more effective.

CONTINUES

Harmonisation of banking sector regulation with EU standards has continued. The NBS has implemented an agenda aimed at further strengthening the banking sector, reducing the NPLs and adjusting the regulatory framework in line with EU standards. The minimum capital requirement ratio has been cut from 12 to 8 per cent and additional capital buffers were introduced. However, reforms of state-owned financial institutions are lagging behind. Some consolidation has occurred in the sector; the National Bank of Greece sold Vojvodjanska Banka to the largest Hungarian bank, OTP.

Regulatory improvements are helping NPL resolution. The Real Estate Appraiser Law was adopted in December 2016, allowing more transparent and professional assessment of collateral values. Official interpretations by the NBS on the application of banking secrecy rules from March 2017, and by the Ministry of Finance on impairment provisions for corporate income tax purposes from September 2016 and March 2017, provide more guidance for sellers and buyers of NPL assets in these matters. The NPL ratio has dropped to 15.6 per cent in June 2017 from 22.8 per cent two years earlier.

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.

CONTINUES

Macroeconomic performance

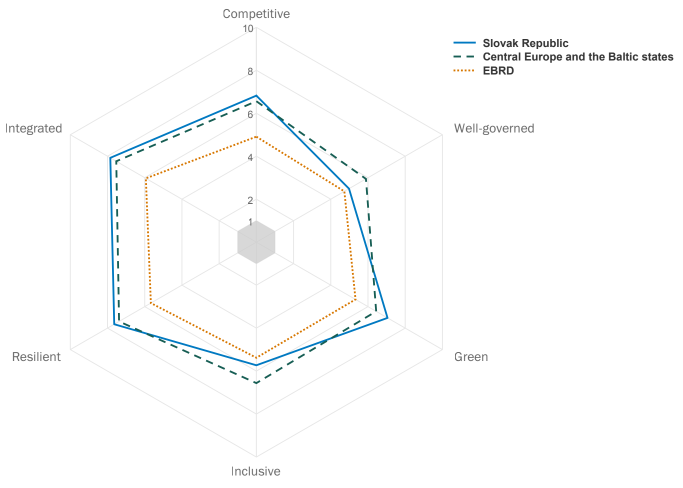
GDP growth has been robust. Economic growth slowed somewhat from 3.9 per cent in 2015 to 3.3 per cent in 2016, but still remained the strongest in central Europe and the Baltic states in 2016. Solid employment growth, rising disposable incomes and double-digit growth in credit to households supported 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)



CONTINUES

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

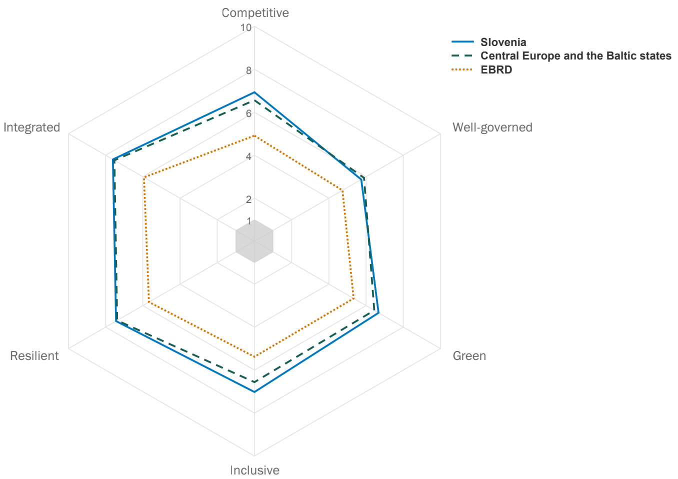
Macroeconomic performance

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)



CONTINUES

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.

CONTINUES

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.

TAJIKISTAN

Highlights

- **Economic growth remains strong but fiscal pressures are building.** The economy grew by 6.9 per cent in 2016 according to official data and 6.8 per cent (year-on-year) in the first nine months of 2017. However, fiscal pressures are rising as a result of the challenges in the financial sector.
- **The banking sector is still in a challenging state.** The government had to bail-out major banks in December 2016, and is trying to secure international support for a fundamental reform of the sector.
- **Construction of the Rogun dam was launched in October 2016.** In September 2017 Tajikistan successfully placed its debut sovereign Eurobond of US$ 500 million to finance the Rogun dam construction. On 28 August 2017, Standard & Poor's (S&P) and Moody's assigned first-time sovereign ratings for Tajikistan as follows: B- (S&P) and B3 (Moody's), both with stable outlooks.

Key priorities for 2018

- **Banking sector weaknesses need to be tackled vigorously.** It will be essential to make a comprehensive assessment of the financial situation of the largest systemic banks, to recapitalise them and restore their liquidity, and to improve their management. The regulatory framework needs to be enhanced, including through the stronger supervision and introduction of an improved non-performing loan (NPL) resolution framework.
- **Reforms need to continue to improve the business environment.** A particular focus is needed on improving tax administration practices and easing currency restrictions, two of the most important constraints for businesses.
- **Efforts should be further accelerated to restructure the vertically integrated electricity company Barki Tojik and rationalise the tariff-setting in the sector.** Cost transparency for electricity generation, transmission and distribution needs to be enhanced, and ultimately the three parts should be unbundled and tariffs adjusted gradually over time, while related social issues need to be addressed. Securing the completion of CASA-1000 and more transparency in the management of the Rogun project will also be important going forward.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	7.4	6.7	6.0	6.9	6.5
Inflation (average)	5.0	6.1	5.8	5.9	8.2
Government balance/GDP	-0.8	0.0	-1.9	-10.6	-6.5
Current account balance/GDP	-7.8	-2.8	-6.0	-3.8	-6.3
Net FDI/GDP [neg. sign = inflows]	-1.5	-3.3	-5.4	-5.0	-3.0
External debt/GDP	47.4	43.0	48.6	57.8	59.5
Gross reserves/GDP	5.6	5.5	6.3	9.4	n.a.
Credit to private sector/GDP	18.6	21.5	23.4	18.2	n.a.

CONTINUES

Macroeconomic performance

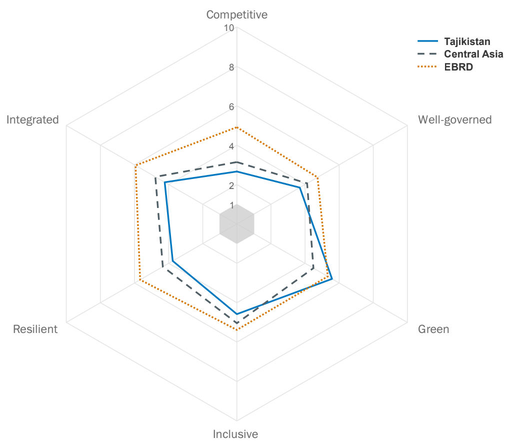
Economic growth remains strong. GDP growth was 6.9 per cent in 2016 and 6.8 per cent (year-on-year) in the first nine months of 2017 according to official figures. However, the headline figures mask the build-up of structural disruptions, reflected in the fragility of the banking sector. The fall in global prices for aluminium and cotton, Tajikistan's main export commodities, impeded the economic performance of the country in 2015 and early 2016. Remittances from Russia declined by 42.4 per cent in US dollar terms in 2015 year-on-year. However, the decline eased to 13.1 per cent in 2016, and the first half of 2017 saw a significant rebound by 22.4 per cent year-on-year, positively affecting domestic demand.

Currency controls kept the somoni broadly stable in 2016, but exchange rate pressures intensified in 2017. The somoni depreciated by 10.5 per cent against the US dollar in the first 10 months of 2017. The National Bank of Tajikistan (NBT) gradually increased its refinancing rate from 4.8 per cent in early 2014 to 16.0 per cent in March 2017. Measures introduced by the authorities in 2015 aimed at preventing sharp currency depreciation have remained in place. They include controls to restrict households' and companies' access to foreign exchange and the banning of all currency exchanges in the country. Foreign exchange and gold reserves have increased recently, to US$ 1.3 billion at the end of September 2017 (an import cover of around five months) mainly due to the Eurobond issuance proceeds. Inflation averaged 5.9 per cent in 2016 and increased to 6.7 per cent in September 2017 year-on-year.

Tajikistan's banking sector has been facing significant challenges since 2015. The fundamental problems in banks, including the longstanding weaknesses in governance and lending to related parties, were aggravated by the significant currency depreciation in the country. Overdue and NPLs, mostly concentrated in the two large banks, rose to around 54.0 per cent in the fourth quarter of 2016 from 29.9 per cent in 2015, according to NBT data and decreased only by 3.7 percentage points between December 2016 and June 2017. Fiscal risks stemming from the government's need to shore up the banking system are substantial. Public external debt rose to US$ 2.3 billion in 2016 (33 per cent of GDP), the issuance of the US$ 500 million Eurobond added an additional 7 per cent of GDP. Domestic public debt stood at the equivalent of US$ 700 million (12 per cent of GDP) at the end of 2016, including US$ 422 million in special government debt securities guaranteed by the NBT issued under the bank bail-out programme.

Officially reported real GDP growth is expected to reach 6.5 per cent in 2017 and slow to around 5.0 per cent in 2018. Significant downside risks remain in light of the possibility of further banking sector turbulence and in view of the difficult fiscal position of the country.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

The investment climate and business environment deteriorated further over 2016-17. Heavy-handed tax administration practices have become more intrusive and arbitrary in the past two years as a result of increased fiscal pressures and, along with currency controls and the difficult access to finance, are negatively affecting businesses and limiting their ability to carry out their operations. The delays in structural reforms to resolve banking sector challenges, as well as to improve the business environment, with a particular focus on tax administration practices and easing currency restrictions, are likely to allow vulnerabilities to accumulate further. Tajikistan ranks 123rd out of 190 countries in the World Bank's *Doing Business 2018* report, with large gaps remaining in most areas, in particular in getting electricity, getting credit, trading across borders, paying taxes and resolving insolvency.

Large parts of the banking sector have been bailed out. The second largest bank, Tojiksodirotbank (TSB), was put into temporary administration in May 2016 and a number of other banks face solvency and liquidity problems. In December 2016, the government announced a US$ 422 million bail-out programme for the two largest banks, Agroinvestbank (AIB) and TSB, and two smaller banks, Tojprombank and Fononbank. The bail-out was funded through the issuance of special government debt securities guaranteed by the NBT. In January 2017, the NBT announced the withdrawal of somoni 1.6 billion (US$ 200 million) from AIB and TSB, which was followed by the revocation of the licences of Fononbank and Tojprombank in February 2017. The government is now considering a fundamental reform of the sector and is working on securing international financial institution financial and policy support.

Currency controls introduced in 2015 have mostly remained in place. These include measures to restrict households' and companies' access to foreign exchange and banning all private currency exchange offices in the country. In January 2017, the NBT started a gradual depreciation against the US dollar, with the currency weakening by 10.5 per cent against the US dollar in the first 10 months of 2017. In May 2017, the AIB reduced its daily withdrawal limit to somoni 500, from Somoni 1,000, while at TSB the limit has remained at somoni 200.

Tajikistan tapped the international bond market with a debut Eurobond issuance. The US$ 500 million 10-year sovereign bond, yielding 7.125 per cent, was successfully placed at the beginning of September 2017. The proceeds of the bond will be used to finance the Rogun dam, construction of which was officially launched in October 2016. In April 2017, the parliament also approved the government's plan to reallocate somoni 530 million (US$ 62.5 million) in bail-out funds for Fononbank and Tojprombank (both of which are liquidated) to the construction of the dam. However, given its struggle to attract investment in the past and with investors facing significant economic risks, securing financing for such a large project remains a challenge.

Tajikistan intensifies exploring Eurasian Economic Union (EEU) membership. In July 2017 the head of the customs service in Tajikistan announced that an expert committee had completed its study of Tajikistan's potential EEU accession. The results have not been made public. Negotiations for Tajikistan's accession to the EEU have been slow. However, the difficult situation in the banking sector and the broader economy might motivate Tajikistan to seek closer ties with the EEU to request financial support.

TUNISIA

Highlights

- **Growth remained weak in 2016 but has picked up in 2017.** GDP grew by just 1 per cent in 2016 and, coupled with policy slippages, this caused the fiscal deficit to widen to 6.1 per cent of GDP and the debt to increase to 61.9 per cent of GDP.
- **The dinar has depreciated sharply.** The most volatile episodes occurred between July and November 2016 (around 10 per cent depreciation) and in May 2017 (12.8 per cent drop), when the interbank market froze due to political uncertainties and strong demand for foreign exchange for energy importers. The depreciation resulted in rising inflationary pressures, higher debt and a widening in the trade deficit.
- **Structural reform performance has improved.** The authorities have: made important progress in restructuring public banks; adopted a new tax strategy; established the Large Taxpayers Unit; adopted a revised strategy to reform the civil service; published the implementation decrees relating to the laws on competition, public-private partnerships (PPPs) and the investment code; and continued with energy subsidy reforms.

Key priorities for 2018

- **Outstanding legislative reforms should be adopted.** These include the laws on lending rates, bank inspections, and the organic budget law; performance contracts for the five largest state-owned enterprises; the functional reviews of key ministries; the creation of the high anti-corruption authority; and the compilation of the databank on vulnerable households.
- **Removing the discrimination against public banks in managing non-performing loan (NPL) portfolios should be a priority.** The recent restructuring plans of public banks now hinge on these banks improving their ability to resolve their legacy NPLs. And the required legislative changes need to be implemented swiftly, as high NPLs contribute to inadequate access to finance.
- **Sound macroeconomic, fiscal and monetary policies should be implemented to complement progress on structural reforms.** Contractionary monetary policies should be taken to support the depreciating dinar and mitigate rising inflation. The removal of entrepreneurship constraints, a more competitive business environment for exporting firms, and import-substitution should be implemented to create jobs at home, and growth-enhancing and social spending should be prioritised, especially within a limited fiscal space.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	2.3	2.3	1.1	1.0	2.2
Inflation (average)	5.8	4.9	4.9	3.7	4.5
Government balance/GDP	-6.9	-5.0	-4.8	-6.1	-5.9
Current account balance/GDP	-8.4	-9.1	-8.9	-8.8	-8.7
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.2	-2.2	-1.7	-2.5
External debt/GDP	58.8	63.7	68.5	74.7	n.a.
Gross reserves/GDP	16.9	17.6	17.8	15.4	n.a.
Credit to private sector/GDP	68.1	69.3	70.1	72.2	n.a.

CONTINUES

Macroeconomic performance

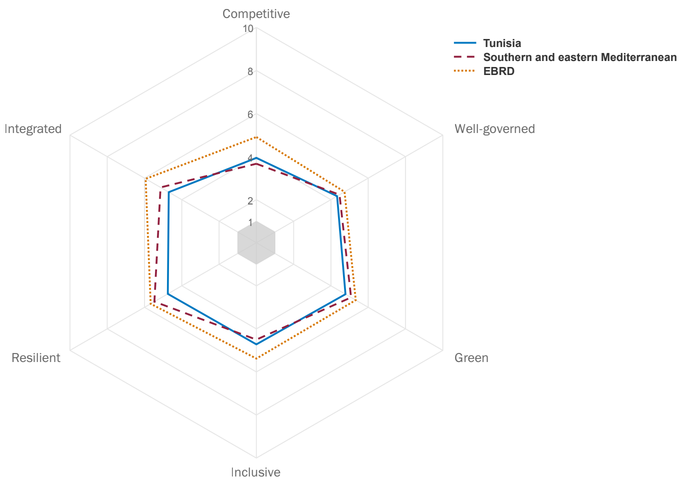
Growth remained weak in 2016. The rate of GDP growth declined slightly to 1.0 per cent from 1.1 per cent in 2015, driven by contractions in mining and agriculture, and slow growth in manufacturing and tourism. However, growth picked up to 1.9 per cent year-on-year in the first half of 2017, supported by a rebound in agriculture, and strong growth in tourism and phosphates production. Unemployment remained elevated at 15.3 per cent in the second quarter of 2017, with youth and female unemployment rates running at double this level.

The fiscal situation worsened in 2016. Lower-than-expected growth and policy slippages caused the fiscal deficit to widen to 6.1 per cent of GDP in 2016 from 4.8 per cent of GDP in 2015. The shortfall in revenues was due also to weaknesses in revenue collection. Meanwhile, the public sector wage bill grew to 14.6 per cent of GDP in 2016 from 13.7 per cent in 2015, among the highest in the world. As a result of the higher deficit, the dinar's depreciation and a reclassification of post office deposits as central government debt, public debt stood at 61.9 per cent of GDP at the end of 2016, up from 55.4 per cent in 2015, with most of it foreign debt.

The external position remained broadly unchanged but reserves are at low levels. The current account deficit was 8.8 per cent of GDP in 2016, almost the same as 2015, as the decrease in exports and current receipts was offset by lower imports of goods. Foreign direct investment declined to 1.7 per cent of GDP in 2016, the lowest since 2011. Meanwhile, a worsening trade deficit eroded gross international reserves, which declined to US$ 5.8 billion at the end of August 2017, covering only 3.3 months of imports.

Growth will recover gradually. Growth is expected to rise in 2017 to 2.2 per cent, but the still-modest rate reflects delays in implementing structural reforms and low private investment. The impact of tax revenue rises and monetary tightening would be mitigated through the recovery of phosphates and tourism, higher public investment and wage increases. Sizeable risks remain; on the domestic side, the fragile socio-political environment, especially in the run-up to the local elections in December 2017, may adversely affect confidence and possibly delay reforms. On the external front, continued conflict in neighbouring Libya and the wider region could affect Tunisia through immigration flows, confidence shocks and weaker social cohesion.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

The authorities have made important progress in restructuring public banks. Following the recapitalisation in 2015 and management changes in 2016 of the three public banks, performance contracts were completed in early 2017. These developments constitute a major step in strengthening the resilience of the financial sector and improving credit availability in the economy. Meanwhile, the viability of the banks' restructuring plans now hinges on these banks improving their ability to resolve their legacy NPLs, but the required legislative changes are seriously delayed.

The authorities have finalised the first implementation decrees of the banking law. The law, adopted in 2016, fell short of good international practices, mainly on the resolution framework, due to constraints of the guarantee fund to finance transactions, creditor hierarchy in liquidation, and government presence in the resolution committee. Secondary legislation was approved in August 2016 to address some of the weaknesses in the banking law regarding the bank resolution framework. Key measures include the adoption of a government decree to implement the framework of the Bank Deposit Guarantee Fund that includes a least cost-test for resolution (with an exception for systemic cases), and adoption of a bylaw of the Resolution Committee providing a short time-frame to determine resolution measures for systemic cases to achieve financial sector stability.

Major fiscal reforms were completed. The Council of Ministers adopted in early May 2016 a strategy to broaden the VAT base by reducing exemptions; rationalising VAT rates (from three to two); introducing a more progressive personal income tax, including through fewer deductions and a significantly higher tax threshold; reducing further the dichotomy between the offshore and onshore corporate tax rates by 2018; and increasing the tax on dividends. The strategy was presented in May 2017 to the signatories of the Pacte de Carthage, the government's road map for the timely prioritisation of reforms signed by nine parties, the Tunisian Confederation of Industry, Trade, and Handicrafts (UTICA), the Tunisian General Labour Union (UGTT) and the Tunisian Union of Agriculture and Fisheries (UTAP). The authorities have also adopted the decree for the establishment of a modern Large Taxpayers Unit (LTU) that assumes formal responsibility for the major tax and enforcement functions, as well as setting up an implementation timetable that will be guided and monitored by a task force.

The government has adopted a revised strategy to reform the civil service. This strategy, adopted in April 2017, aims to improve the provision of public services and reduce the civil service wage bill to about 12 per cent of GDP in 2020. The strategy mandates no further wage increases unless economic growth substantially exceeds the baseline projections and unless the wage bill reduction path can be maintained as envisaged. It also contains a restrictive recruitment policy that will enforce a limited replacement rate for departing employees, and voluntary departure programmes, which would mainly rely on negotiated departures rather than early retirements.

Business environment reforms are being implemented. In September 2016 the authorities published the implementation decrees relating to the laws on competition, PPPs and the investment code. The new investment law, adopted by the parliament in September 2016, provides more clarity to the investment framework, including equal treatment of domestic and foreign investors and the separation between fiscal and financial incentives in line with international best practices. Parliament also adopted the law on whistleblowers in April 2017, enabling the creation of a legal framework underpinning the civic duty to report wrongdoing.

The authorities continued with energy subsidy reforms. The government increased administered fuel prices in July 2017 to reduce inefficient energy subsidies. It also applied the automatic adjustment mechanism (monthly) for the three main fuels starting in July, and revised electricity tariffs in the 2017 budget to include an increase in the prices of electricity (5 per cent) and gas (7 per cent), while keeping the social tariffs unchanged.

CONTINUES

Important reforms are delayed. Despite the inspections of five banks being completed in May 2017, inspections for two other banks were delayed, essentially due to a lack of staff within banking supervision. The signature of performance contracts for the five public enterprises (Tunisair, the electricity and gas companies STEG and STIR, the Office des Céréales, and the national Régie des Tabacs) is also delayed, with work at an advanced stage for four of them and an interim contract signed for Tunisair. Following the government's request, delayed parliamentary discussions on the Organic Budget Law, the law creating the high anti-corruption authority, and the law on the excessive lending rate will be accelerated, after which they will be published in the official gazette.

TURKEY

Highlights

- **The economy has rebounded in 2017.** This is largely due to the impact of various stimuli provided by the government to boost the economy and the strong performance of exports. Measures undertaken by the government to revive consumption include VAT cuts on durable consumer goods and a TRY 250 billion (US$ 70 billion) Credit Guarantee Fund.
- **Monetary policy has been tightened.** This has primarily been achieved by restricting funds available at central bank auctions, requiring banks to borrow through the late liquidity window which has a high rate of interest. As a result, the lira, which had depreciated substantially against the US dollar in the second half of 2016, has recovered in value, reflecting also increased portfolio inflows.
- **There has been some progress in structural reforms.** The government's focus in recent months has been on short-term measures to lift growth. However, the 2016 Action Plan remains valid, and structural reform priorities include increasing labour market flexibility, reform of Turkish Railways, energy security and efficiency, efficient infrastructure financing (for example, public-private partnerships), enhancing private sector competitiveness, deepening local capital markets and promoting regional, gender and youth inclusion.

Key priorities for 2018

- **The government's structural reform agenda needs to be reinvigorated.** The resilience of the economy could be enhanced by further capital market development, in particular by increasing the low domestic savings rate, expanding the small institutional investor base and enhancing foreign participation in the corporate bond market.
- **Enhancing inclusion could increase the competitiveness of the Turkish economy.** Youth unemployment is high, female labour participation is low and there has been a significant influx of refugees from Syria. Their further integration into the economy is important in order to ensure long-term sustainable growth. Regional inclusion would also be helped by a reform and streamlining of the highly complex and costly agribusiness support system.
- **Further infrastructure development is needed.** The current centralised system of investment planning for local infrastructure should be reviewed, and action taken to speed up the delivery of capital investments. Further work is also required to develop a single and overarching public-private partnerships (PPP) law.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	8.5	5.2	6.1	3.2	5.1
Inflation (average)	7.5	8.9	7.7	7.8	10.9
Government balance/GDP	-1.0	-1.1	-1.0	-1.1	-2.1
Current account balance/GDP	-6.7	-4.7	-3.7	-3.8	-4.6
Net FDI/GDP (neg. sign = inflows)	-1.4	-1.4	-2.0	-1.4	-1.3
External debt/GDP	41.1	43.0	46.2	46.9	n.a.
Gross reserves/GDP	13.8	13.7	12.9	12.6	n.a.
Credit to private sector/GDP	60.7	63.8	66.9	70.3	n.a.

CONTINUES

Macroeconomic performance

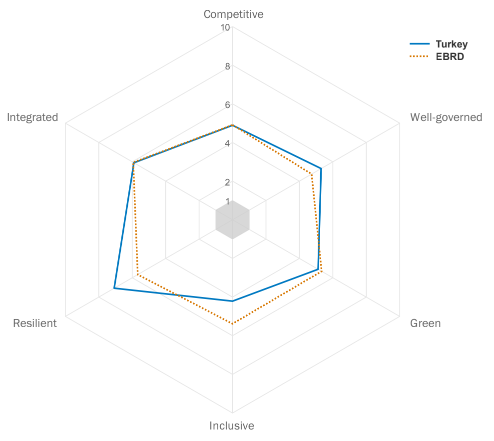
Growth has picked up strongly in 2017. The economy grew by a below-potential 3.2 per cent in 2016. This was due to Russian sanctions on tourism and trade, the decline in agricultural production due to unfavourable weather conditions, along with the negative effect of the failed military coup attempt in July 2016 on consumption and investment and the subsequent state of emergency. Growth has picked up strongly in 2017, reaching 5.1 per cent year-on-year in the first half of 2017, as net exports picked up and domestic demand surged with the help of a series of stimulus measures introduced by the government. These include VAT cuts on durable consumer goods, incentives on payroll taxes and social insurance premiums and an expansion of government-backed credit guarantees to small and medium-sized enterprises under the TRY 250 billion (US$ 70 billion) Credit Guarantee Fund (CGF).

The currency has rebounded. The impact of the failed military coup attempt and the strong performance of the US dollar caused the lira to depreciate substantially against the dollar in the second half of 2016, falling around 27 per cent between July 2016 and the end of January 2017. This, in turn, caused inflation to spike, reaching 12 per cent in April 2017. Actions taken by the central bank to raise the cost of funding to banks (notably restricting availability of funds at its regular auctions, forcing banks to borrow at the high interest rate late liquidity window), and increased portfolio inflows in common with the overall trend in emerging markets, have helped the lira to recover and bring inflation under control. As of October 2017 the lira is around 20 per cent below its July 2016 level against the US dollar, and inflation moved back into single digits in July 2017, although it has risen to double digit figures again since then.

Large external imbalances remain. The current account deficit has been declining in recent years, from 6.7 per cent of GDP at the end of 2013 to around 4.1 per cent of GDP at the end of the second quarter of 2017, as lower oil prices have given rise to a declining energy import bill and exports picked up. However, gross external financing needs to cover the current account deficit and external debt repayments due within a year are estimated at around 25 per cent of GDP in 2017, leaving the country exposed to global liquidity conditions.

Short-term growth is expected to remain robust. Thanks to the stimulus provided by the government, growth is expected to recover to around 5.1 per cent in 2017. However, credit has been growing at a rate of around 20 per cent year-on-year since January 2017 and the loan-to-deposit ratio in lira has exceeded 140 per cent. Thus, the limits to credit-driven growth will likely soon be reached, and the CGF is almost exhausted. In this context, withdrawal of the stimulus is expected to cause growth to weaken in 2018 to around 3.5 per cent. Furthermore, the stimulus has increased the budget deficit from 1.1 per cent of GDP at the end of 2016 to around 2.0 per cent in June 2017, giving rise to concerns about the government's hitherto-strong reputation for fiscal prudence.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

There has been some progress in structural reforms in the past year. Economic policies have primarily focused on providing short-term fiscal stimulus. Nonetheless, the government remains committed to implementing the reforms outlined in the 2016 Action Plan, which aims to improve the business environment and growth. Transforming the legal framework to comply with the constitutional amendments adopted in the April 2017 referendum has occupied an important part of the legislature's agenda, while the executive branch has focused on countering the short-term impact of the failed coup attempt in July 2016.

Measures to improve infrastructure quality and private sector participation in the sector have advanced. Secondary legislation to liberalise rail transport was introduced in August 2016. Preparations to privatise highways, bridges and ports have continued, and large public transport and infrastructure projects are ongoing. However, investment planning for local infrastructure remains highly centralised and delivery of capital investments is slow. Despite a good track record of PPP deals, Turkey lacks a single PPP law, which limits the reach of this financing mechanism.

Reforms continue in the banking sector. Turkey continues to move towards full implementation of Basel III, and the Turkish banking legislation has been fully compliant with Basel III risk-based capital and liquidity coverage requirements since March 2016. Net stable funding ratio regulations and IFRS 9 will be enforced from January 2018. A new resolution framework has been drafted based on recommendations by the Financial Stability Board (FSB) and the IMF in line with the Bank Recovery and Resolution Directive (BRRD). The Banking Regulatory and Supervisory Authority (BRSA) is also working on the requirements for systemically important banks, due to be effective from 2019.

Improvements to the capital markets continue but the pace is uneven. In February 2017 the Capital Markets Board (CMBT) amended issuance regulations to improve reporting and transparency, following some near-defaults in the corporate bond market. Several steps have been taken to improve the transparency of the interest rate-setting process. New money market instruments have been launched on Borsa Istanbul but the take-up has been slow among banks and investment funds. As of October 2017, the CMBT is drafting complementary regulations on mutual recognition of foreign central counterparty clearing houses (CCP) in Turkey as part of the process to achieve recognition by the European Securities and Markets Authority (ESMA) under the European Market Infrastructure Regulation (EMIR). This is essential to facilitate cross-border trading and enhance integration with European entities in Turkey.

The severance pay system and private pension scheme are being reformed. These ongoing reforms should help increase domestic savings. In January 2017 the law for auto-enrolment to private pension schemes was implemented, although the government is now working on updating the regulations as opt-outs have been higher than expected. Efforts to update the existing severance pay system to include a severance pay fund are ongoing.

Measures to improve competitiveness in the manufacturing sector have been introduced. In June 2017 the government adopted a reform package that aims to reduce operational and investment costs for manufacturing companies. The package should ease access to, and lower the cost of, land in organised industrial zones. It also slashes certain fees and taxes on production and investments. The package also contains clauses aimed at improving industry-university cooperation and the quality and governance of universities and higher vocational education institutions.

Legal reforms are continuing. In the first half of 2017 new regional courts were established and the law and regulations for court experts were enacted. Progress has been made in finalising the draft law for employment tribunals, which increases the role of arbitration in labour disputes. A comprehensive new intellectual property rights law has been adopted which restructures the national patent agency and aims to improve the protection of designs, patents, brands and geographic indications.

TURKMENISTAN

Highlights

- **Growth has changed little.** Officially reported real GDP growth was 6.4 per cent year-on-year in the first half of 2017, after 6.2 per cent in 2016 and 6.5 per cent in 2015.
- **The local currency remains significantly overvalued.** The black market rate reached around 6.6 manat to one US dollar by September 2017 compared with the official peg rate of 3.5 manat to one US dollar. The government has responded by introducing harsher currency restrictions. Information on foreign currency reserves is not disclosed.
- **The government terminated social transfers for electricity, gas and water in June 2017.** Exceptions are made for socially vulnerable groups. This indicates that the country has begun to better target budget expenditures, adjusting to lower revenues as the dollar value of gas exports has remained 40 per cent below its peak in 2014.

Key priorities for 2018

- **The authorities need to address currency convertibility issues and move towards unifying the black and official exchange rates.** The harsh currency controls and the significantly overvalued peg are distorting the economy and holding back private sector development.
- **The banking sector needs to be reformed.** Necessary measures include a gradual reduction in state-directed lending and state lending programmes through commercial banks, and a move to a more market-based financial intermediation.
- **Efforts to improve the business environment need to accelerate.** It is important to advance structural reforms, with particular focus on the commercialisation of state-owned companies and their gradual privatisation, and the liberalisation of cross-border trade, which would strengthen the country's integration into regional and global markets.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	10.2	10.3	6.5	6.2	5.7
Inflation (average)	6.8	6.0	7.4	3.6	6.0
Government balance/GDP	1.5	0.9	-0.7	-1.3	-1.1
Current account balance/GDP	-7.3	-6.4	-14.0	-21.0	-15.4
Net FDI/GDP [neg. sign = inflows]	-7.3	-8.8	-8.5	-6.2	-6.1
External debt/GDP	22.1	18.0	19.4	23.9	25.9
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	n.a.	n.a.	n.a.	n.a.	n.a.

CONTINUES

Macroeconomic performance

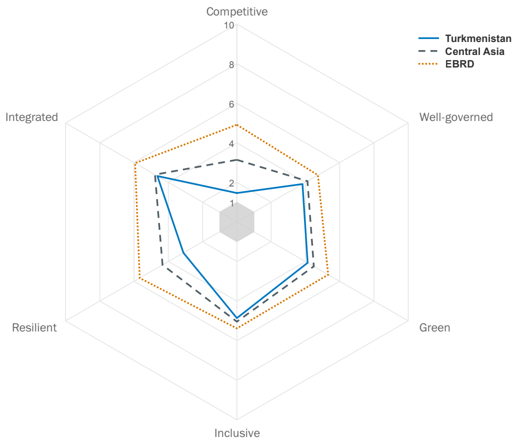
Growth remained little changed in early 2017. Officially reported real GDP growth reached 6.4 per cent year-on-year in the first half of 2017, after 6.2 per cent in 2016 and 6.5 per cent in 2015. This is substantially below the growth rates achieved in 2011-14, when gas exports were increasing rapidly. Recent growth has been supported by rising domestic consumption and import substitution. Retail trade turnover expanded by 16.9 per cent year-on-year in 2016 and by 17.2 per cent in the first half of 2017. However, fixed investment stalled in 2016 and early 2017 despite the preparation of the Asian Indoor and Martial Arts Games, which took place in September 2017. The halt of gas exports to Russia since 2016 and gas disputes with Iran, leaving China as the sole major gas recipient for the country, combined with the fall in global energy prices reduced exports to US$ 7.5 billion in 2016 from its peak of US$ 11.3 billion in 2014, according to the IMF.

The gap between the official and unofficial exchange rates has widened significantly, suggesting that the manat is significantly overvalued. The black market rate depreciated to 6.6 manat per US dollar in September 2017 from 4.4 manat per US dollar, while the official peg of 3.5 manat per US dollar has been maintained since January 2015. The government responds by continuously introducing harsher currency restrictions, severely disrupting trade.

Despite some recovery in revenues, state finances have remained under pressure. The budget slipped into a marginal deficit in 2015. In 2016 the deficit widened to 1.3 per cent of GDP, even though budget expenditures remained 13 per cent below plan, not least due to public wages arrears and cuts and lay-offs of public sector workers. Revenues decreased by 11 per cent year-on-year, and expenditures by 18 per cent, in 2016. In the first half of 2017, revenues began to recover and rose 18 per cent from a year earlier, with expenditures up by a moderate 3 per cent. The end of social transfers for electricity, gas and water from June 2017 will put a further cap on spending growth. Turkmenistan nevertheless spent significant amounts on preparation for the September 2017 Asian Indoor and Martial Art Games (for example, a new sports complex for US$ 6 billion and a new airport for US$ 2 billion), at least in part from off-budget funds.

Real GDP growth can be expected to slow to an average of 5.7 per cent in 2017 and 5.1 per cent in 2018, due to fiscal tightening measures and continuing currency depreciation that eats into real household income and spending. Relatively meagre export growth and the failure to introduce much-needed reforms to enhance the country's competitiveness and attract investment will also weigh on growth.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

Turkmenistan remains in a very early stage of transition. The country has the lowest assessment of transition quality (ATQ) score among the EBRD's countries of operations. Significant gaps remain across all qualities, in particular in competitiveness, resilience and governance. Competitiveness of the private sector is low due to the challenging business environment and the significant state presence in the economy.

A "National Development plan for 2018-2024" was adopted in October 2017. It aims to create job opportunities in all provinces of Turkmenistan; facilitating self-sufficiency up to province level and where possible up to district level; fast-track measures to reduce imports and boost exports; nurturing the small and medium-sized enterprises to serve as the backbone of the economy; creating conditions for the emergence of private farmers as the primary guarantors of food security. It foresees also major industrial projects in the mining, chemical, metallurgical industries and in logistics. The government also passed several legislative reforms, including the amendments to the law on free economic zones, labour code, land code and tax code of Turkmenistan.

The government ended social transfers for electricity, gas and water in June 2017. Exceptions are made for socially vulnerable groups. This termination of transfers suggests better targeting but also that the government faces significant shortages in revenues as a result of low commodity prices. Turkmen citizens had enjoyed such benefits since late 1992, although limits were later imposed on the amounts that citizens could use for free. The government is also pushing to eliminate cash transactions in favour of bank cards, which suggests there is a serious shortage of hard currency.

Customs stamps have been reintroduced. The measure was implemented in June 2017, requiring importer companies to obtain a stamp for the State Commodity and Raw Materials Exchange before customs clearance. This has therefore increased non-tariff barriers to trade. Such a rule had existed from the time of Turkmenistan's independence in 1991 until 2008, when the government ended the requirement for imports valued below US$ 1 million after the official manat exchange rate was harmonised with the market rate.

The construction of a new gas pipeline has been postponed. In March 2017 it was decided to indefinitely postpone work on Line D of the Central Asia-China gas pipeline. Line D is the fourth branch of this pipeline, which was launched in 2009. Line D was particularly important for Turkmenistan as it would have enabled the country to raise its total gas exports to China to 65 billion cubic metres by 2020 from an estimated 30 billion cubic metres in 2016. Turkmenistan's economy is left particularly exposed by this decision, as it is entirely dependent on China as its only gas export market, after gas exports to Russia and Iran were halted in 2016-17. The construction of the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline is progressing slowly, owing to diplomatic, financial, security and technical challenges.

UKRAINE

Highlights

- **A modest economic recovery is under way.** After two years of deep recession GDP grew by 2.3 per cent in 2016 and remained nearly at the same low level in the first half of 2017. The volume of exports declined in 2016 and foreign direct investment (FDI) remains low.
- **Structural reforms have moved forward, but with delays and setbacks.** Key reforms include the application by the National Bank of Ukraine (NBU) of increasingly rigorous regulatory standards, and the adoption of laws on the electricity market and on the energy regulator. The recent passage of education, pension and healthcare reforms is a welcome sign of reform momentum. However, flagship reforms in the gas sector are being delayed and meaningful progress is lacking on the reform of governance in state-owned enterprises (SOEs), privatisation and the administration of justice.
- **The nationalisation of PrivatBank has helped to avert a financial meltdown.** Concerns about the low quality of assets, extensive related party lending and a shortage of capital led to the nationalisation of this systemically important bank, without major disruptions to the broader economy.

Key priorities for 2018

- **The economic recovery needs a stronger momentum.** A major push is required to get the privatisation process off the ground and foster inflows of FDI. Adoption of the new privatisation law and reform of the State Property Fund would bring more transparency to the process. The judicial system requires an overhaul.
- **Reform of the state-owned banks has become increasingly urgent.** The aim should be to scale back the state's large involvement in the banking sector following the nationalisation of PrivatBank. Low operating efficiency and balance sheet concerns at the state-owned banks need to be remedied as a stepping stone to eventual privatisation. Decisive steps must be taken to recover the assets of PrivatBank.
- **Quick and measurable progress is required in energy sector reform.** Implementation of Naftogaz's Corporate Governance Action Plan should be reinvigorated to compensate for significant delays and to eliminate policy uncertainty. Work on its unbundling needs to advance in line with authorities' commitment to the process.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	0.0	-6.6	-9.8	2.3	2.0
Inflation (average)	-0.3	12.1	48.7	13.9	12.8
Government balance/GDP	-4.8	-4.5	-1.2	-2.3	-3.0
Current account balance/GDP	-9.0	-3.4	-0.2	-3.7	-3.3
Net FDI/GDP [neg. sign = inflows]	-2.2	-0.2	-3.3	-3.5	-1.1
External debt/GDP	77.5	94.6	130.4	121.7	n.a.
Gross reserves/GDP	11.1	5.6	14.6	16.7	n.a.
Credit to private sector/GDP	61.8	64.0	49.2	41.8	n.a.

CONTINUES

Macroeconomic performance

Ukraine's economy is growing moderately but output remains well below the pre-crisis level. After a 16.0 per cent cumulative real GDP contraction in 2014-15, Ukraine's economy grew by 2.3 per cent in 2016. The economy sustained this modest pace of recovery in the first half of 2017, growing by 2.5 per cent year-on-year in the first quarter and by an estimated 2.3 per cent year-on-year in the second quarter. Gross fixed capital formation rebounded after a protracted downturn, growing by 20.1 per cent year-on-year in 2016 and by approximately 21.9 per cent year-on-year in the first half of 2017. Household consumption has picked up further this year on the back of increasing real wages and improving confidence, but the real volume of exports of goods and services declined by 1.6 per cent in 2016 and by 1.3 per cent year-on-year in the first half of 2017, dragging down headline GDP growth. In 2016 industrial production increased by 2.8 per cent, thus breaking a four-year cycle of decline. But in the first nine months of 2017, it slipped into 0.3 per cent year-on-year contraction on account of the economic blockade of the area that is beyond the control of the government of Ukraine (the blockade). FDI into the real sector remained low at just around 2.0 per cent of GDP in 2016. Consumer price inflation has slowed from the peak levels of 2015 but remains elevated at 16.4 per cent year-on-year as of September 2017. On 27 October 2017 the NBU raised its key policy rate for the first time since March 2015 from 12.5 per cent to 13.5 per cent.

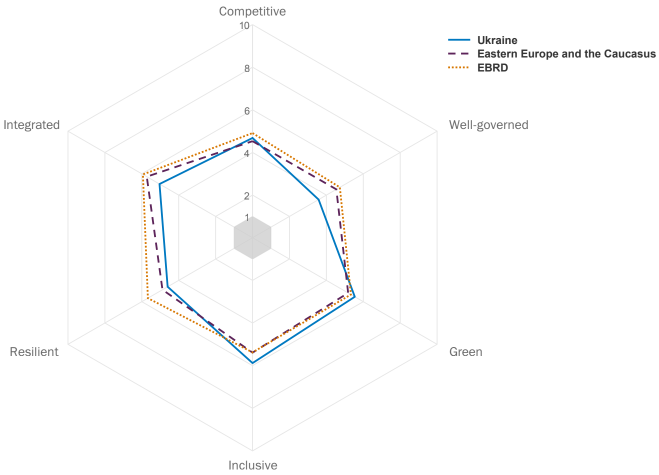
International reserves are on the rise despite a higher current account deficit. The current account deficit widened from near-balance in 2015 to approximately 3.7 per cent of GDP in 2016 due to a domestic demand recovery and weak exports. It remained on the rise in the first half of 2017. However, the balance of foreign exchange inflows to the economy was favourable on account of international assistance inflows, including under the IMF programme, and with the help of foreign exchange cash returning to the banking system after a significant exodus in previous years. In September 2017 successful issuance of sovereign 15-year Eurobonds for the principal amount of US$ 3 billion marked Ukraine's return to the international capital markets. It was accompanied by a liability management operation to buy back up to US$ 1.7 billion of Eurobonds maturing in 2019 and 2020. Ukraine's official reserve assets increased to approximately US$ 18.6 billion (close to four months of imports) as of September 2017. The hryvnia appreciated by approximately 2.5 per cent against the US dollar from the beginning of 2017 until the end of September.

The state of public finances has continued to improve. The combined general government and Naftogaz deficit decreased from 10.1 per cent of GDP in 2014 to approximately 2.3 per cent of GDP in 2016, below the initially planned 3.7 per cent of GDP. The increase of gas tariffs to import parity level in 2016 enabled the authorities to phase out the quasi-fiscal deficit of Naftogaz for the first time in recent years. The overall fiscal deficit is planned at approximately 3.0 per cent of GDP in 2017, which is in line with the IMF programme. The public debt-to-GDP ratio remained steadily high at approximately 81.0 per cent of GDP following the nationalisation of PrivatBank in December 2016, which led to the issuance of domestic government bonds to fill in the capital shortfall at the bank. Pension reform adopted in October 2017 aims to improve fiscal sustainability of the pension system.

Growth is forecast to increase in 2018 but medium-term prospects are contingent on reform implementation. GDP growth is expected to gain pace from 2 per cent in 2017 to a still-modest 3 per cent in 2018. The blockade is expected to have a moderate impact on Ukraine's growth and balance of payments in the near term. At the same time, reform momentum is weak, jeopardising medium-term growth prospects. Ukraine's ability to advance growth-friendly reforms under the umbrella of the IMF programme is uncertain.

CONTINUES

Assessment of transition qualities (1-10)



Major structural reform developments

Continuation of the IMF programme is uncertain. The nationalisation of PrivatBank (see below), the adoption of the 2017 budget compliant with the programme framework, and the successful launch of the online asset declaration system for public officials paved the way for completion of the third programme review in April 2017. This was followed by the release of a US$ 1 billion tranche, bringing total disbursements to US$ 8.4 billion out of US$ 17.5 billion envisaged under the programme. In May 2017 the IMF mission initiated discussions on the fourth programme review but noted that further work was needed to meet the reform objectives in relation to pension reform, the privatisation process and anti-corruption. An adjustment of domestic gas prices to maintain them at import parity level is also one of the conditions for completing the fourth review.

The banking system has been stabilising but credit activity is yet to recover. The NBU has been applying increasingly firm and transparent supervision in key areas such as corporate governance, ownership transparency, related party exposures and capital requirements, supported by an enhanced legislative and implementation framework. Related party diagnostic reviews were finalised for all banks in 2016, identifying 44 banks in which the ratio of credit exposure to related parties exceeded the required level. By the end of 2016, the 60 largest banks in the country, accounting for approximately 98 per cent of the banking sector assets, completed stress tests to determine capital needs and to develop recapitalisation schedules. Plans for recapitalisation and the unwinding of related-party exposures over the three-year horizon have been adopted, covering a large majority of the banking sector. An out-of-court voluntary debt restructuring mechanism became functional in April 2017 but the level of non-performing loans (NPLs) is still exceptionally high at approximately 58 per cent of total loans as of 1 July 2017 with significant concentration of the NPLs in the state-owned banks. Lending activity remained weak on the back of prevailing risk-aversion, deleveraging, lack of progress in creditor rights' protection and high (albeit-decreasing) interest rates.

CONTINUES

PrivatBank was declared insolvent and nationalised to safeguard financial stability. It was the largest commercial bank in Ukraine by the end of 2016, accounting for approximately 20 per cent of total banking sector assets. PrivatBank was nationalised in December 2016 amid concerns about large related party exposures, poor asset quality and a significant capitalisation gap. In the days immediately following the nationalisation, the parliament extended a full state guarantee on all PrivatBank deposits and the NBU provided emergency liquidity assistance to bolster confidence and stem withdrawals from the bank. New supervisory and management boards were swiftly put in place. An international auditing firm was appointed to investigate insider loans issued to the bank's related parties, with the completion of the forensic audit expected before the end of 2017. As of the end of June 2017 the government had issued treasury bonds amounting to approximately 6 per cent of 2016 GDP in order to recapitalise the bank. The fallout from the nationalisation was mostly contained. Exchange rate pressures in the aftermath of the nationalisation were limited and no major disruptions were reported in ordinary bank transactions. The nationalisation of PrivatBank led to increased state involvement in the banking sector with around half of the banking assets presently owned by the state.

Major reforms in the energy sector have been delayed despite some recent progress. In April 2017 the parliament of Ukraine adopted a new electricity market law which stipulates the unbundling of the transmission and distribution of electricity. The law paves the way for enhanced competition in the electricity market. It aims to align the Ukrainian power sector closer to the requirements of the EU's Third Energy Package. The two-year transition period envisaged under the law will provide time to develop secondary legislation and gradually roll out an electricity market structure consistent with EU principles. Despite some recent progress, major gas sector reforms pertaining to the unbundling of Naftogaz, implementation of its corporate governance action plan and liberalisation of the gas market are well behind schedule.

Ukraine's business environment rankings improved but public governance challenges remain. Ukraine ranks 76th out of 190 economies in the World Bank *Doing Business 2018* report, moving up in the rankings compared with the previous year. However, weaknesses in Ukraine's business environment are reflected in the low scores with respect to getting electricity, protecting minority investors, trading across borders, enforcing contracts and resolving insolvency. Progress with the SOE reform is slow and privatisation continues to be mostly stalled. In August 2017 the state's minority stakes in three regional energy companies were sold to the existing majority shareholders. In July 2017 the Cabinet of Ministers of Ukraine endorsed a draft law on privatisation and contemplated a triage of SOEs to determine which need to remain in state ownership, which could be privatised and which could be liquidated. However, tangible results are still lacking. The launch of the online asset declaration system in September 2016 was an important step towards better transparency and accountability in public administration but the extension of declaration requirements to non-governmental organisations and SOEs needs to be rectified. The National Anti-Corruption Bureau of Ukraine (NABU) has opened a number of investigations including high-profile cases but the inefficient court system continues to obstruct the administration of justice.

UZBEKISTAN

Highlights

- **Officially reported GDP growth slowed to 5.3 per cent in the first nine months of 2017,** from 7.0 per cent in the first half of 2017 and 7.8 per cent in 2016, however this likely reflects more accurate accounting rather than a sharp contraction in the third quarter.
- **A series of market-oriented reforms have been initiated.** In addition to the liberalisation of the foreign exchange regime (see below), there have been measures to improve the business and investment climate, a reduction of the state presence in the economy, and judicial reforms.
- **Major steps were made to liberalise the foreign exchange regime.** Since 5 September 2017 the sum has been allowed to float freely and currency controls have been loosened, representing the most important economic reform for the country to date. A comprehensive plan for monetary policy reforms for 2017-21 has also been approved, which includes the gradual move to an inflation targeting regime.

Key priorities for 2018

- **Further deep structural reforms need to be launched.** Fiscal and tax reforms, customs reform, financial market reform, and others are crucial for successful competition with intensified imports after the opening up of the country. Foreign investments need to be encouraged and remaining legal and administrative obstacles need to be removed.
- **Banking sector reforms need to deepen and state-directed lending should be phased out.** The underdeveloped banking system with high state ownership hinders the development of a resilient and competitive economy. Strengthening of the banking sector is needed through stricter enforcement of prudential banking rules and better risk and credit management, and the reduction of state-directed lending at preferential terms is critical.
- **Efforts to improve the business and investment climate need to continue and deepen.** The authorities should carry on with the ongoing work to address excessive regulations, improve business registration and the licensing regime, and reform the complex and distortive tax system.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	8.0	8.1	8.0	7.8	5.4
Inflation (average)	11.7	9.1	8.5	8.0	13.2
Government balance/GDP	2.4	3.4	0.8	0.4	0.6
Current account balance/GDP	2.9	1.7	0.7	0.7	0.9
Net FDI/GDP [neg. sign = inflows]	-1.1	-1.2	-0.1	-0.2	-0.2
External debt/GDP	13.4	14.5	18.1	20.2	22.2
Gross reserves/GDP	39.4	38.2	38.7	37.8	n.a.
Credit to private sector/GDP	n.a.	n.a.	n.a.	n.a.	n.a.

CONTINUES

Macroeconomic performance

Officially reported GDP growth slowed to 5.3 per cent in the first nine months of 2017 year-on-year, from 7.0 per cent in the first half of the year and 7.8 per cent in 2016. However, the lower reported growth figure is likely to be due to more accurate accounting rather than reflecting a sharp contraction in the third quarter. Growth was driven by an increase in exports of 25.6 per cent year-on-year and a strong performance in the industry, construction and services sectors.

The sum has been allowed to float freely. Since 5 September 2017 the Central Bank of the Republic of Uzbekistan (CBU) stopped administratively setting the exchange rate and devalued the official rate by 48 per cent to Sum 8,100 to 1 US dollar from Sum 4,210 to 1 US dollar set previously. Interventions serve only to prevent large fluctuations.

Inflation has accelerated in 2017. Consumer prices were 5.2 per cent higher in June 2017 than in December 2016 mainly reflecting the increases in food prices. This compares with 2.5 per cent a year earlier and 8.0 per cent for 2016 overall. Some further acceleration in inflation might take place when prices, currently partially frozen, will be adjusted. The liberalisation of exports of some goods previously supplied only to the domestic market also contributes to higher inflation, whereas the pass-through from the devaluation of the official exchange rate has been limited thanks to the wide use of the unofficial exchange rate before the currency reform.

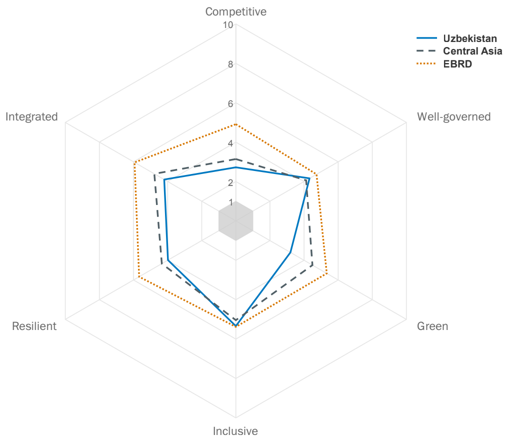
Monetary policy was fairly accommodative until mid-2017, but has been tightened since. The central bank increased its monetary policy rate from 9 per cent to 14 per cent in June 2017 in a move to halt credit expansion during the run-up to exchange rate convertibility. At the same time the central bank opened emergency liquidity lines to banks – up to three months. After significant growth in the first half of 2017, banks have halted credit growth to conserve liquidity and manage capitalisation, as well as reflecting the shift in government policies towards restricting monetary growth during the transition to the new exchange rate regime. Banks had received significant liquidity and capitalisation support from the central bank and a state fund earlier in 2017 as measures to prepare for currency liberalisation.

Fiscal and external positions remain in surplus. The officially reported fiscal balance remained in surplus at 0.4 per cent of GDP in 2016 and in marginal surplus also in early 2017. At the same time the government has kept up significant off-budget investment spending, permitted by the large cash buffer available. The current account balance has been maintained at near balance in recent years, turning out at an estimated 0.7 per cent of GDP deficit in 2016. The inflow of foreign direct investment (FDI) and investment loans totalled Sum 6.6 trillion in the first half of 2017 according to official data, with 68 per cent invested in the oil and gas sector and 10 per cent in telecommunications.

Real GDP growth is projected to reach 5.4 per cent in 2017 and increase moderately to 6.2 per cent in 2018, supported by continued robust domestic investment and the stepwise implementation of economic reforms. Export growth will be supported by the improved economic relations with neighbouring countries. Furthermore, the better economic prospects for Russia and Kazakhstan, the main destinations for Uzbek migrant workers, will support remittance inflows. There is however significant forecast risk with regard to the headline figures, as statistical methods might significantly change during the reform process.

CONTINUES

Assessment of transition qualities (1-10)



Major structural reform developments

A series of reforms were announced after the 2016 presidential election. The government's development strategy, approved in February 2017, includes five priority areas: (i) improving public administration and state buildings; (ii) ensuring the supremacy of law and reforming the judicial system; (iii) maintaining solid economic growth and liberalising the economy; (iv) improving the social safety net; and (v) ensuring security. Alongside these reforms the government plans to implement investment projects worth US$ 40 billion over the next five years in energy, infrastructure, chemicals, pharmaceuticals and other sectors. In order to attract the required foreign investment and advanced technologies, the government also plans to open four additional Free Economic Zones in the Samarkand, Bukhara, Fergana and Khorezm regions.

Uzbekistan showed one of the most notable improvements in the World Bank's *Doing Business 2018* report. With five implemented reforms, Uzbekistan has become the regional leader in the total number of reforms in the Europe and Central Asia region and is among the 10 economies improving most in 2016-17. Uzbekistan's rank was 74th out of 190 countries, up from 87th in the previous year's report. Areas reformed were the starting of businesses, access to electricity, paying taxes, dealing with construction permits and protecting minority investors. The largest improvements were made in two areas: paying taxes was made easier and less costly by introducing an electronic system for filing and paying VAT, land tax, unified social payments, CIT, infrastructure development tax, environmental tax, personal pension fund contributions and cumulative pension contributions, while the process of getting an electricity connection was streamlined by introducing a turnkey service at the utility that fulfils all connection-related services, including the design and completion of the external connection.

Steps have been taken to liberalise the currency regime. The reform was launched by the presidential decree issued on 2 September ordering the exchange rate to be decided by market mechanisms. Since 5 September CBU stopped administratively setting the exchange rate and devalued the official rate by 48 per cent. Interbank currency exchange trading sessions are held daily. CBU interventions are intended to prevent large fluctuations. The official central bank rate continues to be published weekly (every Monday), from now on equal to the average value of the rates fixed at the trades of the currency exchange in the previous week. The official rate applies for accounting purposes, statistical and other reporting, as well as for calculating customs and other mandatory payments on the territory of the Republic of Uzbekistan. The decree relaxed some stringent capital controls on foreign currency for businesses and individuals. Legal entities, as well as individual entrepreneurs and farmers with foreign exchange income can now purchase unlimited foreign currency for use in international payment operations. Individuals can receive foreign exchange on payment cards and use it abroad.

CONTINUES

Further steps to improve monetary policy and introduce inflation targeting are being developed. On 13 September the President advised CBU, the Ministry of Finance and the Ministry of Economy to outline a plan for monetary policy reforms for 2017-21 including measures for the coordination of economic, fiscal and monetary policies; the introduction of monetary policy instruments for liquidity management; increasing transparency and improving communication on monetary policy decisions between CBU and the public; and developing the domestic capital markets in the medium term. Monetary policy will be guided by inflation targeting. CBU has been ordered to present a medium-term road map for the implementation of the 2017-21 monetary policy reforms by March 2018. A new law "On foreign exchange regulation" will be introduced by July 2018.

The business environment has significantly improved. Non-scheduled inspections of companies have been limited by law. The state's influence in non-strategic companies has been reduced (whereas previously the state had special rights even if it had a small shareholding, those rights are proportional now). The government is working on the development of e-services to limit face-to-face interactions of the regulator and private sector representatives. The government established the State Committee for Investments in March 2017, responsible for coordinating the formulation and implementation of a unified state investment policy and attracting foreign investments. The government is also working on public-private partnership (PPP) legislation, a renewables framework and a law on state procurement.

The government has adopted a resolution to revise tax legislation. The legislation was adopted in June 2017, and specifying amendments are to follow in the coming months. The structure of the tax system is impeding the creation of specialised businesses (as part of the production value chain) because the taxation of turnover instead of value-added constrains tax deductibility for smaller businesses. The tax system also disincentivises larger businesses and thus discourages companies from growing beyond a certain size. The government is also working to align definitions of micro-, small- and medium-sized enterprises with international practices.

Cross-border integration is being enhanced. Two new border crossings opened between Uzbekistan and Kazakhstan in July 2017 on a section of the Tashkent-Samarkand road passing through Kazakhstan, which had been closed for more than a decade. A new railway link between Samarkand and Astana via Tashkent was launched in June 2017. Uzbekistan is trying to resolve tensions in its relationships with Tajikistan and the Kyrgyz Republic over issues including territorial disputes and access to water resources. In April 2017, a commercial flight between Uzbekistan and Tajikistan was carried out for the first time in 25 years. Efforts are being made to establish bilateral contacts with Turkmenistan.

A new business district and a technopark are planned to be built in Tashkent. In July 2017 Toshkentboshplan, the state-owned company in charge of urban planning and construction in Tashkent, announced that a 70-hectare district, called Tashkent City, will be constructed at a cost of US$ 1 billion in Tashkent in 2018. The project is part of the President's programme aimed at infrastructure development, modernising the economy and positioning the country as investor-friendly.