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.

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Macroeconomic performance

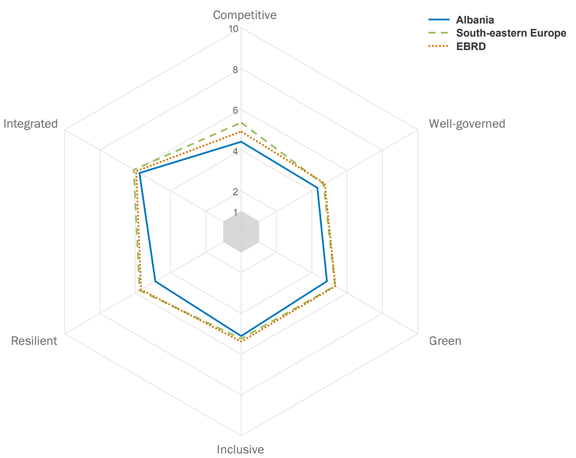
Robust economic growth is continuing. Overall GDP growth reached 3.4 per cent in 2016, compared with 2.2 per cent in 2015, on the back of strong growth in private consumption and investment. Government spending increased moderately after levelling off the year before. Net exports also had a positive 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)



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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.

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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.

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.

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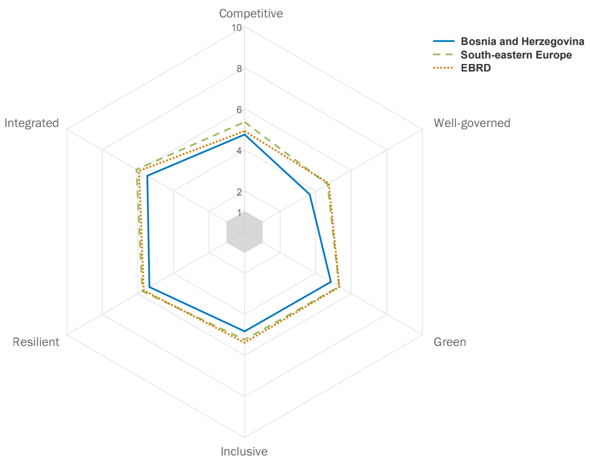
Macroeconomic performance

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)



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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.

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Macroeconomic performance

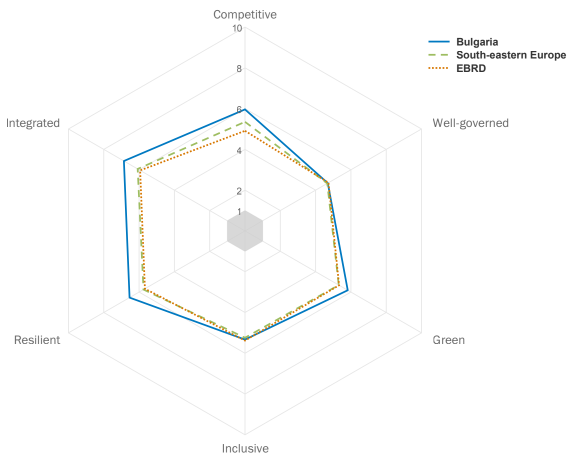
Strong economic growth has continued into 2017. The economy grew by 3.9 per cent in 2016, followed by a consumption-driven growth of 3.7 per cent in the first half of 2017. Net exports, driven by the upswing in key export markets including the EU, contributed to a current account surplus of 4.2 per cent 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)



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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.

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.

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Macroeconomic performance

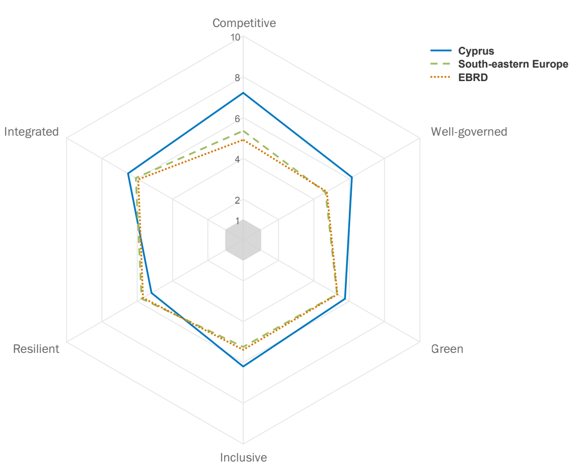
The economic recovery is continuing into 2017. After the return to growth in 2015 (2.0 per cent), following three years of contraction, the economy performed well in 2016, with GDP growth reaching 3.0 per cent, above expectations. Tourism was one of the main drivers of the economy, with arrivals last 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)



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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.

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.

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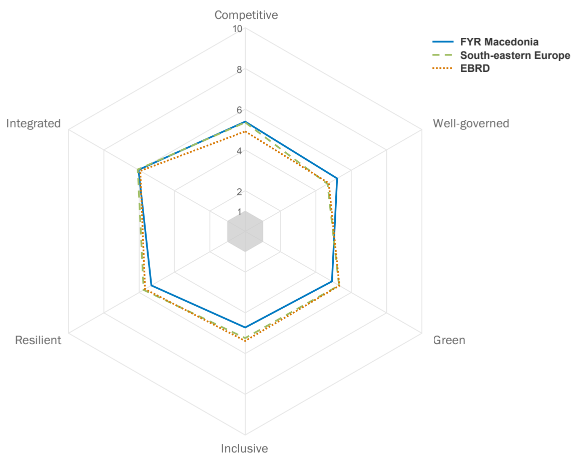
Macroeconomic performance

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)



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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.

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.

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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.

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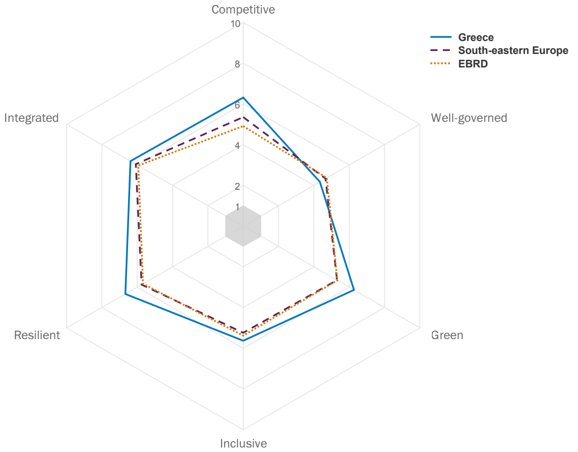
Assessment of transition qualities (1-10)



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.

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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.

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

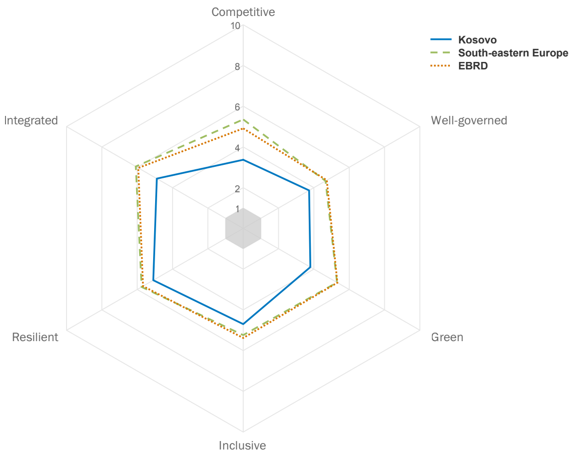
Macroeconomic performance

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)



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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.

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.

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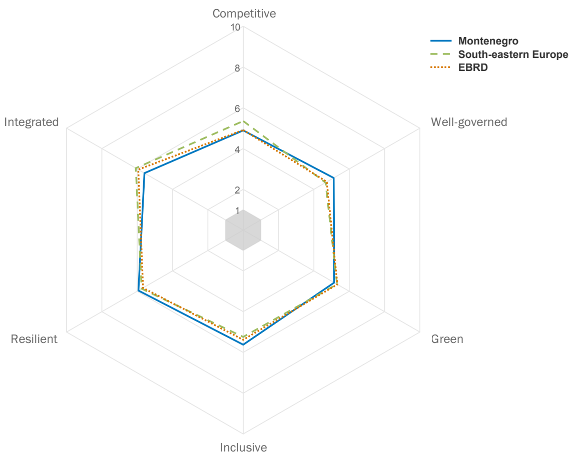
Macroeconomic performance

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)



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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.

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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.

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.

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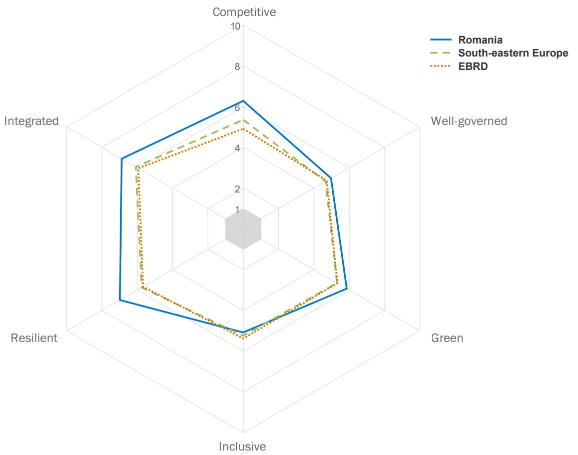
Macroeconomic performance

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)



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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.

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.

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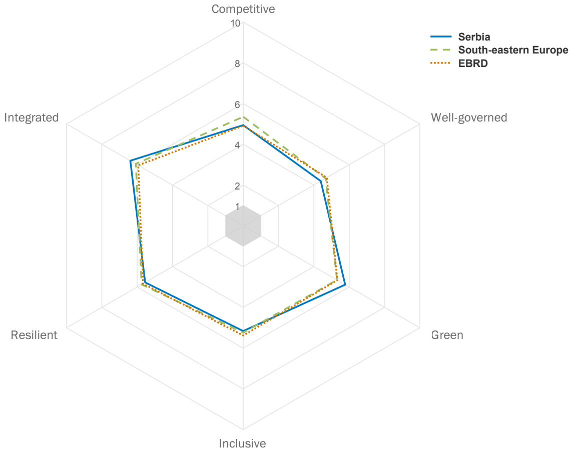
Macroeconomic performance

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)



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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.

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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.