CROATIA

Highlights

- **The economic recovery of recent years has continued but at a slower pace.** The growth rate decelerated to below 3 per cent in 2017, mainly on the back of the slow-down in investment and catch-up in imports, and a further slight moderation of growth has continued into 2018.
- **The fiscal framework is being strengthened.** Fiscal performance improved significantly in 2017, with the government recording a surplus, and new fiscal laws are being introduced in 2018, in line with the European Union's (EU's) Stability and Growth Pact.
- **Croatia has approved a euro adoption strategy.** The strategy outlines the costs and benefits of euro adoption as well as the importance of prudent macroeconomic policies in the run-up to this event. The date of the introduction of the euro has not been fixed, however.

Key priorities for 2019

- **Public sector reforms, including privatisation and improving state-owned enterprise (SOE) corporate governance, should be progressing faster.** The government should step up implementation of its public administration strategy and address persistent weaknesses in the system such as territorial fragmentation, political influence in recruitment and inadequate training and salary systems.
- **Acute shortages in skilled labour need to be addressed sustainably.** Several sectors (tourism, construction, shipbuilding, IT) have long been experiencing a lack of qualified staff. Increased quotas for foreign workers are helping to provide a short-term fix, but a longer-term solution is needed, including improvements in education and training, and a further reduction in labour market rigidities.
- **Corporate deleveraging and restructuring need to be stepped up in order to support long-term growth.** Besides business environment reforms, faster long-term growth would demand corporate restructuring, further decreasing non-performing loans (NPLs) and over-indebtedness; an increased use of EU funds, as well as diversification of the economy away from tourism.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-0.1	2.4	3.5	2.9	2.7
Inflation (average)	-0.2	-0.5	-1.1	1.1	1.6
Government balance/GDP	-5.1	-3.4	-0.9	0.8	0.3
Current account balance/GDP	2.0	4.5	2.6	3.9	2.5
Net FDI/GDP [neg. sign = inflows]	-1.6	-0.5	-4.1	-2.4	-1.0
External debt/GDP	106.8	101.7	89.3	81.8	n.a.
Gross reserves/GDP	29.2	30.7	29.0	32.1	n.a.
Credit to private sector/GDP	68.1	64.6	60.5	57.7	n.a.

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Macroeconomic performance

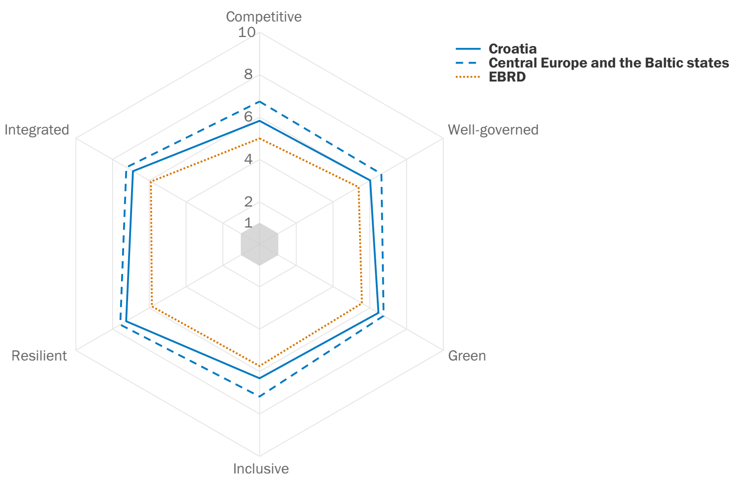
Growth has been gradually slowing down. After a 3.5 per cent rise in 2016, GDP growth slowed to 2.9 per cent in 2017 due to lower investment growth and faster catch-up in imports as the economy entered its third year of recovery. Private consumption, which has continued to recover on the back of a tightening labour market and low inflation, and exports, were the main contributors to GDP growth. A further slow-down to 2.7 per cent year-on-year occurred in the first half of 2018 as exports of goods and services grew more slowly. Unemployment has decreased to 9.0 per cent, still a relatively high level, but labour shortages in sectors such as tourism and construction act as a drag on growth.

Fiscal adjustment has continued but excessive macroeconomic imbalances persist. The fiscal balance moved to a surplus in 2017 (at 0.9 per cent of GDP), primarily on the back of higher profit and value-added tax revenues, as well as increased social security contributions. As a result, the public debt continued trending down and reached 76 per cent of GDP at the end of June 2018 (10 percentage points lower than the peak three years earlier). However, in May 2018 the European Commission concluded that, although reduced, excessive macroeconomic imbalances are still present in Croatia. These imbalances are primarily linked to the still-high levels of public, private and external debt, all of which are largely denominated in foreign currencies. In September 2018 Standard & Poor's upgraded Croatia's BB+ credit rating outlook from stable to positive on the basis of an expected strengthening of the country's fiscal and economic performance.

Inflation has returned to positive territory. After three years of deflation, the inflation rate turned positive in 2017, reaching an annual average of 1.1 per cent. The rise in prices primarily reflected an increase in food and energy prices, and was supported by stronger domestic demand. In the first nine months of 2018, inflation continued to increase, mainly due to rising crude oil prices in the global market, but it is expected to stay below 2 per cent for the year as a whole. Inflationary pressures are partially alleviated by the appreciation of the currency, which is due to favourable macroeconomic developments, reduced fiscal risks and stronger foreign currency inflows on account of robust tourist revenues and higher EU funds inflows.

Growth may decelerate somewhat in 2018 and 2019. Economic growth is projected to slow to 2.7 per cent in 2018 and 2.5 per cent in 2019. Risks to the projection are relatively balanced. While upside risks relate to stronger tourism revenues (as 2018 is on course to be another record-breaking year) and faster utilisation of EU funds, the main downside risks are related to skilled labour shortages and the country's ailing food and retail giant, Agrokor. In July 2018, Agrokor creditors approved the debt settlement, but there are still uncertainties surrounding the restructuring of the company, and negative spillovers to the rest of the economy cannot be excluded.

Assessment of transition qualities (1-10)



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Major structural reform developments

Over the past year, the business environment has worsened somewhat. In the latest World Bank *Doing Business 2019* report, Croatia ranks 58th out of 190 countries, seven places down from the year before. The largest deterioration has been reported in the areas of starting a business and dealing with construction permits, in which it also has the lowest ranking (123rd and 159th, respectively). On the other hand, an improvement has been made in registering property, thanks to the digitisation of the land registry. Croatia also worsened its position in the World Economic Forum *Global Competitiveness Report 2018*, sliding down two places from the year before,[1] to 68th out of 140 countries. According to this report, the main issues remain market inefficiencies, weak institutions and innovation capacity.

Croatia has approved a euro adoption strategy. The new strategy was formally adopted in May 2018. Besides clarifying the benefits and costs of introducing the euro, the strategy envisages prudent macroeconomic and structural policies before the euro adoption. These policies include: the continuation of the fiscal consolidation as well as a strong focus on increasing the productivity of the Croatian economy. The strategy, however, does not fix a date of adoption. The government also set up a national council to monitor the key macroeconomic criteria before formally starting the process of joining the eurozone. The European Central Bank assessed that Croatia fulfils three out of four economic conditions necessary for euro adoption (namely, the criteria relating to price stability, public finances and long-term interest rates). The exchange rate criterion is not fulfilled since the country is not yet a member of the Exchange Rate Mechanism II.

The fiscal framework is being strengthened. In September 2018, the parliament adopted at first reading a new law on fiscal responsibility. The draft law introduces three new rules (on structural balance, budget expenditure and the public debt) in line with the Stability and Growth Pact and the goal of strengthening the independence of the Fiscal Policy Commission. The main task of this commission is to evaluate the implementation of fiscal rules.

The government started tax and pension system reforms. In September 2018, the parliament approved in the first reading a tax reform package comprising amendments to nine tax laws (including laws on VAT, profit tax, income tax, social contributions, real estate tax, excise duties, and the general tax code). It is expected that the changes will affect primarily retailers and employers. In October 2018, the government approved the pension reform pack, with amendments to six laws aimed at the enhancement of pension system sustainability, and sent it to the parliament for approval. Among the rest, the amendments envisage raising the retirement age to 67 years for both men and women as of 2033 (from the current retirement age of 65 years for men and 62 for women), and higher penalties for early retirement.

There has been limited progress in reforming SOEs. The list of companies of special interest was reduced to 39 in 2018, signalling potentially intensified privatisation efforts, but no significant privatisation deal has been announced or concluded since then. However, efforts have been made to strengthen reporting standards and medium-term business planning as well as enhancing the competencies of supervisory boards at SOEs, with the support of the EU's Structural Reform Support Service and the EBRD. In addition, in December 2017 a new SOE corporate governance code was adopted, followed in May 2018 by a new law on state asset management. The restructuring of the highly indebted road sector has started with a seasonal (summer) increase in tolls and financial restructuring (envisaging the extension of the maturity and a cut in interest rates on the existing debt). In November 2017, the government placed a €1.275 billion Eurobond to refinance the road sector debt, while in April 2018 the three road companies (HC, HAC and ARZ) signed a €1.8 billion jumbo loan with eight local banks to re-programme the debt. These financial restructuring measures should result in savings of over €50 million a year.

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[1] The rating for 2017 reflects the change in the methodology. According to the old methodology, Croatia ranked 74th in 2017.

Public administration reforms are progressing quite slowly. According to the European Commission, the Strategy of Public Administration Development 2015-2020 remains largely unimplemented. The main public administration weaknesses to be addressed are: territorial fragmentation (which hinders the implementation of public policies, increases costs and leads to an inefficient use of resources); political influence in the recruitment process; poor design of working positions; lack of in-service training; subjective appraisals; and inconsistencies in the salary system. In June 2018 the government tabled a bill on electronic invoices in public procurement. The bill should reduce administrative costs and facilitate tax control. In August 2018, the government decided to reduce the number of entities with public powers (agencies, institutes, funds, companies, institutions, foundations and others) in order to downsize the state administration. Work on changes in the pay grade system for civil servants has started, but adoption of the announced legislation has been postponed further.

Non-performing loans have continued to decline but at a sluggish pace. The NPL ratio fell to 11.2 per cent at the end of June 2018 (down by two percentage points from the year before), mostly on the back of NPL portfolio sales in the market. NPL sales accelerated in 2017, exceeding €1 billion (an increase by a third from 2016). However, the NPL ratio remains very high for the corporate sector at 22 per cent of total corporate loans.

ESTONIA

Highlights

- **GDP growth peaked in 2017.** Last year, economic growth reached nearly 5 per cent, largely boosted by a double-digit hike in investment and strong household consumption.
- **A pension reform bill has been approved.** It modifies the formula for pension calculations and ties the retirement age to the average life expectancy from 2027 onwards. In addition, a three-pillar system will be introduced and special pensions for certain professions will be abolished from 2020.
- **Port Tallinn was privatised through the local stock exchange.** In addition to corporate governance improvements, the transaction will support the development of the local capital market, as it provides opportunities to investors, including institutional investors such as local pension funds.

Key priorities for 2019

- **The first covered bonds should be issued in 2019.** The expected adoption of the Covered Bonds Act in 2019 creates an opportunity for banks to issue covered bonds and for different investors to invest in them, thereby broadening Estonia's capital market.
- **Estonia's research and innovation potential needs to be better utilised.** The country has been a leader in the region in terms of its innovation achievements, but bottlenecks still need to be addressed, such as the weak links between business and academia and the low level of private investment in research and development.
- **Reducing the gender pay gap would encourage an increased female labour force participation.** Estonia has the highest gender pay gap in the European Union (EU) with an average wage difference between men and women of 25.3 per cent, much higher than the EU average of 16.2 per cent. Improving wage transparency, including through the adoption of the Gender Equality Act and reviewing the parental leave system, both planned for 2018-20, are steps in the right direction.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
DP growth	2.9	1.9	3.5	4.9	3.6
Inflation (average)	0.5	0.1	0.8	3.7	3.3
Government balance/GDP	0.7	0.1	-0.3	-0.3	-0.4
Current account balance/GDP	0.8	1.8	2.0	3.2	1.8
Net FDI/GDP [neg. sign = inflows]	2.4	0.6	-2.3	-3.7	-6.0
External debt/GDP	94.9	92.8	88.4	82.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	67.8	69.1	70.2	65.0	n.a.

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Macroeconomic performance

GDP growth has been strongly driven by domestic demand. Following four years of negative or moderate growth, investment saw a two-digit growth rate in 2017. Amid still-strong household consumption, GDP growth reached 4.9 per cent last year. However, the rate of growth slowed down to 3.5 per cent year-on-year in the first half of 2018, largely induced by a deceleration in investment. The favourable external environment has benefited solid exports, but its positive effect on GDP was effectively offset by the strong growth in domestic demand-driven imports.

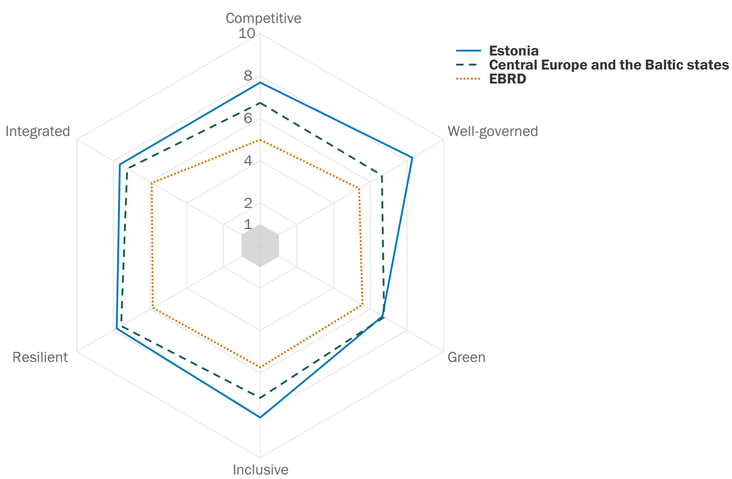
The investment share in GDP remains the highest in the EU. In 2017, the gross fixed capital formation represented 23.7 per cent of GDP, clearly above the EU average (20.1 per cent) and Estonia's regional peers. In 2017, the share of public investment in GDP was the highest in the EU, at 5.6 per cent, which is close to its 10-year average of 5.5 per cent. Nevertheless, these high figures have been strongly dependent on EU funds, which have constituted about half of total public investment expenditures. Therefore, the risk related to an abrupt fall in public investment exists if the new EU budget for Estonia is reduced substantially.

Labour shortages have increased. According to EU surveys, the share of companies complaining about the lack of labour increased to almost 27 per cent in the third quarter of 2018, which represents a 10 percentage increase compared with the beginning of 2017. Overall, the labour market in Estonia has performed well, positively stimulated by the government's labour market policies, such as the Work Ability programme launched in 2017 which aims to bring disabled people into the labour market. But the falling working-age population imposes challenges. The employment rate reached almost 80 per cent in the second quarter of 2018, while the unemployment rate has dropped below 5 per cent.

Public finances remain healthy. The budget deficit in 2017 remained at 0.3 per cent of GDP, slightly lower than expected as the robust economic growth underpinned strong revenue collection. The 2018-2022 Stability Programme, adopted by the government in April 2018, envisages a headline fiscal surplus of 0.2 per cent of GDP this year, which is expected to further widen by 2020. The government has been targeting a move from a broadly balanced fiscal policy to a counter-cyclical fiscal contraction in response to the economic growth above its potential and the high risk of overheating. General government debt dropped to 9.0 per cent of GDP in 2017 and is expected to remain on a downward trend.

GDP growth is forecast to moderate. Following a strong recovery in 2017, economic growth is expected to decelerate to 3.6 per cent in 2018 and further to 3.0 per cent in 2019. The key drivers of the slow-down are the expected weaker investment and exports. In contrast, rising wages will likely further underpin strong household consumption, which will be only fractionally offset by the expected rise in inflation.

Assessment of transition qualities (1-10)



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Major structural reform developments

Port Tallinn was privatised through the local stock exchange. In June 2018, the government sold a 33 per cent stake in AS Tallinna Sadam (Port of Tallinn) through an initial public offering on the Nasdaq Tallinn Stock Exchange. This transaction was the first state-owned company listing in Estonia for almost 20 years. It is expected both to improve corporate governance, through strengthened transparency and efficiency of the company, and to support the development of the local capital market, as it provides opportunities to investors, including institutional investors such as local pension funds.

Electricity market synchronisation has progressed. In June 2018, the three Baltic countries, Poland and the European Commission signed an agreement for the synchronisation of the Baltic power grid with the continental EU network by 2025. The synchronisation of the power grid, which is expected to go through Poland, is anticipated to offer a major contribution to the solidarity and energy security of the EU. Also, it is one of the key goals of the EU's Energy Union project, which was launched in February 2015. Currently, the Baltic states' electricity grid is still operated in a synchronous mode with the Russian and Belarusian systems.

The pension system is being made more flexible. In April 2018 the government approved a pension reform bill. Among other measures, the bill modifies the formula for pension calculations and ties the retirement age to average life expectancy from 2027 onwards. The pension system will consist of three pillars: a first pillar building more on social solidarity, which will depend on the number of contributory years; a second pillar depending on the size of wages; and a third pillar based on people's voluntary contributions. In addition, special pensions for some professions, such as the military, prosecutors and police, will be abolished from 2020. The reform partly addresses the risks to the future sustainability of the pension system. Nevertheless, given the currently low pensions, ensuring adequate pensions in the future remains a challenge, especially for low earners, the disabled and people with short professional careers.

Plans for an undersea railway tunnel between Tallinn and Helsinki have advanced. This project, if carried out, would contribute to the effective creation of a metropolitan "twin-city" of Helsinki and Tallinn. A taskforce, comprising the relevant ministries of Estonia and Finland, concluded in May 2018 that private funding would be required to speed up the progress of the project and to strengthen its financial viability. According to the first feasibility study, published in February 2018, a 103 km tunnel between the two capital cities would cost between €13 billion and €20 billion and its construction could start in 2025 and take 15 years. Its financing would be organised through a public-private partnership and EU funding of up to 40 per cent. The tunnel would be part of the Trans-European Transport Network (TEN-T) and be connected with the Rail Baltica line.

Covered bonds will broaden the Estonian capital market. The Ministry of Finance sent a draft of the Covered Bonds Act for public consultation in August 2018. This creates an opportunity for banks to issue covered bonds and for different investors to invest in them, thereby broadening the Estonian capital market. In November 2017, the ministers of finance of the Baltic states agreed to establish a pan-Baltic covered bond market. The purpose of the cooperation agreement promoting the Baltic capital markets is to make the local capital market more effective. Additional provisions to the draft law necessary for the functioning of the pan-Baltic covered bond market will be considered later. The law should enter into force in 2019.

Local administrative reform was implemented. Starting from January 2018, the number of municipalities has been reduced from 213 to 79. The key aim of the reform is to increase the role of local governments and better divide the competencies of the state institutions. In addition, larger municipalities should have improved capacity to offer better quality services and invest in necessary infrastructure. In addition, the county governments were abolished and their tasks have been distributed among local councils and the different existing authorities.

HUNGARY

Highlights

- **Robust growth is being driven by investment recovery and household consumption.** Investment grew at double-digit levels in 2017 and the first half of 2018, driven by rising credit to the private sector and accelerated European Union (EU) funds absorption.
- **The state is gradually reducing its ownership in the banking sector.** Following a successful sale of its stake in the small-sized Granit Bank, the government has committed to privatising the Budapest Bank, but the procedure has been delayed.
- **The tax wedge has been gradually reduced.** New measures are being introduced to continue with cuts to employers' social security contributions, helping to bring down the tax wedge which is among the highest in the OECD.

Key priorities for 2019

- **Labour reserves should be released through higher-quality active labour market policies.** In light of increasing labour shortages, new active labour market policies are needed because the current public work scheme has had limited success in bringing labour force participants back to regular employment.
- **Improving education and healthcare systems would increase Hungary's competitiveness.** Education and health outcomes remain below the EU average, reflecting the limited effectiveness of their provision by the state. A more active role for the Competitiveness Council in addressing these two areas would be welcome.
- **Productivity of SMEs should be improved.** Measures should focus on boosting innovation and value added, because despite the preferential lending schemes targeting small and medium-sized enterprises (SMEs), the productivity difference between large firms and SMEs still remains higher than in other EU countries.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.2	3.5	2.3	4.1	4.3
Inflation (average)	0.0	0.1	0.4	2.4	2.8
Government balance/GDP	-2.6	-1.9	-1.7	-2.4	-2.3
Current account balance/GDP	1.5	2.8	6.2	3.2	2.4
Net FDI/GDP [neg. sign = inflows]	-2.8	-1.1	-2.0	-1.3	-2.1
External debt/GDP	117.1	108.7	97.0	84.9	n.a.
Gross reserves/GDP	30.0	26.9	20.5	19.9	n.a.
Credit to private sector/GDP	67.8	69.1	70.2	65.0	n.a.

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Macroeconomic performance

Domestic demand is underpinning strong GDP growth. Household consumption has continued to strengthen since 2014, reaching 4.8 per cent growth in 2017. The key growth contributor in 2017, however, was investment, which increased by 18.2 per cent, lifting the overall GDP growth in 2017 to 4.1 per cent. In the first half of 2018, economic expansion accelerated further to 4.7 per cent year-on-year, fuelled by the continuously strong domestic demand. Despite strong exports, the net contribution of trade has been negative, as the recovered investment has required a major increase in imports.

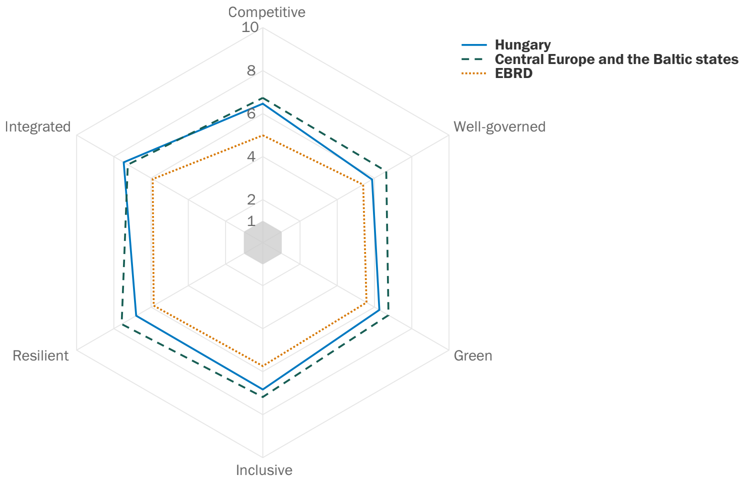
Banks' willingness to lend has improved, in particular to corporates. Following almost eight years of contraction, credit growth to the private sector started to recover in mid-2017. In the first half of 2018, corporate credit grew on average by 10 per cent year-on-year. At the same time, household borrowing also went up, although by just 1.0 per cent. Profitability of the banking sector has improved, while non-performing loans further declined from 7.4 per cent at the end of 2016 to 4.2 per cent by the end of 2017, below the central Europe and the Baltic states' average.

Labour shortages are among the most severe in the EU. According to the third quarter of the 2018 European Commission business survey, nine out of 10 companies in Hungary cite labour shortages as the key factor limiting industrial production. With unemployment rates at an historical low (3.9 per cent in June 2018), and employment rates at a peak of 74.4 per cent in the first quarter of 2018, the squeeze on the labour supply pool is negatively affecting companies' expansion plans and constitutes a threat to future economic growth. The government's gradual withdrawal from the public works scheme is expected to shift more workers towards the private sector, although more active labour market policies are required to bring more disabled, Roma and elderly people back to employment.

Fiscal policy remains pro-cyclical. Although fiscal policy has been pro-cyclical, the growing economy contributed to a government deficit of just 2.0 per cent of GDP in 2017, better than initially forecast. This was despite the reduction of the corporate income tax to 9.0 per cent, the lowest rate in the EU, and cuts to social security contributions. Public debt dropped in 2017 from 76.0 per cent to 73.6 per cent of GDP.

Economic growth is forecast to moderate. GDP growth in 2018 is expected to reach 4.3 per cent, before it slows down to 3.3 per cent in 2019. Strengthening credit to the private sector will further boost investment over the forecast horizon. Household consumption will also remain strong, although a rise in inflation may somewhat offset the ongoing increase in disposable incomes. The shrinking labour supply and potential turmoil in global trade constitute the main risks to the outlook, especially in the automotive industry.

Assessment of transition qualities (1-10)



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Major structural reform developments

Tax changes have been introduced. In July 2018, the parliament approved a package of tax changes for 2019. Among other things, the package includes the following: first, a reduction in social contributions by two percentage points to 17.5 per cent as of the second half of 2019, if private sector wages increase by more than 6.0 per cent in the first quarter of 2019. Second, tax relief will be eliminated for almost all kinds of fringe benefits although health insurance and pension saving may be left in the fringe benefit system (the so-called "cafeteria"). Third, a 25 per cent tax is being introduced on the revenues of non-governmental organisations (NGOs) that materially support the immigration of non-EU nationals without proper residency permits. The reduction in social contributions will help reduce Hungary's tax wedge, which is one of the highest among the OECD countries. However, the introduction of the tax on NGOs has led to the launch by the European Commission of an infringement procedure against Hungary in July 2018.

Steps to boosting the innovation and productivity of SMEs are being taken. In May 2018 the government established an innovation and technology ministry. The new ministry is expected to streamline the government's efforts to promote higher value-added creation among Hungarian corporates, including SMEs. A recent study by the National Bank of Hungary (NBH) showed that SMEs' productivity is on average only about a third of that in large companies.

New incentives for investment are being introduced. In April 2018, the government awarded HUF 17 billion (€53 million) of investment incentives for industrial development. A total of 65 companies will benefit from these incentives, supporting new investments worth more than HUF 38 billion (€118 million), mainly in new capacities and efficiency and technological improvements.

The government is gradually reducing its ownership in the banking sector. In December 2017, the state sold a 36.5 per cent stake in the small-sized Granit Bank for HUF 4.5 billion (€14 million). The state entered Granit Bank in mid-2013, acquiring a 49.9 per cent stake in the bank, which was diluted in late 2015 but without the state's participation. The government has committed to sell its stake in Budapest Bank but the procedure has been repeatedly delayed so far.

EU funds utilisation has been impressive. In the 2014-20 budget, Hungary was allocated €25 billion of EU funds, which represent about 3 per cent of GDP annually. By the end of 2017, about 94 per cent of the funds were already allocated to projects on the ground, and more than half was already disbursed.

The construction of the Budapest-Belgrade railway line has advanced. First applications for the tender were submitted in June 2018, which will be followed by negotiations, and a contract with the winning bidder should be signed by the end of 2018. The costs on the Hungarian side are estimated at €1.6 billion, and a part of that is expected to be financed through a loan from China. The connection is expected to be the fastest overland route from Greece to central Europe and is scheduled to be finalised by the end of 2023.

LATVIA

Highlights

- **Investment has recovered strongly.** Following a sharp contraction in 2016, investment recorded double-digit growth in 2017 and the first half of 2018, boosted in part by higher EU funds absorption and contributing to a GDP expansion of above 4.5 per cent.
- **The reputation of the banking sector has been dented.** The ABLV Bank, the third-largest bank in Latvia, is being voluntary liquidated after accusations of money laundering linked to aiding North Korea's nuclear programme and some illegal activities in eastern Europe.
- **Tax reform has brought positive results.** A more progressive income tax system was introduced from January 2018, which reduces the high tax wedge on low-income earners and improves tax compliance.

Key priorities for 2019

- **The reputation of the financial sector should be restored.** Following recent scandals in the banking sector in Latvia, ambitious self-cleaning measures should be implemented in order to better address potential risks associated with money laundering, corruption and combating the financing of terrorism.
- **Labour market constraints should be further reduced.** Taking advantage of the currently strong GDP growth, the government should focus on measures that encourage greater employment of targeted groups, such as in rural areas, as well as reduce structural unemployment.
- **Efforts to make Latvia's economy more innovative should be continued.** The ongoing working group meetings among the various state-owned companies on how to increase the innovativeness of Latvia's economy are a step in the right direction. However, a greater and early involvement of the private sector is needed in order to successfully achieve the desired results.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.9	3.0	2.1	4.6	3.9
Inflation (average)	0.7	0.2	0.1	2.9	2.4
Government balance/GDP	-1.5	-1.4	0.1	-0.5	-0.8
Current account balance/GDP	-2.0	-0.8	1.4	0.7	-0.5
Net FDI/GDP [neg. sign = inflows]	-1.6	-2.3	0.0	-2.0	-2.2
External debt/GDP	143.7	143.7	149.6	141.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	52.4	49.9	49.2	43.4	n.a.

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Macroeconomic performance

A solid recovery in investment has accelerated GDP growth. In 2017, GDP growth reached 4.5 per cent, and 4.7 per cent in the first half of 2018, underpinned by a rebound in investment and still-solid household consumption. Following two consecutive years of contraction, investment growth turned positive and registered double-digit growth in 2017 and in the first half of 2018. The surge in investment coincides with improved EU funds utilisation, as well as a hike in private sector investment. The latter is mainly financed by companies' own funds, rather than credit growth, which remains subdued, partly because of the government's ambition to decrease the foreign share of deposits in Latvia's banking sector, a move recently reinforced by new legislation (see below).

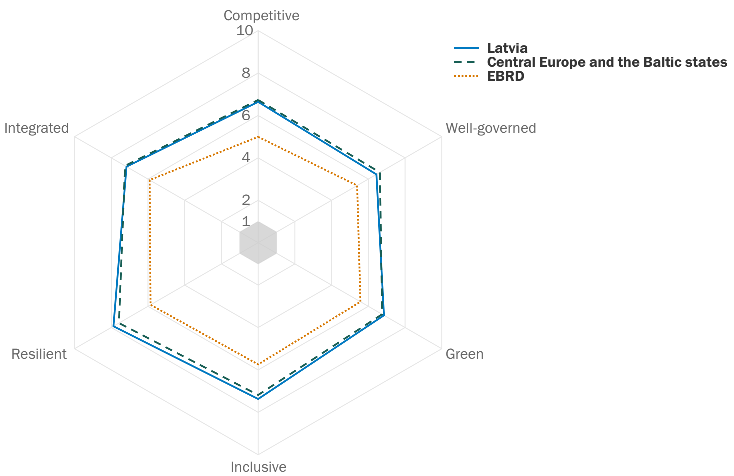
Robust household consumption, at 5.1 per cent growth in 2017, continued to be supported by a tightening labour market, which saw average real wage growth of 4.8 per cent. Only strong investment-driven imports weighed somewhat on the robust recovery of GDP growth.

A shortage of qualified labour remains a challenge for Latvia's competitiveness and long-term growth potential. Due to the current strong GDP figures, Latvia's labour market is flourishing, with falling unemployment (7.4 per cent in June 2018) and rising employment rates (76.6 per cent in the first quarter of 2018). The gap between employment of men and women dropped to only 3.8 percentage points, which is substantially below the EU average of 11.7 percentage points. At the same time, the ongoing emigration remains a challenge. Between 2009 and 2016, the outflow of people with higher education accounted for 40 per cent of net outward migration, according to a study by the European Centre of Expertise. That loss constitutes more than 17 per cent of the highly educated working-age population in Latvia.

Fiscal policy has been pro-cyclical. According to the Fiscal Discipline Council, the government is failing to take advantage of the current favourable economic situation and pro-cyclical trends to further reduce the fiscal deficit. While the government debt is expected to drop to 37 per cent of GDP in 2018, the European Fiscal Board calculations, based on the European Commission's forecasts, project a 0.7 per cent fiscal expansion in 2018 and 0.2 per cent in 2019, despite clear signs of overheating.

GDP growth is estimated to moderate. Economic expansion in the short term is expected to be further driven by investment and household consumption, but these two should be more balanced in their contribution to growth. GDP growth is expected to slow down to 3.9 per cent and 3.5 per cent, this and next year, respectively. In the short term, household consumption is forecast to remain solid, backed by higher wages and lower unemployment.

Assessment of transition qualities (1-10)



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Major structural reform developments

A scandal has damaged the reputation of the banking sector. The Latvian financial regulator, the Finance and Capital Market Commission (FCMC), started an investigation of ABLV Bank in February 2018, after the US Financial Crimes Enforcement Network (FinCEN) proposed sanctions against the bank's money-laundering allegations linked to aiding North Korea's nuclear programme and illegal activities in Azerbaijan, Russia and Ukraine. As a result, the FCMC requested ABLV to stop all payment orders and transactions. A voluntary liquidation plan was proposed in March 2018, which was approved by the financial regulator in June 2018. It is likely to begin by the end of 2018. The ABLV Bank was the third-largest in the country and its liquidation will affect about 25,000 customers, to whom €1.5 billion-worth deposits are expected to be returned.

Financial operations by high-risk customers have been limited. A bill aimed at reducing transactions between Latvian banks and shell companies was approved in April 2018. The bill also improves information exchange in the financial sector. Consequently, the share of foreign deposits is expected to drop from the current 30 to 20 per cent, while the aim of the government is to cut it to only 5 per cent of all deposits. While the law will likely have a negative impact on GDP growth in the short term, it is aimed at strengthening the banking sector, which was severely hit by the ABLV crisis.

Tax reforms are addressing the shadow economy and promoting inclusion. Starting from January 2018, a more progressive income tax system was introduced, which reduces the high tax wedge on low-income earners and improves tax compliance. According to an early estimate of the finance ministry, the reform has already brought positive results, in particular to unreported wages. Latvia's shadow economy is estimated at 22 per cent of GDP in 2017, according to the Shadow Economy Index for the Baltic Countries by the Stockholm School of Economics in Riga, which is higher than in neighbouring Baltic states.

EU cohesion policy funds will be reduced in the new budget. According to the early proposal for the 2021-27 EU budget, announced by the European Commission in May 2018, Latvia's cohesion funding is expected to shrink by 13 per cent, relative to the current budget. Overall, the implementation of all EU funds available to Latvia for 2014-20 (€5.6 billion) stood at 60 per cent by mid-2018. The EU cohesion funds are expected to be reduced for those countries and regions, where income per capita approaches the level of 75 per cent of the EU average. In 2016, Latvia's purchasing power-adjusted GDP per capita reached 65 per cent.

LITHUANIA

Highlights

- **A recovery in private investment has supported GDP growth.** Private consumption has grown robustly too in the past year, as a tightening labour market has contributed to real wage increases, while the export sector is also performing well.
- **Tax and pension reforms have been launched.** The tax reform introduces new progressivity along with increased tax exemptions for incomes under a certain threshold. The pension reform fully separates the state-backed pension system from the second-pillar voluntary private system, while at the same time strengthening the latter. Both reforms will take effect in January 2019.
- **Lithuania has joined the OECD.** The accession process took five years and was concluded in July 2018. Lithuania will benefit from the exchange of policy experience with other OECD members, which ultimately should positively shape policy decisions in the country.

Key priorities for 2019

- **Enhancing labour supply is critical to offset demographic pressures and to increase potential growth.** The new, modern labour code, which entered into force in July 2017, should be accompanied by additional employment-enhancing measures, such as a reduced tax wedge, lower costs of childcare and a reformed immigration policy to attract more highly skilled labour.
- **A successful implementation of the tax reform may reduce the shadow economy.** It will be important to ensure that the income tax reform, which will come into effect in January 2019, reduces the tax burden for those living on the lowest income, as this sector is often operating in the shadow economy.
- **Improving energy efficiency should be continued.** The greatest financing needs have been identified in the energy efficiency sector. According to the Public Investment Development Agency (VIPA), such needs can reach €1 billion until 2023.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.5	2.0	2.4	4.1	3.4
Inflation (average)	0.2	-0.7	0.7	3.7	2.7
Government balance/GDP	-0.6	-0.2	0.3	0.5	0.7
Current account balance/GDP	3.2	-2.3	-0.8	0.9	0.4
Net FDI/GDP [neg. sign = inflows]	0.0	-1.9	-0.4	-1.3	-1.0
External debt/GDP	69.9	75.7	85.2	82.5	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	40.5	41.3	42.7	41.1	n.a.

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Macroeconomic performance

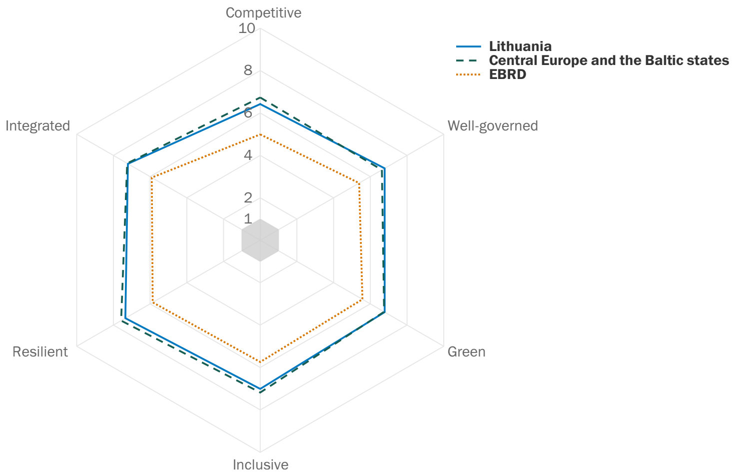
GDP growth has been fuelled by strong private consumption and a recovery in investment. Real GDP growth reached 4.1 per cent in 2017, followed by 3.8 per cent growth year-on-year in the first half of 2018. Robust private consumption has been accompanied by a strong pick-up in investment (by about 8.0 per cent), which is expected to improve further, in line with the accelerated absorption of EU funds. Exports also showed a robust recovery, although their positive effect on GDP has been largely offset by an investment-led strong rise in imports.

The labour market has tightened further. The current employment rate is among the highest in central Europe and the Baltic states, at 76.8 per cent in the first quarter of 2018, while the unemployment rates continue to fall, reaching an historic low of 6.8 per cent in June 2018. Long-term unemployment has dropped to only 2.4 per cent. Nevertheless, in absolute numbers employment is expected to fall during the next few years, in line with the fall in the working-age population.

The general government balance remains in surplus. In 2017, Lithuania managed to register a budget surplus for the second year in a row, reaching 0.5 per cent of GDP last year. The improved tax collection, underpinned by strong economic performance and robust consumption, mitigated the costs associated with the labour market and pension reforms. Public debt remains on a downward path, dropping to below 40 per cent of GDP by the end of 2017. The recently introduced pension system reforms will likely improve long-term fiscal sustainability, in particular through introducing an automatic indexation system.

GDP growth will likely moderate gradually. Strong wage growth and a further tightening of the labour market will continue supporting strong private consumption. GDP growth is forecast to reach 3.4 per cent in 2018, before it decelerates to 2.8 per cent in 2019. Nevertheless, the expected weakening in external demand from Lithuania's major trading partners, amid an investment-led surge in imports, will result in a negative trade balance, and thus will weigh on GDP growth in the forecast horizon. The shrinking working-age population is expected to hurt businesses increasingly, which in turn may defer investment decisions, as the lack of skilled labour may not be easily replaced by machines. In contrast, the accelerated utilisation of EU funds will likely propel a rise in public investment.

Assessment of transition qualities (1-10)



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Major structural reform developments

Lithuania has joined the OECD. In July 2018 the agreement was ratified by the French government and concluded an accession process that lasted five years. Lithuania will benefit from the exchange of policy experience with the other 35 members and draw on the OECD's expertise, which ultimately should positively shape the policy decisions in the country.

Tax reform is advancing. In July 2018, the President signed into law tax amendments, including to personal income taxation and social security contributions. The reform consolidates labour-related taxes on the employee side by introducing two personal income tax rates. Incomes below €107,000, calculated as the average monthly wage multiplied by 120, will be taxed at 20 per cent and incomes higher than that will be taxed at 27 per cent. Other measures include an increase in the tax-exempt threshold and a significant cut in social security. These changes will likely reduce Lithuania's tax wedge, which is substantially above the OECD average (37 versus 28 per cent). A reduction of the tax wedge was one of the OECD's recommendations, on the occasion of Lithuania's accession, to make low-skilled workers more attractive to employers.

Pension reforms have been adopted. Along with the tax reform (described above), the government has adopted reforms to the pension system. According to the amended law, the state social insurance fund (Sodra) will stop making transfers to the second pillar pension system. At the same time, Sodra will become the sole payer of pension annuities. In addition, employees younger than 40 years will be automatically enrolled to the second pillar, with the right to opt out during the first three years. Under the second pillar scheme, employees will transfer 3.0 per cent of their salary to a private pension fund, which will be complemented by a 1.5 per cent transfer from the state. Pension fund fees will be reduced from 1.0 to 0.5 per cent of the average annual value of funds. The law will enter into force in January 2019. While the second pillar will be strengthened, it remains unclear if the reform will generate sufficient replacement rates in the future.

Lithuania has issued its first green bonds. In May 2018, the government issued a €100 million sovereign green bond, the first country to do so among the Baltic states. The net proceeds from that placement were on-lent to VIPA, the Public Investment Development Agency, and will be used exclusively to improve the energy efficiency of multi-apartment buildings throughout the country. According to VIPA's *ex ante* assessment, the financial needs in the energy efficiency sector until 2023 amount to €1 billion, of which about 30 per cent could be covered by VIPA and the remaining part by the private sector.

The new energy strategy aims to achieve complete energy independence. An updated National Energy Independence Strategy was adopted by the parliament in June 2018. It foresees a gradual increase of power produced locally, reaching 35 per cent in 2020, 70 per cent in 2030 and 100 per cent in 2050. Renewables are expected to become the key source of energy in all sectors, starting from a share of 30 per cent in 2020, then 45 per cent in 2030 and 80 per cent in 2050. Natural gas imports are expected only by 2050, supplied by the Klaipeda liquefied natural gas terminal and, from 2021, the gas pipeline interconnection between Lithuania and Poland (GIPL), which is currently under construction. Also, the strategy stipulates the full integration of Lithuania's energy system with the continental European system by 2025.

The state-owned railway monopoly is being split up. In February 2018, the government approved the transport ministry's proposal to divide the Lietuvos Gelezinkeliai (Lithuanian Railways) into three separate entities managing the country's railway infrastructure, passenger transport and infrastructure. The three companies are expected to remain 100 per cent state-owned but such a model will likely allow more efficient management and transparency. According to the EU's Fourth Railway Package, infrastructure and rail operators should be managed separately.

POLAND

Highlights

- **GDP growth remains robust.** The economic expansion was underpinned by continuously robust household consumption and improved investment, in particular in the public sector. In contrast, gross fixed capital formation by domestic private sector companies has remained low.
- **Public spending on healthcare is being reformed.** In June 2018 the government approved an amendment to the healthcare legislation to gradually increase public spending on health from the current 4.7 per cent to 6.0 per cent of GDP by 2024.
- **Special economic zones have been extended to cover the entire country.** In order to incentivise investment, companies will benefit from tax breaks for 10 to 15 years. The size of the relief will depend on the site of the investment, its nature and the quality of employment created.

Key priorities for 2019

- **Controversies relating to the ongoing judicial reform should be resolved to ensure the proper functioning of judicial bodies and the independence of the judiciary.** A satisfactory resolution of these issues would have a positive effect on business sentiment and could help attract private sector investment.
- **More measures to tackle high air pollution should be introduced.** Poland is home to 7 out of 10 cities in the European Union (EU) with the highest levels of particulates.
- **The efficiency and effectiveness of the social benefits system should be improved.** Among other measures, steps should be taken to expand access to long-term care and childcare in order to relieve bottlenecks and further increase employment.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
DP growth	3.3	3.8	3.0	4.6	4.7
Inflation (average)	0.1	-0.7	-0.2	1.6	1.7
Government balance/GDP	-3.6	-2.6	-2.3	-1.7	-1.4
Current account balance/GDP	-2.1	-0.6	-0.5	0.2	-0.7
Net FDI/GDP [neg. sign = inflows]	-2.4	-2.1	-0.9	-1.3	-2.0
External debt/GDP	72.7	71.8	76.5	67.1	n.a.
Gross reserves/GDP	18.4	19.9	24.3	22.6	n.a.
Credit to private sector/GDP	49.8	51.1	52.5	52.2	n.a.

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Macroeconomic performance

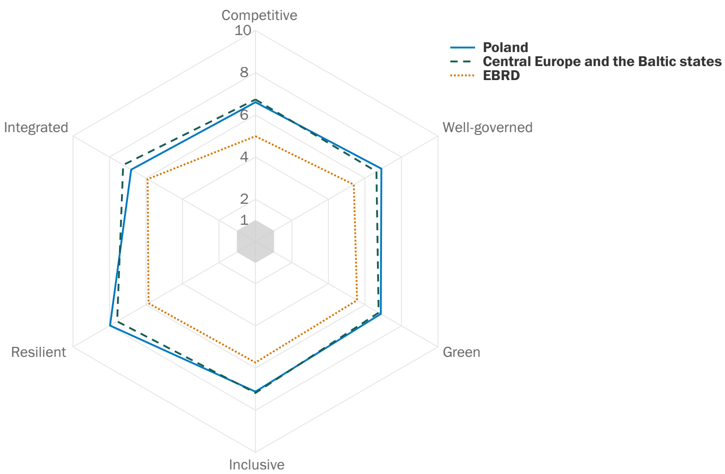
GDP growth has remained strong. The economy grew by 4.8 per cent in 2017 and the economic expansion accelerated further to 5.1 per cent year-on-year in the first half of 2018, amid continuously robust household consumption and improved investment, the latter rising by 3.4 per cent in 2017 and accelerating to 6.0 per cent year-on-year growth in the first half of 2018. Public investment has been expanding for some years, while private sector investment has finally showed early signs of recovery since the second quarter of 2018, driven mainly by foreign-owned companies and in sectors such as machinery, technical equipment, tools and transport. The expansionary fiscal policy and improving labour conditions underpinned the solid household consumption growth. Export demand has been strong, although its positive impact on GDP growth was markedly offset by consumption- and investment-led imports.

Labour shortages are increasing. The employment rate grew to 72 per cent in the first quarter of 2018, slowly approaching the EU average of 72.9 per cent. At the same time, the unemployment rate dropped to 3.7 per cent in mid-2018, the third lowest in the EU. The shrinking pool of labour, induced mainly by ageing, the decreased retirement age and higher social benefits, has resulted in decreased labour force participation, especially of women, and constitutes a limiting factor by almost 50 per cent of companies in Poland, according to the third quarter of 2018 European Commission business survey. While difficulties in employing new workers may be a factor in favour of greater automatisation in about 16 per cent of companies, according to a local employment agency, the shortage of workers has already delayed investment plans. This is especially visible in the construction sector.

Fiscal policy remains pro-cyclical, despite the booming economy. The budget deficit declined to 1.7 per cent of GDP in 2017, benefiting from strong GDP growth and improved tax collection, including higher VAT compliance. Public debt is forecast to remain at 53 per cent of GDP by the end of 2018, according to the European Commission, but the increased number of additional fixed expenditure positions introduced in the past two years constitutes a significant fiscal risk in case of a cyclical economic slow-down.

Strong economic growth will likely moderate. GDP growth may have peaked in mid-2018, but it is expected to remain robust over the forecast horizon. Amid increasing inflation, household consumption will likely soften to some extent, but the tightening labour market, noticeable largely in rising wages, will keep it at a high level. Investment is expected to continue its recovery, in particular in the public sector. Nevertheless, a possible delay in the recovery in private investment of domestic companies constitutes a downside risk to that scenario. Global trade disruptions contribute also to that uncertainty. As a result, GDP growth in 2018 is forecast to reach 4.7 per cent and to slow down to 3.6 per cent in 2019.

Assessment of transition qualities (1-10)



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Major structural reform developments

Judicial reform has raised controversy, seen as undermining the independence of the judiciary. The ongoing reform of the judiciary, including of the Supreme Court, the National Council for the Judiciary and the organisation of ordinary courts, has been seen by relevant international organisations as undermining the independence of the judiciary. The European Commission submitted in December 2017 a reasoned proposal to the Council inviting it to adopt a decision under Article 7(1) of the Treaty on European Union. The General Affairs Council (GAC) held two hearings under Article 7(1) TEU on the rule of law in Poland, in June and September 2018. The Commission also launched an infringement procedure against Poland concerning the law on ordinary courts (December 2017) and an infringement procedure regarding the law on the Supreme Court (July 2018). The United Nations, the Organisation for Security and Co-operation/Office of Democratic Institutions and Human Rights and the Council of Europe have also voiced their concerns, as have Polish judges. The Polish Supreme Court appealed to the European Court of Justice (ECJ) to rule on the legality of some of the changes adopted by the law on the Supreme Court. The government of Poland has, nevertheless, considered those concerns to be unjustified and has proceeded with the judicial reform.

New taxes are being introduced. The government plans to introduce several new taxes in 2019, such as a solidarity tax, an emissions charge on the fuel price, a removal of the limit on social security contributions and the so-called exit tax. The solidarity tax would be paid on any income over PLN 1 million (about €230 million) a year as a way to finance more spending on disabled persons, following protests by this group in early 2018. The emissions charge is expected to support the so-called Low Emission Transport Fund, which will finance environmentally friendly investments, largely aimed at reducing air pollution. The removal of the limit on social security contributions will force taxpayers to continue paying contributions even if their income exceeds 30 times the average. Lastly, the exit tax will be payable on unrealised capital gains on assets that would be transferred abroad.

Use of cohesion policy funds has been moderate. In the 2014-20 budget, Poland was allocated €86 billion of EU funds, which represents about 2.8 per cent of GDP annually. By the end of 2017, about 55 per cent of the funds had already been allocated to projects on the ground. About €3.4 billion is expected to be delivered via financial instruments, which is three times more than in the previous budget.

Public spending on healthcare is being reformed. In June 2018 the government approved an amendment to the healthcare legislation to gradually increase public spending on health from the current 4.7 per cent to 6.0 per cent of GDP by 2024. The amendment law was a pledge to resident doctors in order to end a strike over low pay in late 2017. The number of practising doctors and nurses relative to the population remains among the lowest in the EU, which has negative implications for access to healthcare. Without a significant increase in the tax wedge, a jump in healthcare spending of this scale will require a major change in the health funding system, which today is directly linked with tax-like contributions.

The new posted worker directive is expected to affect Poland the most among the EU member states. In June 2018, the European Council adopted posted worker rules, which will limit posted work to 12 months, with a possible extension by an additional six months. Afterwards, the posted workers will need to be hired under local conditions, including higher social insurance payments to the host country. Poland, together with Hungary, voted against that approval, which will come into effect after a two-year adjustment period. Out of the estimated 2 million posted workers in the EU, Poland accounts for some 22 per cent of them.

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Gas import dependence on Russia is falling. According to PGNiG, the state-controlled natural gas company, the reliance on imported natural gas from Russia was reduced from 90 per cent in 2015 to 70 per cent in 2017. The reduction was possible through increased liquefied natural gas (LNG) imports from Qatar via the new LNG terminal on the Baltic Sea, opened in late 2015. The expected additional LNG gas imports from the United States of America, together with the imports from Norway through the Baltic Pipe, to be ready in October 2022, are expected to cover all of the country's gas consumption needs by the end of 2022.

Measures to increase savings and pensions are being introduced. Following the initial declaration in mid-2016, the Employee Capital Plan (PPK) scheme was officially announced by the prime minister in February 2018. The main goal of the scheme is to increase the low domestic savings, as participants will put aside between 0.5 and 4.0 per cent of their income, topped up by an additional 1.5 per cent to 4.0 per cent by the employer, and some additional money by the state. The additional money saved by participants is aimed to partially offset the expected low pension replacement rates. The PPK was approved by parliament in October 2018 and it is expected to gradually enter into force from June 2019, starting with the biggest companies.

The government has introduced new incentives for investment. In May 2018 parliament approved a bill that simplifies the current system of 14 special economic zone tax incentives. Tax breaks will be given to investors for 10 to 15 years, and the size of the relief will depend on different factors, such as the site of the investment, its nature and the quality of employment created. The government wants to attract more investment, in particular related to know-how transfer, research and development and cluster development, mainly in less-developed regions.

SLOVAK REPUBLIC

Highlights

- **Recent GDP growth has been driven by several components.** Household consumption, investment and exports all supported GDP growth in 2017 and further in the first half of 2018. Investment benefited from strong credit growth and extended production capacity in the car industry.
- **Major education reforms are being developed.** A 10-year national programme for the development of the education sector has been launched with the main aim of easing over the long term the mounting skills mismatch problem in the labour market.
- **The ease of doing business is improving.** A package of 25 measures to improve the ease of doing business was approved by the government. It is mainly intended to improve conditions for family businesses and to reduce red tape for employers.

Key priorities for 2019

- **The booming credit market should be carefully monitored.** The annual double-digit growth of credit to the private sector, in particular mortgage lending, over the past 10 years may pose financial stability risks.
- **Labour market shortages should be addressed through short-term, as well as long-term, measures.** Recent labour market and education reforms are steps in the right direction but will take time to yield full benefits, so more rapid measures such as relaxed migration policies may be required to counterbalance the current record-high skilled labour needs.
- **Trust in the judiciary should be enhanced.** The Slovak Republic remains one of the lowest-ranked European Union (EU) member states in terms of perceived independence of the judiciary. Among other measures, the appointment process of judges, including the security screening, should be strengthened.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.8	3.9	3.3	3.4	3.9
Inflation (average)	-0.1	-0.3	-0.5	1.4	2.7
Government balance/GDP	-2.7	-2.7	-2.2	-1.0	-0.8
Current account balance/GDP	1.1	-1.7	-2.2	-2.0	-1.8
Net FDI/GDP [neg. sign = inflows]	-0.5	-0.1	-0.8	-2.0	-1.5
External debt/GDP	90.0	85.2	90.9	110.8	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	50.9	53.9	57.3	60.1	n.a.

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Macroeconomic performance

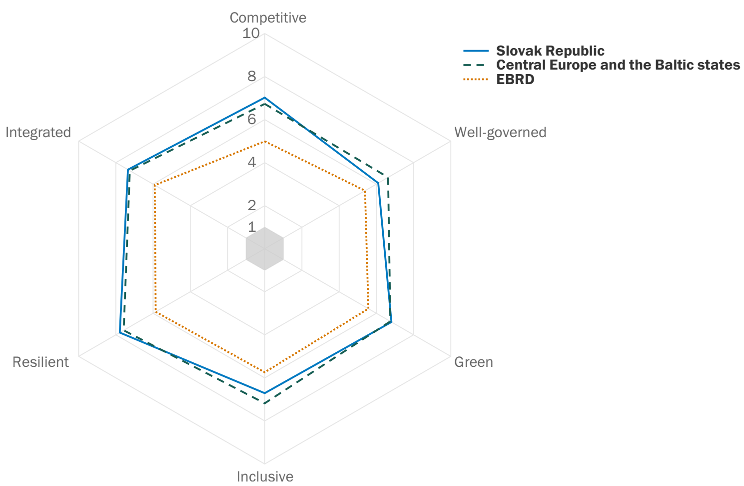
Household consumption and investment are keeping GDP growth strong. The economic expansion of recent years accelerated to 3.2 per cent in 2017 and to 3.9 per cent in the first half of 2018. GDP growth has been fairly balanced, underpinned by a further strengthening of household consumption and buoyant investment. Net exports have positively contributed to GDP growth, benefiting from strong external demand and extended production capacity in the car industry.

Credit to the private sector has experienced double-digit growth. Even though mortgage credit growth slowed somewhat as a result of the recently introduced macro-prudential measures, overall credit to the private sector rose by 11.6 per cent in 2017 and further by 10.0 per cent year-on-year in the first half of 2018. Its overall stock exceeded 60 per cent of GDP in mid-2018, with household credit comprising two-thirds of it. On the demand side, this development is supported by robust economic growth, accommodative monetary policy by the European Central Bank and the preference of households and businesses to lock in lower borrowing costs for longer maturities. On the supply side, the low interest margins have put downward pressure on the profitability of the banking sector, thus encouraging increased volume amid further eased credit conditions. According to a recent IMF study, private sector indebtedness has become higher than levels implied by economic fundamentals. Therefore, further tightening of macro-prudential measures should not be ruled out.

Record-high skilled labour shortages are a bottleneck for the booming economy. While the unemployment rate dropped to below 7 per cent in mid-2018, the share of long-term unemployed stood at 63 per cent of the total unemployed, which is one of the highest rates in the EU. The high levels of structural unemployment and skills mismatch exacerbate the already-persisting labour shortages, which have ballooned over time, largely triggered by significant gaps in the quality of education. The recently launched education reform (see below) is designed to ease the pressures in the labour market, but positive results are likely to be in the long term only.

Domestic demand will likely remain the key growth engine. This year, GDP growth is forecast to reach 3.9 per cent, rising marginally to 4.0 per cent in 2019. Investment is expected to remain solid, underpinned by the anticipation of faster EU funds utilisation and a further expansion of production capacities in the car industry. Labour shortages will contribute to rising nominal wages and, as a result, household consumption will remain strong, only slightly held back by growing inflation. On the downside, the rising trade protectionism constitutes a direct risk for the export-oriented Slovak economy. Long-term growth will strongly depend on ultimate solutions to structural challenges, in particular in the labour market.

Assessment of transition qualities (1-10)



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Major structural reform developments

A major education reform will address labour shortages. In June 2018, the government approved a 10-year national programme for the development of the education sector. The programme consists of five action plans, containing 106 measures split into three areas: regional education, university education and lifelong learning. A large part of the reform is devoted to inclusive education, such as the integration of marginalised Roma communities and pupils from socially disadvantaged environments. The reform is also aimed at increasing the attractiveness of the teaching profession, including through expanding the number of professional staff at schools as well as providing higher teachers' wages. The reform is expected to cost €9 billion over the next 10 years. The quality of the education system does not effectively address the country's regional disparities. In 2017, 17.7 per cent of the youth population (aged between 15 and 24) living in the eastern part of the Slovak Republic were neither in employment nor in education, compared with 7.9 per cent in the capital, Bratislava.

Further measures to soften the tight labour market have been introduced. As skilled-labour shortages have been a key problem impeding stronger industrial production, the government approved in February 2018 the establishment of a new advisory body: a government council for employment development. The council will have three key tasks: first, to monitor the current situation in the labour market and to provide recommendations to the respective ministers; second, to work on measures to boost the supply of qualified labour and address the sources for its shortage; and third, to coordinate the policies of the individual ministries. Also, in October 2018, the government approved a new strategy to simplify the conditions for employing skilled workers from non-EU countries. This streamlining only applies to designated professions where labour offices record a lack of qualified workers and for regions with unemployment rates below 5 per cent.

The business environment is expected to improve. A package of 25 measures to improve the ease of doing business in the Slovak Republic was approved by the government in May 2018. It is mainly intended to improve conditions for family businesses and to reduce red tape for employers. The proposed measures include a reduction of interactions between businesses and public administration, which involves the "once only" principle, now enshrined as an EU standard. As a result, an obligation to submit certain documents that are accessible from public registers should be eliminated. Also, the package envisages a simplification of social security procedures, as well as accelerated procedures for granting temporary residence to foreigners. In the World Bank's *Doing Business 2019* report, the Slovak Republic took 42nd position out of 190 countries.

Public procurement law is being amended. In August 2018, an amendment to the law on public procurement was approved by the government. The bill is intended to accelerate tenders, increase transparency and preserve participants' rights. If successfully implemented, it will make public spending more efficient, including through better utilisation of EU funds. By the end of September 2017, the Slovak Republic had absorbed only about 14 per cent of EU funds in the current budget through 11 operational programmes (OPs). The highest share has been drawn under OP Integrated Infrastructure.

Conditions for granting regional investment assistance have been revised. The new law, which was adopted by the government in February 2018, is intended to address regional disparities as well as to attract investors in higher value added activities. The approved changes envisage, among others, a removal of the requirement for job creation in industrial projects. In case of direct investment aid for industrial projects in developed regions with low unemployment, the priority is to support investment into high-tech industries and innovative technologies. The favoured type of aid will be a tax relief. Also, investments by small and medium-sized enterprises will be preferred. Research and development business enterprise expenditures in the Slovak Republic represented only 0.4 per cent of GDP in 2016, substantially below the EU average of 1.3 per cent.

North-South gas market integration has progressed. In May 2018, gas transmission operators, the Polish Gaz-System and the Slovak Eustream, signed an agreement to construct a 165-km long gas interconnection. Earlier this year, Eustream and Transgaz, a Romanian gas transport operator, signed a Memorandum of Understanding in February 2018 to construct a gas interconnection with the Slovak Republic. Both pipelines will be crucial parts of the North-South gas interconnections, which will provide a direct link between the liquid western Europe markets, including from Norway, and the Balkans and Turkey. This way, regional security of supply as well as natural gas markets integration will be enhanced. The project was granted EU support under the Connecting Europe Facility in December 2017. The construction is expected to be completed by the end of 2021.

SLOVENIA

Highlights

- **Strong growth in 2017 has continued into 2018.** GDP growth accelerated to 4.9 per cent in 2017, mainly on strong investments and exports. Despite decelerating in the first half of 2018, the growth rate remained strong at 4.2 per cent.
- **Slovenia has exited the European Union (EU)'s Macroeconomic Imbalances Procedure.** This reflects significant progress in fiscal consolidation (including a balanced budget in 2017), and important improvements in bank resolution and corporate deleveraging.
- **Privatisation continues to advance slowly.** The government has committed to privatise the country's largest bank, NLB, but progress with the sale of state-owned enterprises in the privatisation plan has been limited.

Key priorities for 2019

- **Further fiscal adjustments are needed to reduce public debt sustainably.** In light of still-high public debt levels, the authorities should keep expenditure growth under strict control to achieve their medium-term fiscal targets, while an ageing population highlights the need to reform the pension, health and long-term care systems.
- **Simplifying corporate ownership structures in the state sector and stepping up privatisation would enhance competitiveness.** Privatisations continue to lag behind schedule and need to be accelerated, while tackling cross-ownership among Slovenian companies would lead to better corporate governance.
- **Corporate over-indebtedness calls for more capital market financing (primarily equity) and governance improvements.** The country has one of the highest ratios of long-term debt of over-indebted companies to GDP among central and eastern European countries, preventing companies from operating more efficiently.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.0	2.3	3.1	4.9	4.2
Inflation (average)	0.2	-0.5	-0.1	1.4	1.9
Government balance/GDP	-5.5	-2.8	-1.9	0.1	0.6
Current account balance/GDP	5.8	4.5	5.5	7.2	7.5
Net FDI/GDP [neg. sign = inflows]	-1.6	-3.3	-2.1	-1.0	-1.2
External debt/GDP	125.6	120.0	111.0	101.9	n.a.
Gross reserves/GDP	2.2	2.0	1.7	1.7	n.a.
Credit to private sector/GDP	54.5	49.9	46.7	44.8	n.a.

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Macroeconomic performance

The economy grew strongly in 2017. Growth rose to 4.9 per cent in 2017 (from 3.1 per cent in 2016) on the back of increased investment and exports. Investments jumped by more than 10 per cent as public investments recovered with the start of the new EU funding cycle, while double-digit growth in exports was supported by strong demand from the eurozone. Consumption growth continued at around 2.0 per cent, reflecting favourable labour market trends and improved consumer confidence. At the same time, higher domestic demand and more intense export activity was accompanied by a significant increase in imports (above 10 per cent). Economic growth eased to 4.2 per cent year-on-year in the first half of 2018, mainly as a result of somewhat-weaker exports, but investment growth remained strong.

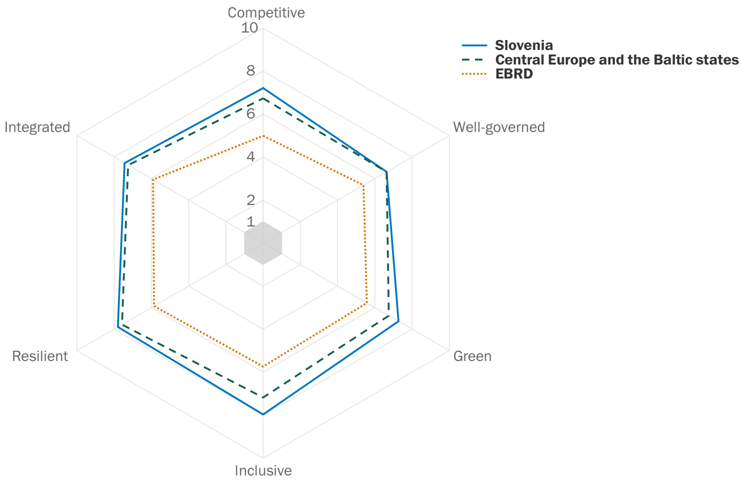
Labour shortages have become more prevalent. Economic recovery led to a fall in the unemployment rate to below 6.0 per cent in the first half of 2018 (from around 10.0 per cent in 2014), while employment growth averaged 2.8 per cent in 2017, the highest rate since 2007. As a result, the share of enterprises reporting a shortage of workers has risen to levels similar to those before the crisis in 2008-09. Slovenian employers face particular difficulties in recruiting highly skilled professionals, despite the increase in hiring of foreign workers.

Inflation has picked up but remains low. After a two-year period of deflation, inflation rose to 1.4 per cent in 2017 and 1.7 per cent in the first nine months of 2018, primarily on the back of higher oil prices.

The fiscal position has improved, but the long-term sustainability of public finances remains a major challenge. The general government budget was in a (slight) surplus (0.1 per cent of GDP) in 2017 for the first time since independence. The improvement in the fiscal position came as a result of expenditure restraint, the strong cyclical growth in revenues, and the reduction in the interest payment burden on outstanding debt. The budget balance improvement and strong nominal GDP growth led to a significant decline (around 4.5 percentage points) in the ratio of public debt to GDP in 2017. However, despite falling further, at 72.8 per cent of GDP in June 2018, the debt level is still high and there are calls for additional measures, especially in view of the ageing population and consequent future demand on social security programmes and health care.

Growth is likely to moderate in the medium term. Slovenia's economy is projected to grow more slowly in 2018 and 2019, at 4.2 and 3.3 per cent, respectively, as temporary effects of the new EU funding cycle subside and the economy reaches its potential. The downside risks come from possibly weaker demand from Slovenia's main trading partners, high corporate over-indebtedness as well as slow structural reforms and privatisation. However, a stronger than envisaged government investment cycle and growth in private consumption could push up short-run growth rates above projections.

Assessment of transition qualities (1-10)



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Major structural reform developments

The business environment remains problematic in some areas. According to the World Bank *Doing Business 2019* report, Slovenia ranks 40th out of 190 countries, three places down from the year before. The largest deterioration was reported in dealing with construction permits, where the country now occupies 120th position. The two other, similarly problematic areas are getting credit (112th) and enforcing contracts (110th), although in the latter the country has made some progress over the past year, by introducing a pre-trial conference as part of case management techniques used in court. According to the World Economic Forum *Global Competitiveness Report 2018*, the country's competitiveness remained unchanged. Slovenia ranks 35th out of 135 countries.[1] The biggest obstacles to improving competitiveness further are the financial system (with room for improvement in the areas of market capitalisation, soundness of banks and non-performing loans) and the insufficiently flexible labour market.

Slovenia has exited the EU's Macroeconomic Imbalances Procedure (MIP). The country had been under the MIP since April 2013 due to risks from corporate indebtedness, financial stability and slow progress in privatisation. According to the European Commission, Slovenia has made significant progress in fiscal consolidation, bank resolution and corporate deleveraging.

The processes of privatisation of NLB and Abanka have started. A decision in July 2018 by the interim government to sell 50 per cent of NLB, the country's largest state-owned bank, by the end of 2018 and another 25 per cent by the end of 2019 was well received by the European Commission, which set it as one of the key requirements when approving the bank's bailout in 2013. A controlling 25 per cent plus 1 share is to be kept by the state in the long term. In October 2018, the State Sovereign Holding (SSH) endorsed an initial public offering of NLB and also published an invitation to investors to express interest in Abanka, after which qualified investors will be able to submit their bids. Abanka has been state-owned since its bailout in December 2013 and, similar to NLB, the bank's sale (by mid-2019) was a key condition for the European Commission's approval of state aid. In addition, the SSH and NLB announced their intention to list NLB shares on the Ljubljana and London Stock Exchanges, while a total of 10 per cent of NLB shares should be offered to small investors in Slovenia.

The profitability of state-owned enterprises (SOEs) improved in 2017 but privatisation has progressed slowly and ownership structures remain complex. Slovenia still has a large state-owned sector, with assets of SOEs (including financial sector) exceeding 135 per cent of GDP in 2016. The SOEs' return on equity increased slightly in 2017 (to 6.1 per cent), but remained below the target (7.1 per cent) set in the State Assets Management Strategy. In 2017, only two significant privatisation deals were completed (Cimos and Paloma), both in the first half of the year, while out of 14 SOEs in the 2018 privatisation plan, a Sale and Purchase Agreement was concluded for only two companies in minority state ownership (Casino Bled and Central Securities Clearing Corporation KDD). Furthermore, corporate governance and ownership structures are complex (often with several state-owned companies cross-owning each other), which holds back their efficiency. In line with the Slovenian Compensation Fund Act, SSH transferred €200 million of capital assets to the Republic of Slovenia at the end of 2017, and further transfers are envisaged to take place in 2020.

[1] The rating for 2017 reflects the change in the methodology. According to the old methodology Slovenia was ranked 48th in 2017.