ALBANIA

Highlights

- **Robust economic growth is continuing.** GDP grew by 3.8 per cent in 2017, driven equally by private consumption and investment. Monetary policy remains accommodative, while fiscal deficits have been reduced.
- **EU approximation is advancing.** The European Council at its meeting in June 2018 set out the path towards opening EU accession negotiations with Albania in June 2019, subject to further progress in reforms.
- **Consolidation in the banking system is taking place.** The banking sector now comprises 14 banks, two fewer than in mid-2017. In addition, two other banks are in the process of changing owners.

Key priorities for 2019

- **Power sector reforms should be pursued vigorously.** In the short term the priorities are to further liberalise the market, enforce payment discipline in state-owned companies, and improve the regulatory framework to ensure cost-reflective tariff-setting.
- **Infrastructure projects should be carried out transparently.** Albania's requirements in areas such as roads, railways and ports remain numerous, but it is vital that investment projects are tendered according to best practice competitive rules and standards.
- **Factors holding back credit growth should be tackled.** Non-performing loans have declined but remain high by regional standards and are holding back credit growth; efforts to reduce them further should be intensified.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.8	2.2	3.4	3.8	4.0
Inflation (average)	1.6	1.9	1.3	2.0	2.3
Government balance/GDP	-5.5	-4.1	-1.8	-1.4	-2.2
Current account balance/GDP	-10.8	-8.6	-7.6	-6.9	-7.1
Net FDI/GDP [neg. sign = inflows]	-8.1	-8.0	-8.7	-8.4	-6.9
External debt/GDP	56.1	63.0	61.9	63.2	n.a.
Gross reserves/GDP	20.4	27.5	26.1	27.1	n.a.
Credit to private sector/GDP	39.4	37.5	34.4	32.2	n.a.

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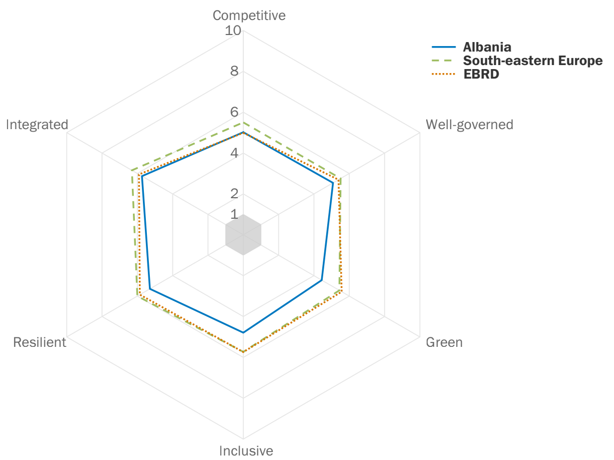
Macroeconomic performance

The economy continues to grow strongly. GDP grew by 3.8 per cent in 2017, following 3.4 per cent in 2016. Growth in 2017 was driven equally by private consumption and investment. The construction of two major energy projects, namely the Norwegian investment in hydropower plants on the river Devoll and the Trans Adriatic Gas Pipeline (TAP), was the main contributor to overall investment, although the direct economic impact on GDP is expected to decelerate in the short term (construction continued to slow down in the first quarter of 2018, following its peak in the first half of 2017). Economic activity accelerated in the first half of 2018, with growth reaching 4.4 per cent year-on-year, driven mainly by industry (including electricity production, fuelled by heavy rainfall particularly during the second quarter following a prolonged drought in the second half of 2017), which contributed more than half of value added.

Further monetary easing has occurred amid a strengthening currency. Average inflation in 2017 was just 2 per cent, once again below the central bank's target of 3 per cent, and has continued to be below the target in the first half of 2018. In response, the Bank of Albania made another cut to its key policy rate by 0.25 percentage points in June 2018 to 1 per cent, a new historical low. The central bank's low interest rate policy in recent years has supported the overall lowering of interest rates across several segments of the financial market, thus stimulating private domestic demand to some extent. However, lending remains sluggish, especially for business loans. Meanwhile the lek has been appreciating against the euro in recent years, and particularly during 2018, providing a further justification for the policy rate cut. This reflects the ongoing de-euroisation policy initiative of the central bank in the financial sector, as well as the capital conversion of some banks (see below) and a good tourism season. Some unrecorded cross-border activities may also be contributing to the appreciation pressures. In early June 2018 the Bank of Albania intervened in the market to dampen these pressures.

Fiscal policy continues to be prudent. Restoration of a significant degree of fiscal stability was among the major achievements of the authorities in the past few years, assisted by an IMF programme which ended in early 2017. The 2017 budget deficit was 1.4 per cent of GDP, the lowest level in the last two decades, while the government's 2018 budget targets a deficit of 2 per cent of GDP. The government is taking steps to reduce public arrears further, especially those related to VAT reimbursements and local government arrears, particularly of the capital Tirana. Public debt had fallen to approximately 70 per cent of GDP as of the end of 2017, and is equally divided between external and domestic creditors, but recently signed infrastructure projects under a public-private partnership (PPP) framework are adding to potential public debt liabilities in the future.

Assessment of transition qualities (1-10)



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The short-term outlook remains positive but risks remain. Growth of 4.0 per cent is expected in 2018, with a similar rate (3.9 per cent) projected for 2019. 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 non-performing loans (NPLs) in the banking sector. Private consumption and investment are expected to remain the main drivers of growth, both having a boost from increased confidence. The economy will likely benefit from enhanced foreign investor interest, especially if there is further progress in the EU approximation process. However, downside risks remain, associated with the embedded structural weaknesses in public administration and infrastructure, the potential slow-down of the reforms due to internal political tensions, as well as vulnerability to external shocks in Albania's main economic partner, the eurozone.

Major structural reform developments

The European Commission has recommended the launch of EU accession talks with Albania. In April 2018 the European Commission (EC) issued the recommendation to open EU accession negotiations with Albania. The European Council at its meeting in June 2018 set out the path towards opening EU accession negotiations in June 2019, subject to further progress in reforms. Meanwhile, the EC has launched the screening process to evaluate the readiness of the country to start accession talks, with a focus on the crucial rule of law chapters 23 and 24 of the EU's *acquis communautaire*. Albania applied for EU membership in 2009 and has been an EU candidate since June 2014. The speed of EU approximation remains conditional on (among other things) tangible progress in implementing judicial reform, in particular with regard to the law on re-evaluation of judges and prosecutors, known as the vetting law, and progress in the fight against corruption and organised crime. The EC has also urged the government to pursue civil service reform, including a change of their recruitment model, basing it fully on candidates' professional achievements (rather than on their political orientation, as is currently sometimes the case).

Progress in business environment reforms has been mixed. The country was ranked 63rd overall (out of 190 countries) in the World Bank *Doing Business 2019* report, two places up from a year ago, and more than 20 places higher than a few years ago. The most notable reform over the past year registered in the report was in enforcing contracts, as Albania made this area easier for doing business by amending the code of civil procedure, thus establishing a simplified procedure for small claims and introducing time standards for certain court events. However, the most problematic areas, according to the report, are still in the areas of enforcing contracts, dealing with construction permits and getting electricity.

Plans to develop renewable energy sources are advancing. In August 2018 the government invited bids for a 50 MW photovoltaic solar power plant near the southern coastal city of Vlora. Albania relies entirely on hydropower production, but the government is moving forward with its plans to diversify renewable sources by targeting the implementation of 120 MW of solar and 70 MW of wind power capacity by 2020.

The power distribution operator, OSHEE, has started the process of unbundling. The company registered three new companies in April 2018, thus beginning the unbundling process in response to pressure from the Energy Community. OSHEE will operate as the key company managing the three new subordinated companies: the Distribution System Operator, which will manage and operate the power distribution network; the Free Market Supplier, which will manage the unregulated supply and trading of electricity; and the Universal Service Supplier, which will manage the final stage of the power delivery to customers in the regulated market. The government is considering plans to float OSHEE on the stock exchange at some point.

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Major road projects are advancing amid concerns about openness of procurement. In February 2018 the government signed a €240 million contract with local company Gjoka Construction for the construction, operation and maintenance of a section of the Arber road, connecting Tirana with the Macedonian border. Similarly, in July 2018 the government awarded a €225.8 million contract to local company Gener 2 for the construction, operation and maintenance of the Kashar-Thumane motorway, connecting Tirana with the northern part of the country. Both projects are within the framework of the government's €1 billion PPP programme announced in 2017. The scheme, which envisages financing of the construction by contractors and repayment of long-term debt by the government, has been criticised by some observers, including the IMF, because of the potential for hidden liabilities for public finances and the fact that projects are based on unsolicited bids. Meanwhile, an attempt to introduce the first toll road in the country – the Durres-Kukes motorway – initially encountered significant resistance from local communities because of the perceived high cost of the tolls, but came into force in September 2018.

Consolidation and change of ownership in the banking system are ongoing. In the fourth quarter of 2017 the Albanian branches of Intesa Sanpaolo (the fourth largest bank in the country) and Veneto Bank (among the smallest banks in the country) began to merge, a process expected to be completed by the end of 2018. In February 2018 the local American Bank of Investments (ABI) signed an agreement with the National Bank of Greece (NBG) to buy the Greek bank's Albanian branch. In August 2018, FYR Macedonia's Komercijalna Banka signed a binding agreement with Albanian investment group Balfin to acquire together Tirana Bank from Greece's Piraeus Bank. And in August 2018 the Hungarian OTP Bank acquired an 89 per cent stake in Banka Societe Generale Albania, the country's fifth-largest bank with a market share of 6 per cent. OTP Bank expects to close the transaction in the fourth quarter of 2018, pending regulatory approval.

ARMENIA

Highlights

- **Armenia's "Velvet Revolution" resulted in a peaceful transition of power.** The new government of Armenia took early steps to deliver on its declared commitment of fighting corruption, alleviating tax evasion, reducing the shadow economy and tackling monopolisation.
- **Strong GDP growth has been largely unaffected by political developments.** Following a growth stagnation in 2016, economic growth rebounded to 7.5 per cent in 2017 and then to 8.3 per cent in the first half of 2018.
- **The fiscal framework has been refined to strike a better balance between stimulation of growth and public debt reduction.** The new fiscal rule has been introduced with the aim of providing more flexibility for growth-enhancing capital expenditure while keeping current spending in check.

Key priorities for 2019

- **Fostering transparency and demonopolisation are top priorities.** The anti-corruption drive should be pursued vigorously, tax and customs reforms need to focus on transparency, fairness and compliance, while informal barriers to entrepreneurship should be dismantled.
- **More fiscal space is necessary to finance critical public infrastructure upgrades.** To put the public debt-to-GDP ratio on a downward sloping trajectory, Armenia needs to implement the new fiscal rule and boost the tax revenue intake.
- **Armenia needs to develop and implement a comprehensive programme of vertical reforms.** Initial steps taken by the authorities to combat corruption and economic crimes are welcome and should be followed up by sector-specific economic reform plans and prompt execution.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.6	3.2	0.2	7.5	5.5
Inflation (average)	3.0	3.7	-1.4	1.0	3.0
Government balance/GDP	-1.9	-4.8	-5.5	-4.8	-2.7
Current account balance/GDP	-7.6	-2.6	-2.3	-2.4	-3.8
Net FDI/GDP [neg. sign = inflows]	-3.3	-1.5	-2.6	-2.0	-2.5
External debt/GDP	73.6	84.5	94.4	91.2	n.a.
Gross reserves/GDP	12.8	16.8	20.9	20.1	n.a.
Credit to private sector/GDP	48.8	45.6	52.2	52.9	n.a.

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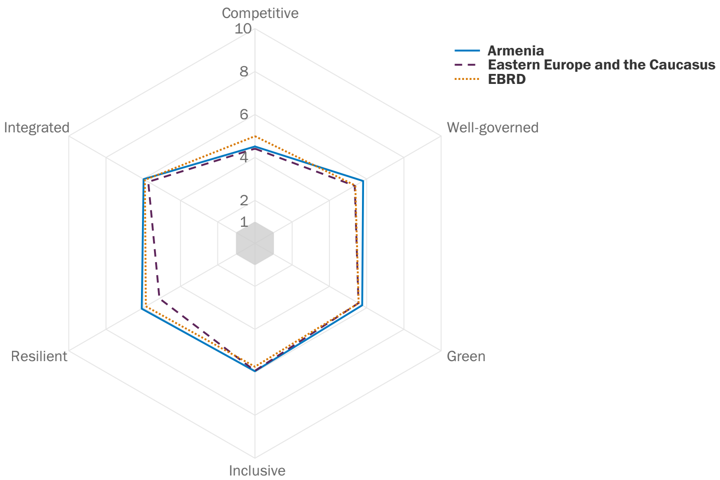
Macroeconomic performance

Armenia's economy is growing at a robust pace despite political uncertainty. GDP growth rebounded from a near-standstill in 2016 to 7.5 per cent in 2017, driven by a combination of strong demand from major trading partners and a recovery in internal consumption and investment. The volume of exports from Armenia increased by approximately 40.8 per cent in 2016-17 in cumulative terms, with the European Union (EU) and Russia accounting for approximately 28 and 24 per cent of goods, respectively, exported from Armenia in 2017. Following two consecutive years of decline, household consumption increased by 8.8 per cent in 2017, supported by a recovery in remittances. In 2017 capital investment recorded growth of 7.7 per cent after eight years of decline (with the exception of 2015 when it grew by 2.5 per cent). From a sectoral perspective, GDP growth in 2017 was broad-based, although agricultural output declined for the second consecutive year. The economic impact of political turmoil and the peaceful revolution was limited in the first half of 2018. GDP growth is estimated at 8.3 per cent year-on-year in this period. Capital investment and exports expanded by 14.7 per cent and 9.7 per cent, respectively, in the first half of 2018.

The macroeconomic environment remains generally sound. The current account deficit-to-GDP ratio averaged approximately 2.4 per cent in 2015-17. This is significantly lower than the 9.8 per cent averaged in the period 2010-14. Money transfers to Armenia increased by approximately 14.6 per cent in 2017 and by 4.9 per cent year-on-year in the first eight months of 2018. The dram remained stable against the US dollar in the first nine months of 2018. Gross international reserves stood at US$ 2.1 billion in September 2018, providing approximately four months of imports coverage. Inflation is gradually picking up although, at 2.6 per cent in the first nine months of 2018, it remains below the central bank's target of 4.0 per cent. Monetary policy remains relatively loose with the central bank's policy rate at the lowest level since the beginning of 2010. The budget deficit widened to 5.5 per cent of GDP in 2016 before declining to 4.8 per cent of GDP in 2017 (including a large one-off military loan of approximately 1.5 per cent of GDP). The public debt-to-GDP ratio increased to approximately 59 per cent in 2017. To put it on a declining path, the Armenian authorities have attempted fiscal consolidation with a plan to bring down the budget deficit to around 3 per cent of GDP in 2018.

The economy is set to maintain strong growth momentum. Real GDP is forecast to grow by 5.5 per cent in 2018 and by 5.0 per cent in 2019. The near-term economic outlook is shaped by a relatively benign external environment and the expected positive growth effects of ongoing governance reforms. At the same time, downside risks come from the exposure of the economy to fluctuations in commodity prices, both directly through copper exports, and indirectly through the impact on major economic partners.

Assessment of transition qualities (1-10)



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Major structural reform developments

The new government is tackling deep-seated governance problems. The government has pledged to root out corruption, decrease the size of the shadow economy, boost tax revenues (at 22.9 per cent of GDP, one of the lowest ratios in the region) and tackle monopolies. A series of high-profile corruption and tax evasion inquiries as well as arrests have been made against former public officials and politically connected business representatives. A number of customs brokerage firms have been prosecuted for tax evasion and fraud as part of the efforts to tackle informal monopolies on imports and customs corruption. According to the authorities, more than US$ 42 million of unpaid taxes was recovered from 73 companies by mid-July, which is approximately 1.6 per cent of tax revenue in 2017.

The authorities have adopted a new fiscal rule. The new rule, effective from January 2018, is designed to curb current spending while leaving more flexibility for the implementation of growth-enhancing investment projects in case public debt levels exceed the preset threshold. Under the new rule, if the government debt-to-GDP ratio exceeds 40 per cent, the government will be allowed to run a fiscal deficit exclusively for financing of capital expenditures. If the ratio rises above 50 per cent, the government will be further required to cap current spending and develop a medium-term plan to lower the debt burden. In addition, if public debt surpasses 60 per cent of GDP the government will need to link current expenditures to tax revenues and submit a remedial action plan to the parliament. Escape clauses were introduced for extreme cases (such as natural disasters, wars or economic shocks). New budget allocation rules that incentivise competitive procurement through the new e-procurement system will foster spending efficiency.

A mandatory funded pension system has come into effect for all workers. The new system is in place for private sector workers from July 2018, having become compulsory for public sector employees in 2014. Implementation for private sector workers had been kept optional until July 2018 due to a strong public outcry when first introduced. At this initial stage, employee contributions into an individual savings account will amount to 2.5 per cent of their salary and will be matched by a 7.5 per cent contribution from the state. Retirement savings are to be placed into one of two approved asset management providers and invested into both local and foreign financial assets.

Armenia has completed its inaugural renewable energy auction. The winner of the international tender for construction of a solar plant in Armenia was announced in March 2018 and the agreement signed in July 2018. This is the first instance of attracting private sector participation in renewable energy development through a competitive international auction in eastern Europe and the Caucasus (EEC). Once installed and operational, the solar power plant will contribute towards the diversification of Armenia's energy sources.

A Comprehensive and Enhanced Partnership Agreement (CEPA) with the European Union has been provisionally applied from 1 June 2018. The Armenian parliament had previously ratified the CEPA in April 2018. Priority areas of cooperation include: strengthening institutions and good governance; economic development and market opportunities; connectivity, energy efficiency, environment and climate action; and mobility and people-to-people contacts.

AZERBAIJAN

Highlights

- **Azerbaijan's economy escaped recession in 2017.** GDP grew by 0.1 per cent in 2017 following a 3.1 per cent contraction in 2016. In the first nine months of 2018, output has continued to rise slowly, supported by growth in the non-oil sector.
- **Strategic energy projects reached important milestones.** The first commercial gas deliveries were made from the new Shah Deniz 2 gas field to Turkey. Azerbaijan has extended the Production Sharing Agreement with a consortium of international energy companies for the management of the country's largest oil field.
- **New public agencies were set up to support the non-oil private sector, although their effectiveness is yet to be tested.** The newly established agencies aim to promote food safety standards, improve regulation of the energy sector and support the development of small and medium-sized enterprises, including by lowering their borrowing cost through unfunded risk participation.

Key priorities for 2019

- **Investment climate reforms should build on recent positive changes.** Tax administration reform should be one of the reform priorities, with an emphasis on enhancing predictability of taxation and shrinking the size of the shadow economy through improving taxpayer compliance, expanding the tax base and reducing tax exemptions.
- **Decisive steps are needed to finalise banking sector restructuring.** Privatisation of the International Bank of Azerbaijan is one of the key priorities for lowering risk in the banking system and should be pursued without delay. The large stock of non-performing loans (NPLs) needs to be resolved, capital deficiencies in some banks addressed, and the independence and operations of the financial regulator (FIMSA) strengthened.
- **To fulfil their mandate, the newly established state agencies need to develop stronger institutional capacity.** Recently established public agencies are generally understaffed and lack both expertise and a sound operational framework. The authorities should take the necessary steps to ensure transparency and effectiveness of their operations.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.8	1.1	-3.1	0.1	1.5
Inflation (average)	1.4	4.0	12.4	12.9	3.5
Government balance[1]/GDP	2.7	-4.8	-1.2	-1.7	4.8
Current account balance/GDP	13.9	-0.4	-3.6	4.1	6.6
Net FDI/GDP [neg. sign = inflows]	-2.9	-1.5	-5.1	-0.7	-3.5
External debt[2]/GDP	14.5	18.5	20.4	n.a.	n.a.
Gross reserves[3]/GDP	18.3	9.5	10.5	13.1	n.a.
Credit to private sector/GDP	31.4	40.0	27.2	16.8	n.a.

[1] Includes central government and main extrabudgetary funds, including operations of the oil fund and the social protection fund. Figures for 2016 and 2017 are a projection.
[2] Public and publicly guaranteed external debt outstanding.
[3] Excluding assets of the State Oil Fund (SOFAZ).

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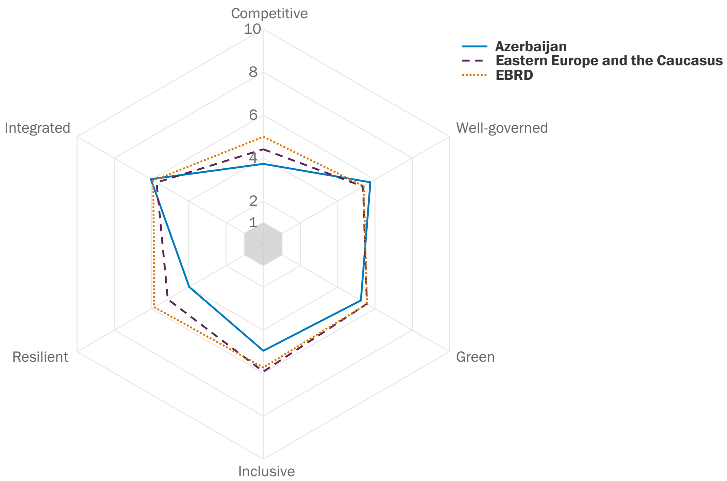
Macroeconomic performance

The economy has started growing slowly. After the GDP decline in 2016, economic growth was nearly flat at 0.1 per cent in 2017. The stabilisation of the economy was driven by a recovery in non-oil GDP, which grew by 2.7 per cent. In the first nine months of 2018, the economy expanded by 0.8 per cent year-on-year, although non-oil GDP growth slowed to 1.0 per cent year-on-year. Overall capital investment is in the fifth consecutive year of decline, although in the non-oil sector investment in fixed assets has posted growth in the first nine months of 2018. Inflation fell from an average of 12.9 per cent in 2017 to 2.6 per cent year-on-year in the first nine months of 2018, paving the way for looser monetary policy. The Central Bank of Azerbaijan (CBA) lowered the refinancing rate four times from 15 per cent in February 2018 to 9.75 per cent in October 2018.

The higher oil price is driving stronger external balances. Since April 2017, the manat-US dollar exchange rate has been maintained within a very narrow fluctuation band despite the recovery in the oil price. The current account switched from a deficit in 2016 to a surplus of 4.1 per cent of GDP in 2017 on the back of higher hydrocarbon revenues. In the first half of 2018, the current account surplus surged by growing more than fourfold compared with the first half of 2017. External trade trends were also positive outside of the oil and gas sector, supported by competitiveness-enhancing real devaluation of the manat in recent years. Exports of non-oil goods and services increased by 15.6 per cent in 2017 and by 19.5 per cent year-on-year in the first half of 2018, both in nominal US dollar terms, but their overall volume remains low compared with exports of hydrocarbons. Official foreign exchange reserves of the CBA are slowly recovering from US$ 4 billion in December 2016 to US$ 5.5 billion as of September 2018, covering 3.8 months of imports. Assets of the State Oil Fund of Azerbaijan (SOFAZ) increased from US$ 33.1 billion in 2016 to US$ 39.0 billion in the third quarter of 2018, providing a significant liquidity buffer.

Economic recovery is expected to continue in the absence of further commodity price shocks. Real GDP is forecast to grow by 1.5 per cent in 2018 and by 3.5 per cent in 2019. Near-term growth prospects are supported by a relatively stable oil price trend and ongoing expansion of gas production and export capacity. Recent moderate diversification gains augur well for medium-term economic growth but much more needs to be done to bolster the role of the non-oil economy.

Assessment of transition qualities (1-10)



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Major structural reform developments

New agencies have been established to enhance delivery of public services and render assistance to small and medium-sized enterprises (SMEs). In December 2017, the authorities established the Agency for Development of Small and Medium-Sized Enterprises to enhance and better coordinate the provision of public services to SMEs. The agency is planning to expand its geographical coverage by setting up outposts in the regions of Azerbaijan and offer a range of financial and non-financial services, as well as provide information on all other public resources available to SMEs. A Food Safety Agency was set up in the first quarter of 2018. It is aiming to help uphold quality standards and thus improve Azerbaijan's agricultural exports potential. Meanwhile, the state agency for public services (ASAN) has broadened the range of offered services. As of February 2018, ASAN has been issuing energy-related permits. In March 2018 the agency was mandated to implement and regulate state policy on e-government. The institutional capacities of these agencies remain to be tested and are likely to need strengthening over time.

Initiatives to promote the credit flow to the economy have been rolled out but their effectiveness is still uncertain. The credit to GDP ratio declined from approximately 40.0 per cent in 2015 to 16.8 per cent in 2017 due to the contraction in credit activity and IBA balance sheet restructuring. The decline in credit activity levelled off in the first half of 2018, but loan portfolio growth remains subdued. The authorities have taken a number of remedial steps. A credit guarantee fund was established and made operational in the second half of 2017. Entrepreneurs in the non-oil and gas sector are able to apply to the fund for state guarantees and interest rate subsidisation on loans provided by the authorised commercial banks. In December 2017, the Financial Market Supervision Authority (FIMSA) started discussing a new mechanism to encourage restructuring of NPLs. In the first quarter of 2018, the IBA together with seven other banks set up the first private credit bureau. Compared with the existing state-managed credit bureau, the private bureau is expected to cover a larger number of borrowers and to provide more exhaustive information. In March 2018, the state collateral registry for movable assets established by the FIMSA started operating online.

Meaningful progress has been made in strategically important energy projects. The Shah Deniz 2 gas field and South Caucasus Pipeline Expansion (SCPX) were officially inaugurated in May 2018. The second stage of the Shah Deniz gas field development is part of the South Gas Corridor (SGC) project which is set to almost triple Azerbaijan's annual gas production capacity. Another part of the SGC project, the Trans-Anatolian Pipeline (TANAP) which will carry gas from Azerbaijan to Europe, became operational in June 2018. In September 2017 Azerbaijan signed an amended and restated Production Sharing Agreement (PSA) for continued development of its largest oil field Azeri-Chirag-Deepwater Gunashli (ACG), extending the PSA tenure until 2049 and increasing the share of the State Oil Company of Azerbaijan Republic (SOCAR) in the project to 25 per cent. The agreement was ratified by Azerbaijan's parliament in October 2017.

A new energy regulator has been established. In December 2017 the Azerbaijan Energy Regulatory Agency (AERA) was created, in line with the government's Strategic Roadmap on the development of utilities. AERA's goal is to propose and calculate utility tariffs and oversee their implementation. Other objectives include the development of regulator law, currently under preparation, and other measures to promote legislative approximation with EU benchmarks. The regulator is also tasked with enhancing transparency and competition in the utility markets.

BELARUS

Highlights

- **The economic recovery has accelerated.** The economy grew by 2.4 per cent in 2017, following two years of recession, and has picked up speed in the first half of 2018.
- **Inflation has been brought down to its lowest level.** Consumer price inflation averaged 6.0 per cent in 2017 and decreased further to 4.8 per cent in the first nine months of 2018 on the back of prudent monetary, fiscal and credit policies.
- **Work is under way to improve governance and management in the state enterprise sector.** The authorities have rolled out pilot projects on commercialisation of the state road construction holding company and on strengthening the state's ownership function.

Key priorities for 2019

- **Further progress should be made in the modernisation of the financial sector.** The ongoing institutional building and pre-privatisation work in some of the state banks is paving the way for attracting good-quality equity participation by private investors. State lending programmes need to be decreased and, in the near future, fully phased out.
- **The authorities need to undertake benchmark-setting privatisation in the real sector.** A successful entry of a credible international investor in a state-owned company (SOE) would set a precedent that could be replicated by other SOEs, thus enhancing productivity and the role of the private sector.
- **Initial steps to commercialise the state sector need to be scaled up.** Replication of the model state holding company by other SOEs and wider application of OECD corporate governance principles will be necessary to improve the quality of management in the state sector.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.7	-3.8	-2.6	2.4	3.0
Inflation (average)	18.1	13.5	11.8	6.0	5.5
Government balance[1]/GDP	0.1	-3.0	-1.7	-0.3	-2.4
Current account balance/GDP	-6.6	-3.2	-3.3	-1.6	-2.5
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.7	-2.4	-2.2	-2.1
External debt/GDP	50.7	67.5	78.6	73.4	n.a.
Gross reserves/GDP	6.4	7.4	10.3	13.4	n.a.
Credit to private sector/GDP	21.1	23.1	21.2	22.0	n.a.

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

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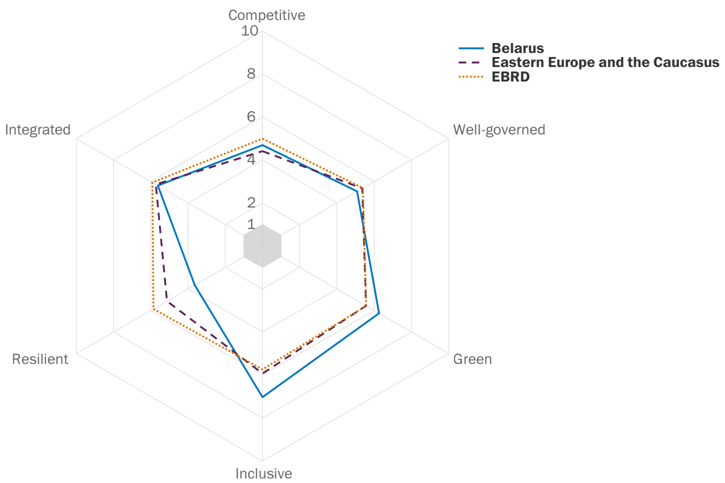
Macroeconomic performance

GDP growth has rebounded after two years of recession. In 2017, GDP expanded by 2.4 per cent, driven mainly by external demand and a recovery in household consumption. Growth of exports in volume terms accelerated from 2.6 per cent in 2016 to 7.3 per cent in 2017. Gross value added (GVA) of manufacturing, the economy's largest sector accounting for over one-fifth of the entire GDP, grew by 6.1 per cent in 2017. Following two years of contraction, household consumption grew by 4.6 per cent supported by a 7.5 per cent increase in real wages in 2017. The low comparison base resulting from the 2015-16 recession also helped boost the 2017 output growth rate. GDP growth is estimated to have gained pace to 3.7 per cent year-on-year in the first nine months of 2018. All main sectors except agriculture recorded positive growth rates in this period.

Low inflation and a stable exchange rate attest to well-calibrated macroeconomic policies. Near-term balance of payments pressures have abated as the authorities resolved the energy dispute with Russia in the first half of 2017 and repeatedly tapped the international capital markets, including the most recent Eurobond issuance in February 2018 for the total principal amount of US$ 0.6 billion. International reserve assets increased to US$ 7.2 billion in the beginning of September 2018, covering approximately 2.2 months of imports, still relatively low compared with external financing needs. The current account deficit shrank from 3.3 per cent of GDP in 2016 to 1.6 per cent of GDP in 2017 on the back of strong export receipts and increased money transfers from abroad. The exchange rate has remained relatively stable since the beginning of 2016. At 6.0 per cent on average in 2017, consumer price inflation was at its lowest level before declining further to 4.8 per cent year-on-year in the first nine months of 2018. The refinancing rate was lowered from 11 per cent at the end of 2017 to 10 per cent in June 2018.

Positive near-term growth prospects are balanced against structural weaknesses. Current forecasts are for economic growth at 3.0 per cent in 2018 and 2.5 per cent in 2019, supported by continued macroeconomic stability and improved external economic conditions. But the longer-term prospects for growth and prosperity depend on the willingness and ability of the authorities to enhance the private sector's role in the economy.

Assessment of transition qualities (1-10)



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Major structural reform developments

The authorities have been focusing on improving governance and quality of management in SOEs. In September 2017, the state-owned road-management holding company Belavtodor was chosen for the implementation of a pilot commercialisation project. It implies the establishment of a model state holding company based on the OECD principles via a corporate governance action plan. Work is under way to enhance the capacity of the state property fund in order to create a commercially sound holding structure for state assets.

A set of measures was adopted to promote the development of the IT sector. A presidential decree on digital economy development was adopted in December 2017. The decree prolongs the special taxation and regulation regime of the High-Technology Park (HTP) until 2049. It expands the range of eligible activities that are subject to preferential treatment, including marketing, advertising and other services related to developed software products. The new decree has introduced a liberal legal framework for Blockchain technologies and legalised so-called smart contracts in Belarus. Financial and legal tools have been introduced to stimulate venture capital transactions. Procedures for recruitment of foreign specialists by HTP residents have been simplified. The residents of the park have been allowed to sponsor and provide vocational training programmes. Established in 2005, the HTP hosted close to 200 resident companies as of September 2018, more than half of which were foreign-owned or joint ventures. In 2017, production and sales revenues of HTP resident-companies increased by 21 per cent and amounted to approximately US$ 1.1 billion, with an export share of approximately 92 per cent. The ICT sector accounted for approximately 5.0 per cent of GDP in 2017.

Monetary policy and banking supervision frameworks have been improved. The policy of the National Bank of the Republic of Belarus (NBRB) to move from targeting exchange rate stability to a fully fledged inflation targeting regime is on track. The monetary authorities have started to focus on managing the overnight interbank market interest rate instead of the rouble monetary base. The transparency and effectiveness of the public communications by the NBRB have also improved. Monetary policy objectives and their implementation are clearly communicated on the recently upgraded NBRB website. From January 2018, Belarusian banks are required to maintain capital ratios compliant with Basel III framework. In January 2018, the NBRB also published the list of systemically important banks which are required to maintain additional capital buffers.

Measures were taken to promote de-dollarisation and gradually liberalise foreign exchange regulations. In January 2018 the NBRB increased the reserve requirements for deposits in foreign currency from 15 per cent to 17 per cent. This was the third consecutive increase since the beginning of 2017, when the ratio stood at 7.5 per cent. To discourage foreign currency lending to unhedged borrowers, a higher reserve requirement was introduced for such loans. To incentivise lower interest rates on local currency loans, higher reserve requirements were imposed on rouble loans with an interest rate above the specified threshold, which is linked in turn to the NBRB overnight rate. The requirement for the mandatory sale of foreign currency proceeds was lowered from 20 per cent to 10 per cent in October 2017, and then abolished in August 2018.

BOSNIA AND HERZEGOVINA

Highlights

- **The economy has once again proved to be resilient to reform slow-down and political uncertainty.** GDP grew by 3.0 per cent in 2017, following similar growth rates in the previous two years.
- **Reforms have slowed down in 2018 in advance of elections.** Some progress occurred in late 2017 when the law on an increase of the fuel excise duties was adopted, paving the way for a resumption of infrastructure financing. Since then, reforms have slowed markedly and the latest review of the IMF programme has been delayed.
- **Privatisation in the Federation remains stalled, despite having announced plans.** Major assets remain in state hands and there appears to be little appetite to make substantive progress.

Key priorities for 2019

- **New growth momentum is needed.** Once new governments are in place following the October 2018 elections, it is vital that a firm commitment is made to a new reform agenda, with a concrete, measureable set of deliverables on improving the investment climate and standards of governance, and advancing the country's EU approximation agenda.
- **The Federation's telecommunications companies should be privatised.** Progress in this area would not only improve the financial viability of the companies but also demonstrate a genuine commitment to attracting investment in key sectors.
- **Further efforts are needed to resolve non-performing loans (NPLs).** While the situation has improved in recent years, banks still face difficulties in writing off NPLs or selling them to non-bank entities.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.1	3.1	3.1	3.0	3.0
Inflation (average)	-0.9	-1.0	-1.1	1.2	1.4
Government balance/GDP	-2.9	-0.2	0.3	2.1	1.5
Current account balance/GDP	-7.4	-5.4	-4.9	-4.8	-6.0
Net FDI/GDP [neg. sign = inflows]	-2.9	-1.7	-1.6	-2.1	-2.1
External debt/GDP	61.6	62.3	62.4	61.0	n.a.
Gross reserves/GDP	26.3	29.6	30.5	35.7	n.a.
Credit to private sector/GDP	56.4	55.0	54.4	55.8	n.a.

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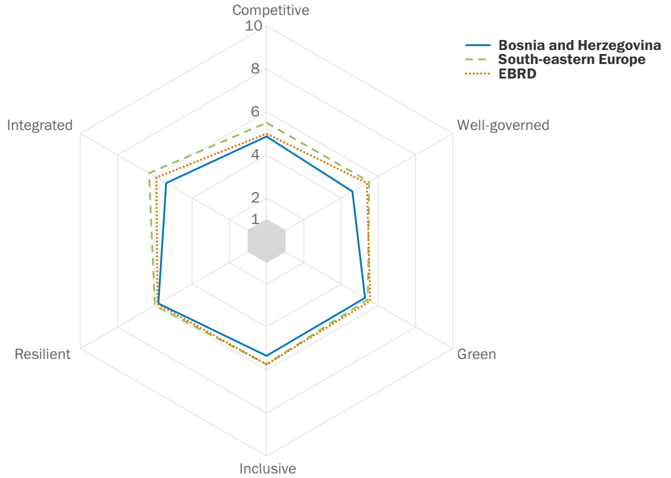
Macroeconomic performance

Moderate growth has continued. The economy grew by an estimated 3.0 per cent in 2017, following similar growth rates in the previous two years, and has once again proved to be resilient to reform slow-downs and political uncertainty. Services, and particularly domestic trade, were the main growth drivers, supported by private consumption. Industry also performed well last year, whereas the agriculture sector had a slight drag on growth. At the same time, there was a significant slow-down in investments, partly due to the significant delays in implementing reforms needed to unlock major infrastructure projects. Remittance inflows to Bosnia and Herzegovina rose by 7.2 per cent in 2017 to €1.3 billion, about 8.0 per cent of GDP, helped by the economic recovery in the eurozone. However, the overall current account remains in deficit at almost 5.0 per cent of GDP. GDP growth continued into the first half of 2018 at a similar pace, of 2.9 per cent year-on-year. Investment levels recovered after a slow-down in 2017, as adoption of the law on an increase of fuel excise duties in late 2017 paved the way for a resumption of infrastructure financing.

Further delays are occurring to the IMF programme amid fiscal concerns. Economic reforms are currently anchored by a €533 million, three-year IMF Extended Fund Facility signed in September 2016. However, progress under the programme has been far from smooth. The first review was eventually completed in February 2018 after an approximately one-year delay. The passage through parliament, after several failed attempts, of the law on an increase of the fuel excise tax in December 2017 enabled the completion of the review. However, the second review is currently on hold because of concerns over new spending proposals in both entities: in the Federation, the government adopted a law expanding benefits for veterans, while the government in Republika Srpska decided to increase the minimum wage and pensions as of 1 July 2018.

Further growth is expected in the short term, but downside risks are significant. The economy is projected to grow by 3.0 per cent in 2018 and 3.5 per cent in 2019. The resumption of infrastructure financing in the roads sector, including for Corridor Vc, and investment should therefore play a more growth-supportive role in the coming period. Nevertheless, uncertainty associated with the aftermath of the general elections in October 2018 and the stalling, or even possible reversal, of reforms remain important downside risks.

Assessment of transition qualities (1-10)



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Major structural reform developments

Progress in reforms remains slow. In February 2018 Bosnia and Herzegovina submitted answers to the EU's questionnaire, received in December 2016. The lengthy time it took to complete the questionnaire reflected the country's complicated, multi-layered administrative structure and internal disagreements. Having received the questionnaire, the European Commission is preparing an opinion on the country's EU membership application. In April 2018 the European Commission noted in its progress report that, although the state-level government had made some progress in implementing legislation changes agreed under the Reform Agenda in place since 2015, delivery on a number of reforms was delayed by lack of agreement within the ruling coalition members. The report urged the authorities of Bosnia and Herzegovina to adopt countrywide strategies in areas such as energy, employment and public financial management, and to step up reforms of public administration and the judicial system.

The business environment remains difficult. Bosnia and Herzegovina was ranked 89th overall (out of 190 countries) in the World Bank *Doing Business 2019* report, the lowest ranking among the Western Balkans countries. Nevertheless, the country has experienced a small improvement in its absolute score, on a scale from 0 to 100 (where the latter represents the best performance), and it now scores 63.55. The most problematic areas remain in dealing with construction permits, protecting minority investors, starting a business and enforcing contracts.

Privatisation in the Federation remains stalled, despite announced plans. In February 2018 the government of the Federation approved the privatisation plan for 2018, which foresees the sale of government equity in four major companies: the engineering company Energoinvest, fuel retailer Energopetrol, aluminium smelter Aluminij and insurer Sarajevo Osiguranje. However, resistance to the privatisation process within the Federation remains strong and prospects for successful sales are limited. There has also been no progress in the past year in privatising the telecommunications companies BH Telekom and HT Mostar, and the related due diligence – a prior action for the IMF programme – has not taken place yet.

Road construction is moving ahead. China's Shandong is close to securing a concession contract for the Banja Luka-Prijedor highway. The Chinese company and the Republika Srpska road company signed a deal to cooperate on the construction of the Banja Luka-Prijedor-Novi Grad highway in November 2017. The arrangement is worth US$ 320 million. The 42 km-long Banja Luka-Prijedor section is the first phase of this deal. The concession is expected to be given for a period of 25 to 30 years and the Chinese company is supposed to secure funds for construction without sovereign guarantees from either the Bosnia and Herzegovina or Republika Srpska governments.

Renewable energy projects are advancing. Bosnia and Herzegovina aims to increase the share of electricity produced from renewable sources to 40 per cent by 2020 from the current 34 per cent. After being delayed for years due to legal issues, the construction of the 49.5 MW Trusina wind park in Republika Srpska is scheduled to start in the last quarter of 2018. The wind park, which is estimated to cost around €72 million, should be operational by the end of 2019. In July 2018 the authorities in Republika Srpska launched a tender for the construction of a 65 MW solar power plant near Ljubinje, which would be the country's largest so far.

Key banking legislation has advanced but has not yet been adopted. The government of Bosnia and Herzegovina has adopted the law on insurance of bank deposits, required by the IMF as part of the set of reforms aimed at stabilising the banking sector. The new legislation secures better protection of depositors and is part of an overall modernisation of the banking sector. Under the new law, banks that obtain permits to operate from the entities' banking agencies automatically enter into the deposit insurance process. The law is one of five to be adopted to reform the banking sector, and needs approval by the state-level parliament, which is still pending.

BULGARIA

Highlights

- **Growth has been robust in the past year.** The economy grew by a healthy 3.8 per cent in 2017, helped by continuing strong domestic demand.
- **Reforms in the energy sector have continued.** The authority of the energy regulator has been strengthened in line with the relevant EU legislation, while an independent energy exchange for intraday trading has been launched.
- **Non-performing loans (NPLs) continue to decline steadily.** As a result of successful portfolio sales, the gross NPL ratio declined below 10 per cent in 2018. While the gross NPL ratio remains above the EU average, the banking sector has accumulated a capital surplus which fully covers net NPLs.

Key priorities for 2019

- **Further efforts are required within the framework of the EU's Cooperation and Verification Mechanism.** In particular, the government needs to implement the new anti-corruption law, further improve the independence and efficiency of the judiciary, and step up the fight against organised crime by improving the legislative framework and increasing transparency.
- **Reforms aiming to prepare the country for joining ERM II and the Banking Union need to continue.** While Bulgaria currently meets the macroeconomic conditions to become part of ERM II, the Bulgarian authorities need to remain committed to undertaking key reforms, including entering into close cooperation with the European Central Bank (ECB), introducing new macro-prudential instruments and amending the existing insolvency and anti-money laundering frameworks.
- **Reforms on improving the business environment need to be implemented.** Bureaucratic processes remain an impediment to doing business while access to skilled labour is a growing challenge. Efforts need to focus on reforming the business environment as outlined in the coalition programme, retaining qualified workers and improving the skills of the existing labour force.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.3	3.6	3.9	3.8	3.6
Inflation (average)	-1.6	-1.1	-1.3	1.2	2.6
Government balance/GDP	-3.6	-2.8	1.6	0.9	-0.1
Current account balance/GDP	0.2	0.0	2.3	4.6	2.4
Net FDI/GDP [neg. sign = inflows]	-3.6	-5.4	-3.1	-2.9	-3.1
External debt/GDP	85.5	81.6	76.4	74.0	n.a.
Gross reserves/GDP	44.2	47.3	49.9	44.3	n.a.
Credit to private sector/GDP	59.5	55.3	52.7	51.8	n.a.

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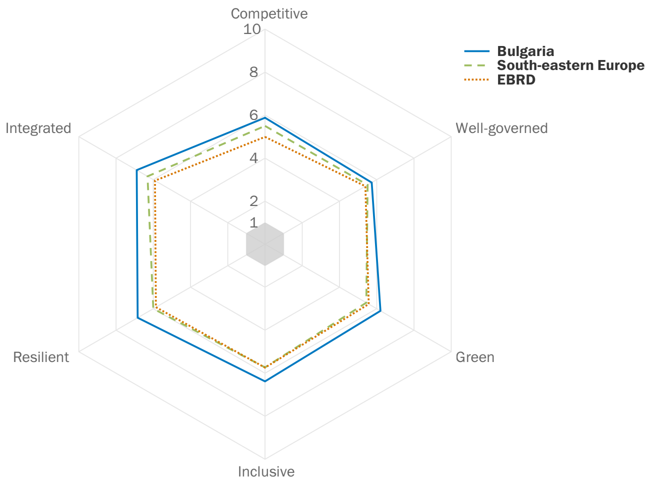
Macroeconomic performance

Growth has remained robust while inflation is rising. The economy grew by 3.8 per cent in 2017 and by 3.4 per cent year-on-year in the first half of 2018. Private consumption has been the main driver of growth, as the tightening labour market as well as minimum and public sector wage hikes pushed real wages up and unemployment down to 5.2 per cent in August 2018. Investment has also been strong, helped by the growing disbursement of EU funds since the second half of 2017. As a result of the recovering energy and food prices, inflation returned to positive levels in 2017, averaging 1.2 per cent, with a further rise in 2018, reaching a five-year high of 3.7 per cent in August 2018.

Fiscal policy has remained prudent and public debt levels have declined. Fiscal consolidation has continued in the past two years with revenue growth outstripping expenditure growth, resulting in two consecutive years of budget surpluses in 2016 and 2017. A significant surplus has been reported for the first half of 2018 and the government expects a positive budget out-turn for the year as a whole of around 0.5 per cent of GDP. Helped by sizeable primary surpluses, the public debt-to-GDP ratio has decreased by 3.4 per cent in 2017 to stand at 25.6 per cent, one of the lowest levels in the European Union.

Growth is expected to remain strong over the next two years. Private consumption is likely to underpin stable GDP growth rates, currently projected at 3.6 per cent in 2018 and 3.4 per cent in 2019. Public and private investment will also contribute positively to growth, as the absorption of EU funds will continue. In addition, fiscal policy is expected to support growth due to an increase in the public sector wage bill. Key risks to the outlook are: prolonged weakness in major trading partners, not least Turkey; exacerbation of current labour shortages and worsening of investor sentiments towards emerging markets. While convergence prospects remain high, with GDP per capita standing at 49 per cent (purchasing power parity-adjusted) of the EU average, sustaining the current high growth rates in the long run will require structural reforms to be reinvigorated.

Assessment of transition qualities (1-10)



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Major structural reform developments

Steps have been taken to integrate Bulgaria further into the EU's financial architecture. At the end of June 2018 the Bulgarian authorities officially declared their intention to join the eurozone's exchange rate mechanism, ERM II, and the Banking Union by July 2019, and ultimately the eurozone. The action plan adopted by the government in August 2018 lays out the reforms in financial sector regulation and economic governance to be undertaken over the next year.

There was some progress in implementing the Cooperation and Verification Mechanism (CVM). In February 2018 parliament adopted an Anti-corruption and Forfeiture of Assets Act, thus creating a powerful anti-corruption commission, introducing new conflict of interest regulations and regulating the seizure of illegally acquired assets. Parliament also adopted in March a new Anti-Money Laundering Act, bringing the legal framework in line with the relevant EU directive. Secondary legislation is expected to be published later in 2018.

Bulgaria's business environment remains close to the regional average, although there is room for improvement. According to the latest World Bank *Doing Business 2019* report, Bulgaria ranked 59th out of 190 countries in ease of doing business, dropping nine places compared with the previous year. The report points out that there were no reforms to improve the business environment over the past year. Procedures for starting a business, paying taxes and getting electricity remain burdensome, although Bulgaria performs better than the regional average in importing and exporting procedures.

Energy market liberalisation has advanced, and energy infrastructure improvements have continued. A two-way gas pipeline with Turkey was completed in August while the construction of a new interconnector with Greece is expected to start in late 2018. As part of the efforts to liberalise the market, the Independent Bulgarian Energy Exchange (IBEX) launched intraday trading in April 2018. From 1 July 2018 the electricity market in Bulgaria was further liberalised: all electricity producers with installed capacities above 4 MW, which used to benefit from preferential prices and long-term contracts, are now obliged to sell electricity on the free market. The recent amendments to the Energy Act transpose European legislation by giving the energy regulator powers to strengthen integrity and transparency of the wholesale electricity market for the benefit of end-consumers.

Confidence in the financial sector has improved. NPLs have continued to decline in the past year, as many banks have followed successful policies since early 2017 for the reduction of NPLs, including write-offs and sales of corporate secured NPLs. Even though Bulgaria's gross NPL ratio of 9.1 per cent as of June 2018 remains above the EU average of around 4.0 per cent, net NPLs are fully covered by the capital surplus accumulated in the banking sector. Meanwhile, the banking sector consolidation that started in 2014 has continued into 2018, including the merger of UBB and CIBANK, which was completed in February 2018.

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

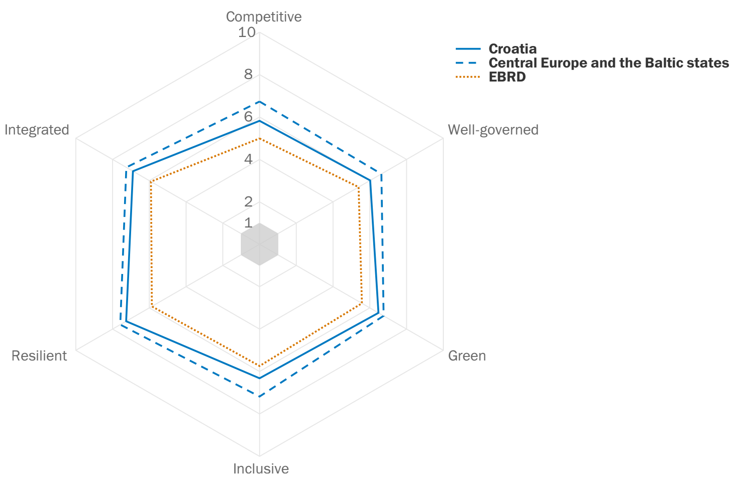
Growth has been gradually slowing down. After a 3.5 per cent rise in 2016, GDP growth slowed to 2.9 per cent in 2017 due to lower investment growth and faster catch-up in imports as the economy entered its third year of recovery. Private consumption, which has continued to recover on the back of a tightening 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.

CYPRUS

Highlights

- **A major economic recovery is continuing.** GDP growth in 2017 was 4.2 per cent, and the level of economic output has almost reached the pre-crisis level. Fiscal performance remains strong and the government reached an overall fiscal surplus for the second year in a row.
- **Privatisation remains largely on hold, while liberalisation of the energy sector has been delayed.** There appears to be little appetite for selling a majority stake of the state-owned telecommunications company, although this had been one of the government's priorities during the crisis.
- **The Cyprus Cooperative Bank (CCB) has been liquidated.** The healthy part was bought by the Hellenic Bank, while the state will absorb the remaining parts of the bank.

Key priorities for 2019

- **A new push for renewable energy is needed.** The government is developing a new renewable energy strategy to help meet long-term renewable targets, but a firmer commitment to implementing a competitive tariff regime and support for auctions of renewable energy is necessary for the long-term viability of the sector.
- **Heightened efforts are needed to tackle non-performing loans (NPLs).** The level of NPLs remains exceptionally high by international standards. Recent progress in restructuring of companies and banks and in sales of NPL portfolios are encouraging and should be further developed.
- **Targeted business environment reforms are needed.** The authorities should focus on areas such as contract enforcement and permitting, where Cyprus continues to lag behind best practice in other EU countries.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-1.3	2.0	4.8	4.2	3.9
Inflation (average)	-0.3	-1.5	-1.2	0.7	0.8
Government balance/GDP	-9.0	-1.3	0.3	1.8	2.1
Current account balance/GDP	-4.3	-1.5	-4.9	-6.7	-3.1
Net FDI/GDP [neg. sign = inflows]	-7.9	47.4	-7.8	-23.1	-5.5
External debt/GDP	554.4	572.7	588.9	557.3	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	287.4	282.1	250.5	224.6	n.a.

*Cyprus is a member of the Euro area.

CONTINUES

Macroeconomic performance

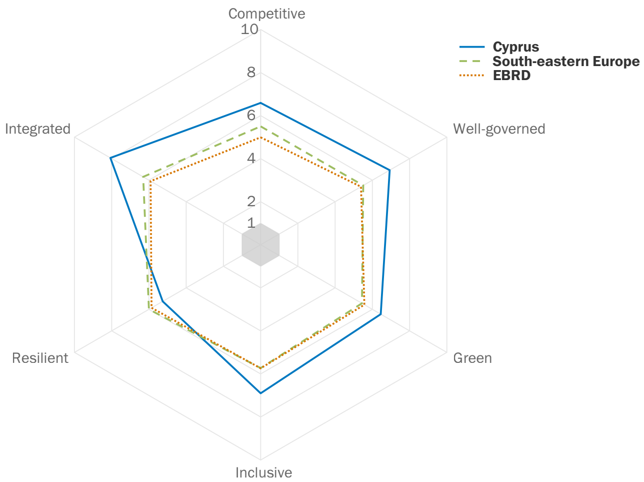
Robust growth is continuing. Economic activity in Cyprus continued at a strong rate in 2017 with GDP growth of 4.2 per cent. Growth in 2017 was mainly driven by investment and private consumption. Gross fixed capital formation accounted for more than 20 per cent of GDP for the first time after 2010, driven by the construction and real estate sectors. After many years of negative contribution to growth, government spending also provided a small growth boost. Net exports were the only drag on growth as imports, supported by rising private consumption and investments, grew by a higher rate than exports. Tourist arrivals in 2017 increased by almost 15 per cent and the leading indicators in the first half of 2018 point to another strong year for tourism in Cyprus, which is continuing to benefit from instability elsewhere. Meanwhile, unemployment has dropped to single-digit levels, reaching 7.4 per cent in September 2018, more than three percentage points lower than a year previously, and more than seven percentage points lower than its peak in 2014. After a few years of declining prices, inflation returned to the economy, averaging 0.7 per cent in 2017 and 0.4 per cent in the first eight months of 2018. The positive GDP trends have continued into 2018 with growth in the first quarter of 4.0 per cent year-on-year and 3.9 per cent year-on-year in the second quarter.

Fiscal performance remains strong. For the second year in a row, the government reached an overall surplus in 2017 of 1.8 per cent of GDP. This was due to a strong recovery in revenue collection owing to the stronger-than-expected GDP growth. These positive trends have helped drive down general public debt to below 100 per cent of GDP by the end of 2017, although the ratio has risen again in 2018 because of the one-off restructuring of the cooperative banks (see below). This is expected to cost the government more than 15 per cent of GDP, putting back the government's debt reduction efforts. However, the move is expected to reduce systemic risks in the banking sector significantly.

Cyprus's credit ratings have further improved in the past year. The latest upgrades by major ratings agencies were by Standard & Poor's in September 2018 and by Fitch in October 2018, both from BB+ to BBB-, lifting the country back to investment grade for the first time since the crisis. The Standard & Poor's upgrade was followed by a 10-year €1.5 billion bond issuance at a yield of just 2.4 per cent, significantly below previous issues.

Strong growth is likely to continue in the short term. GDP growth for 2018 is projected at 3.9 per cent and 3.5 per cent in 2019.These growth rates are likely to be accompanied by further fiscal surpluses, contributing to another reduction in the public debt-to-GDP ratio. However, significant downside risks remain to this forecast, given the relatively undiversified nature of the economy and reliance on a few sectors, and given the difficulties in reducing the burden of exceptionally high levels of NPLs on the financial sector, which are still around 40 per cent of total loans.

Assessment of transition qualities (1-10)



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Major structural reform developments

Overall reform momentum has been limited in the past year. The election cycle in early 2018 contributed to the slow-down in reforms. Privatisation remains largely on hold; the law abolishing the privatisation unit in the Ministry of Finance, passed in 2017, was upheld by the Supreme Court in February 2018. Regarding the telecommunications company CyTA, the plan now is to corporatise the company, with the government retaining a majority stake. The business environment still has serious deficiencies in several respects, notably in the areas of contract enforcement and dealing with construction permits, as illustrated by the country's poor overall ranking (57th out of 190 countries) in the World Bank's *Doing Business 2019* report.

Energy sector liberalisation has been delayed. The authorities are committed to liberalising electricity and gas markets by July 2019, but progress to date has been slow, and the target may be missed. A step forward occurred in 2018 when a licence was given to F. E. First Electric Supply, the first independent power producer in Cyprus. This supplier would interact with producers and consumers of electricity based on bilateral contracts. Further licences are expected to be granted in the coming months. However, plans for full unbundling of the sector have been delayed.

The Cyprus Cooperative Bank (CCB) is being restructured and sold. The bank is still the second biggest in the country but has struggled to recover from the negative effects of the crisis five years ago, with more than half of its loans non-performing. In March 2018 the government offered the bank for sale and in April 2018 it carried out a balance sheet operation, injecting €2.5 billion into the bank. In June 2018 it was announced that Hellenic Bank, the third largest in the country, would take over management of the healthy part of the bank, consisting of the majority of assets and customer deposits, while the state would absorb the remainder, including the portfolio of NPLs. Hellenic Bank officially took over the operations of CCB in September 2018.

NPLs are being tackled slowly. Despite the economic recovery in recent years, NPLs in Cyprus remain exceptionally high, at 44 per cent of total exposures as of January 2018, only marginally below the level of a year earlier. Some legislative changes have been enacted recently, or are in progress, in order to speed up the process. In particular, in July 2018 the parliament amended the legal framework around insolvencies and foreclosures in order to speed up the process of NPL resolution. Sales of NPLs have advanced during 2018. In January 2018 Hellenic Bank sold €145 million of NPLs to Norway's B2Holdings ASA. In addition, the Bank of Cyprus, the country's biggest bank, is in the process of selling a portion of its NPLs to an asset management company. The deal was agreed in August 2018 but is pending regulatory approval. This would represent the first major such deal in Cyprus since the crisis.

EGYPT

Highlights

- **Growth continued to accelerate and inflation declined to within the central bank's target.** GDP has been growing for five consecutive quarters and fiscal and external deficits are narrowing, anchored within the IMF-supported programme.
- **Reform progress since the end of 2016 was significant.** More recently, there was progress on the industrial licensing, natural gas industry, railway, investment, companies and bankruptcy laws. In addition, the government cut fuel, electricity, water and metro ticket subsidies.
- **Foreign interest increased in local investments and debt.** The approval of the IMF programme in November 2016, coupled with the strong reform momentum, led to higher foreign direct and portfolio investments, increased remittances, a build-up of reserves and increased creditworthiness.

Key priorities for 2019

- **There is a need to move forward with the IPO programme.** The sale of state assets would boost the capital market, increase efficiency and increase private ownership. There is a need to prioritise the sale of well-performing, bankable and profitable companies, to rebuild confidence and attract international investors, even from unconventional destinations.
- **Commitment to the current reform programme should continue.** To date, the economic reform programme has improved Egypt's overall macroeconomic position and its business climate. Further legislation and implementation are needed to strengthen the recovery, including land registration reform.
- **Maintaining meticulous debt management mechanisms is needed to ensure repayment sustainability.** The government's appetite for borrowing remains high, and commitment to the debt strategy implemented by the Ministry of Finance is crucial to reduce the level of public debt, currently at 92.5 per cent of GDP.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.9	4.4	4.3	4.2	5.3
Inflation (average)	10.1	11.0	10.2	23.5	20.9
Government balance/GDP	-12.0	-11.4	-12.5	-10.9	-9.8
Current account balance/GDP	-0.9	-3.6	-6.0	-6.1	-2.6
Net FDI/GDP [neg. sign = inflows]	-1.3	-1.9	-2.1	-3.1	-2.8
External debt/GDP	15.1	14.4	16.6	33.6	35.8
Gross reserves/GDP	4.7	4.9	7.9	16.1	n.a.
Credit to private sector/GDP	24.0	25.3	31.1	24.4	n.a.

* Data for Egypt corresponds to fiscal year, July to June, except for reserves and credit to the private sector.

CONTINUES

Macroeconomic performance

Growth continued to accelerate for the fifth consecutive quarter. It reached 5.3 per cent year-on-year in the second quarter of fiscal year 2017-18, and an estimated 5.3 per cent for the year, the highest rate in a decade. The acceleration was driven by manufacturing; trade; tourism and construction; and the recovery in mining. In per capita US dollar terms, GDP shrank in fiscal year 2016-17, as a result of the currency depreciation and sustained population growth, and increased by 5.0 per cent in fiscal year 2017-18. Unemployment declined for the seventh consecutive quarter but remained elevated at 9.9 per cent in the second quarter of 2018, and higher among the youth (24.8 per cent) and women (21.2 per cent). The continued moderation in the unemployment rate is due mainly to the bold reforms implemented in late 2016 and throughout 2017, which have boosted export-oriented businesses and improved the economic outlook. The government has also launched large construction projects that have generated many jobs.

Inflation declined from its record high level of 33.0 per cent in July 2017 to 16.0 per cent in September 2018. Meanwhile, in January 2018, the real interest rate turned positive for the first time in almost two years, and continued to increase, supported by the decline in inflation, despite the easing of monetary policy which started in February 2018.

Fiscal and external positions have improved. The government achieved its first primary budget surplus in 15 years of 0.2 per cent of GDP in fiscal year 2017-18, and the overall fiscal deficit narrowed to 9.8 per cent of GDP (slightly below the target of 9.0 per cent) from 10.9 per cent in fiscal year 2016-17. The narrowing in the deficit was driven by a contained wages bill and lower interest payments, coupled with a continued strong tax performance, despite increases in spending on subsidies and transfers. Gross public debt declined from 103 per cent of GDP in fiscal year 2016-17 to 92.5 per cent of GDP in fiscal year 2017-18. Meanwhile the current account deficit narrowed from 6.1 per cent of GDP in fiscal year 2016-17 to 2.8 per cent in fiscal year 2017-18, thanks to the strong pick-up in tourism receipts, exports (oil, non-oil), Suez Canal revenues, and private transfers, notably remittances, which more than offset increases in imports. In recent months, Egypt has stepped up external borrowing and shifted away from costly short-term domestic debt to rebuild foreign exchange reserves, and reduce crowding out of credit to the private sector. International reserves rebounded to surpass pre-2011 levels, reaching a record high of US$ 44.5 billion in September 2018, and covering close to 7 months of imports, up from a critically low level of 3.1 months in June 2016.

Strong economic growth is expected to continue in the short term. GDP is expected to grow at 5.5 per cent in fiscal year 2018-19 and by 5.8 per cent in fiscal year 2019-20, supported by a number of factors. These include the continued boost in confidence, recovery in tourism, an increase in foreign direct investment, improved competitiveness, continued strengthening of exports, the start of natural gas production from the Zohr field, the implementation of business environment reforms and prudent macroeconomic policies. In nominal dollar terms, GDP per capita will continue to grow in the short term. The main risks to the outlook arise from a slow-down in reforms, and increases in global oil prices which would delay fiscal consolidation. These risks are mitigated by the authorities' strong commitment to, and ownership of, the economic reform programme.

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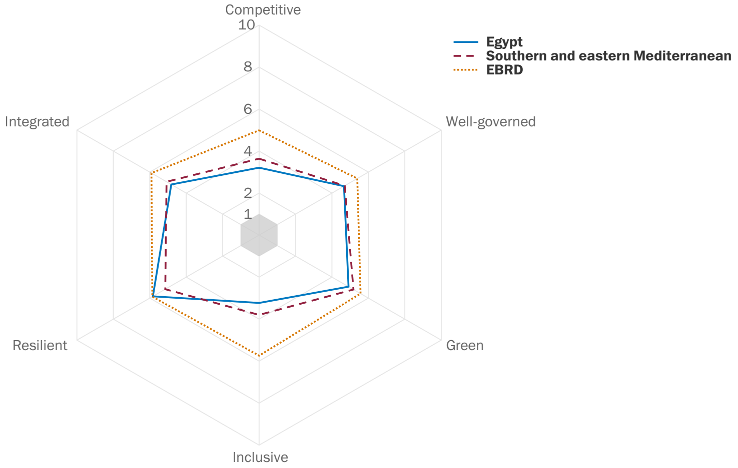
Assessment of transition qualities (1-10)



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The government performed several rounds of fuel and electricity subsidy reforms, and increased water and metro ticket prices. The Transport Ministry announced in May 2018 a new tariff scheme for the Cairo Metro that saw ticket prices more than triple in some instances and changed the pricing scheme to a tier system based on distance travelled. Ticket prices doubled under similar circumstances in March 2017. In the latest round of fuel subsidy reform in June 2018, the price for gasoline and diesel increased by 17.4 to 50.7 per cent and the price for a canister of gas for both households and for commercial purposes was raised by 66.7 per cent. Electricity prices increased in July 2018 on all consumption brackets by up to 42 per cent. In June 2018, the government raised piped water prices by up to 46.5 per cent as well as sewerage fees. Lastly, in July 2018, the government partially removed the subsidy on natural gas consumption for the household and business sectors. As a result, gas prices increased by up to 75 per cent.

Private sector participation in previously blocked sectors has been enabled. Two new pieces of legislation came into force in August 2017 and March 2018, respectively: the Natural Gas Act and the Railway Act. The former legislation allows private companies to import and trade natural gas, thus transforming the state from a monopoly distributor to a regulator. The Act also allows incentives to investment in the liquefied natural gas, petrochemicals, and fertiliser industries. Similarly, the latter law would allow private sector participation in developing, managing and operating railway projects.

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Reforms to facilitate land ownership and remove barriers to trade are lagging behind. The investment law approved in 2017 did not resolve some of the difficulties facing investors in land acquisition procedures, despite considerably easing the process of establishing companies and obtaining licences. Moreover, in July 2018, parliament approved amendments to the Customs Act, to slash customs duties on capital goods and expand temporary exemptions for production inputs and packaging equipment, in addition to introducing provisions that aim to curb customs evasion. Meanwhile, an overhaul of the Act is yet to be presented to parliament, including measures to facilitate the flow of goods through Egypt's ports, including establishing a "white list" of importers who will benefit from expedited clearance of goods.

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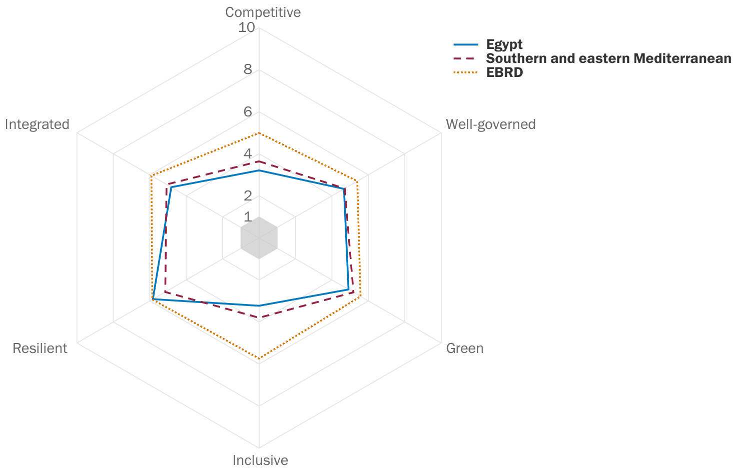

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ESTONIA

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.

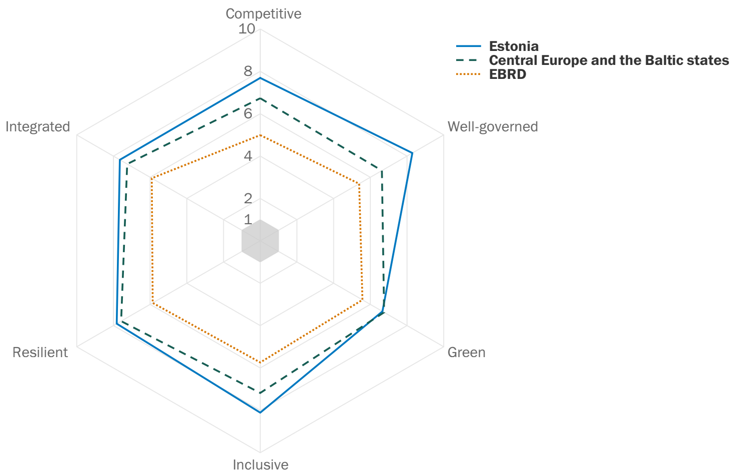
The investment share in GDP remains the highest in the EU. In 2017, the gross fixed capital formation represented 23.7 per cent of GDP, clearly above the EU average (20.1 per cent) and Estonia's regional peers. In 2017, the share of public investment in GDP was the highest in the EU, at 5.6 per cent, 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.

FYR MACEDONIA

Highlights

- **EU approximation is advancing.** The European Council at its meeting in June 2018 set out the path towards opening EU accession negotiations with FYR Macedonia in June 2019, subject to further progress in reforms.
- **The economy has struggled in the aftermath of the political crisis.** Growth was negative in the first half of 2017 but recovered somewhat in the second half, leaving growth for the overall year at zero, and further growth has been modest so far in 2018.
- **Energy sector reforms are progressing.** A new Energy Law, which is fully transposing EU energy legislation, has been adopted.

Key priorities for 2019

- **Renewable energy capacity should be developed further.** The authorities face a window of opportunity in terms of attracting new investments following the introduction of the new energy law.
- **Consolidation in the banking sector should be pursued.** The banking sector has a large number of banks relative to the size of the economy, and a consolidation could help strengthen the sector overall and lending to the real economy.
- **Implementation of the government's digitisation strategy can help to attract investment and jobs.** Progress in areas such as e-governance can help further boost FYR Macedonia's reputation as a business-friendly environment.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.6	3.8	2.9	0.0	2.0
Inflation (average)	-0.3	-0.3	-0.2	1.4	1.8
Government balance/GDP	-4.2	-3.5	-2.7	-2.7	-2.9
Current account balance/GDP	-0.5	-2.0	-2.7	-1.3	-1.1
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.2	-3.3	-2.3	-3.3
External debt/GDP	64.9	68.0	70.7	77.1	n.a.
Gross reserves/GDP	26.4	26.3	22.2	24.3	n.a.
Credit to private sector/GDP	48.2	49.9	47.0	48.0	n.a.

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Macroeconomic performance

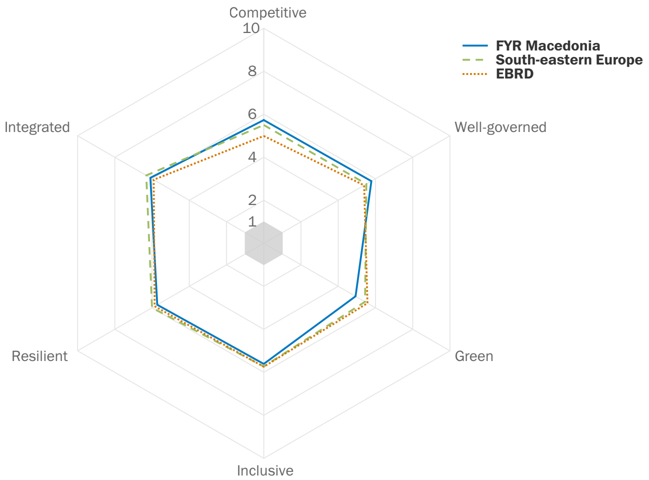
The economy has struggled in the aftermath of the political crisis. Following a few relatively good years of economic performance, the slow-down that began in 2016 continued through 2017 and into the first part of 2018. Growth in 2017 was zero, although a bad first half of the year, when the crisis was still in full swing, was balanced by a recovery in the second half following the formation of a new government. Government consumption also fell in 2017, but private consumption and net exports both increased, with gross exports rising by 18.0 per cent, helping to keep the current account deficit at low levels, of just about 1.0 per cent of GDP in 2017, among the lowest in the region. After a weak first quarter, economic activity picked up in the second quarter of 2018, driven by private consumption and net exports, bringing the overall growth in the first half of 2018 to 1.6 per cent year-on-year. The central bank cut its long-term policy rate by 0.25 percentage points to 3.0 per cent in March 2018. Inflation turned positive in 2017 after three years of price declines, averaging 1.4 per cent.

Public debt has been rising steadily amid continuous fiscal deficits. The government's fiscal deficit in 2017 was 2.7 per cent of GDP, slightly lower than 2.9 per cent planned when the budget was revised in August 2017 by the new government. The level of public debt is still relatively modest at 47 per cent of GDP, and within the Maastricht criteria of 60 per cent of GDP, but has been rising steadily in recent years, by 20 percentage points since 2009. A further rise is expected due to the measures adopted by the government, including business incentives for roll-out of additional employment and an increase in the minimum wage.

The credit outlook and investor confidence are improving. In February 2018, Fitch revised the outlook on its BB rating for FYR Macedonia from negative to positive to reflect the fact that the country's domestic political situation is stabilising. FYR Macedonia is rated BB-/Stable by Standard & Poor's and BB/Positive by Fitch (and not rated by Moody's). Meanwhile, international investors also appear to be showing increased confidence in the country's prospects, reflected to some extent in the historically low interest rate of 2.75 per cent on a seven-year €500 million Eurobond issued in January 2018.

Growth is expected to pick up in the short term. Prospects for short-term private and public investment are improving. The impact of the rising minimum wage and other social protection measures on private consumption is also expected to boost overall growth, while lending conditions are easing, helping businesses. A further rise in exports is also expected in the short term, following last year's strong performance, in light of the improved economic prospects in the European Union (EU), the country's key trading partner. As a result, the 2018 forecast for growth is 2.0 per cent, with a moderate increase to 3.0 per cent in 2019 on the assumption of continued political stability, the unblocking of further reforms and the arrival of much-needed investments. The key downside risk is the possibility of a resumption of political turbulence and uncertainty if progress in resolving the name dispute is not maintained.

Assessment of transition qualities (1-10)



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Major structural reform developments

EU approximation is advancing. In June 2018 the European Council set out the path towards opening EU accession negotiations with FYR Macedonia in June 2019, subject to further progress in reforms. This follows progress in resolving the name issue with Greece, which has held up FYR Macedonia's approximation progress for many years. The council underlined the need for FYR Macedonia to continue making further progress on areas such as judicial and public administration reform and the fight against corruption. Meanwhile, the EC has launched a screening process to evaluate the country's readiness to start accession talks in June 2019, with a particular focus on the crucial rule of law chapters 23 and 24.

Corruption perceptions appear to have worsened, despite the favourable business environment. FYR Macedonia is now ranked joint 107th (out of 180 countries), the lowest in the Western Balkans region, in Transparency International's Corruption Perceptions Index, down from 90th last year and 66th the previous year. On the positive side, the country continues to perform exceptionally well on the World Bank's Doing Business ranking, reaching 10th position in the 2019 report (published in late October 2018) compared with 11th position in the 2018 report.

A new Energy Law is in place. In May 2018 the parliament adopted a new Energy Law aimed at fully transposing EU energy legislation. The law envisages further liberalisation of the electricity market from 2019, foreseeing the appointment of a universal service provider and allowing households and small firms to choose their supplier. The law also encourages the production of electricity from renewable sources. In response, the Energy Community has formally closed several cases against FYR Macedonia. Starting from 2019, the state-owned power producer ELEM will be obliged to direct 80 per cent of its production to a universal supplier, which will be selected via a tender. Gradually this percentage will be lowered; by 2025 only 30 per cent of ELEM's production should be handed over to the universal supplier.

Cross-border energy integration is slowly improving. MEPSO, the country's transmission operator, is currently constructing the Macedonian portion of a 400 kV cross-border electricity interconnection between FYR Macedonia and Albania, the first interconnection between the two countries. Also, in April 2018 FYR Macedonia signed a Memorandum of Understanding (MoU) with Bulgaria that will allow the integration of the two countries' electricity markets. For the MoU to be implemented, FYR Macedonia should first establish an electricity market on a day-ahead trade principle, which is foreseen by the new Energy Law (see above). In the gas sector, FYR Macedonia has signed MoUs with both Greece and Bulgaria to explore the feasibility of developing further cross-border interconnectors, and thus diversifying its gas supply.

FYR Macedonia's regional connectivity agenda is progressing. The construction of the 28 km-long Demir Kapija-Smokvica motorway section in the southern part of the country, leading to the Greek border, was completed in April 2018. With this section and with the final works on the rehabilitation of the part between Negotino and Demir Kapija, the southern section of the pan-European road Corridor X, running between central Europe and Greece via Serbia and FYR Macedonia, has been finalised. Also, FYR Macedonia has invited tenders for the construction of a 34 km-long second section, Beljakovce-Kriva Palanka, of railway Corridor VIII, linking Bulgaria and Albania via FYR Macedonia. At the same time, FYR Macedonia and Kosovo have launched the construction of a new EU-funded joint border crossing which should facilitate enhanced cross-border trade.

Banking sector stability has been strong but the number of banks remains large relative to the size of market. Demand for credit fell sharply during the political crisis of 2016-17, but lending stayed positive, growing by approximately 3.0 per cent in 2017. This is however much lower compared with the previous years. Capital adequacy stood at 16.2 per cent as of the end of 2017, well above the regulatory requirement of 8.0 per cent. NPLs fell to 6.3 per cent, after being stable for the past three to four years at around 10.0 to 11.0 per cent of total loans, reflecting recent measures to write off NPLs that are fully provisioned for over two years. However, despite some consolidation over the years there are still 16 banks in FYR Macedonia, a large number for a small market.

GEORGIA

Highlights

- **Strong foreign direct investment (FDI) and a favourable external economic environment are fuelling growth.** GDP grew by 5 per cent in 2017 and at a similar pace in the first nine months of 2018, while FDI inflows amounted to a sizeable 12 per cent of Georgia's GDP in 2017.
- **The authorities introduced mandatory retirement savings as part of the pension reform.** Contributions by an employee and an employer will be matched by the state, with each contributing party providing 2 per cent of gross salary into the pension fund.
- **Taxation of small businesses was further simplified.** The rate of turnover tax was lowered and the turnover ceiling was raised to broaden the pool of eligible enterprises. The system of advance tax payments was abandoned in favour of monthly tax declarations and payments.

Key priorities for 2019

- **The justice administration system requires further reform.** Enhancing the transparency and efficiency of law enforcement, and ensuring the independence and competence of courts, including commercial chambers, would further increase public trust in the system.
- **The development of multimodal infrastructure should be stepped up.** To enhance Georgia's role as a regional hub economy for sectors such as tourism, trade and logistics, the country needs to make further progress in developing connectivity-enhancing infrastructure.
- **The new public-private partnership (PPP) framework should be put into operation promptly.** This can help mobilise private sector participation in various priority infrastructure schemes in a financially sustainable manner.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.6	2.9	2.8	5.0	4.5
Inflation (average)	3.1	4.0	2.1	6.0	2.8
Government balance[1]/GDP	-3.2	-3.7	-4.0	-3.9	-3.3
Current account balance/GDP	-10.8	-12.6	-13.1	-8.8	-10.5
Net FDI/GDP [neg. sign = inflows]	-8.5	-9.6	-8.1	-10.7	-8.7
External debt/GDP	84.6	109.0	110.4	113.8	n.a.
Gross reserves/GDP	16.4	18.0	19.2	20.0	n.a.
Credit to private sector/GDP	44.5	50.4	55.6	58.6	n.a.

[1] According to the definition by the Ministry of Finance.

CONTINUES

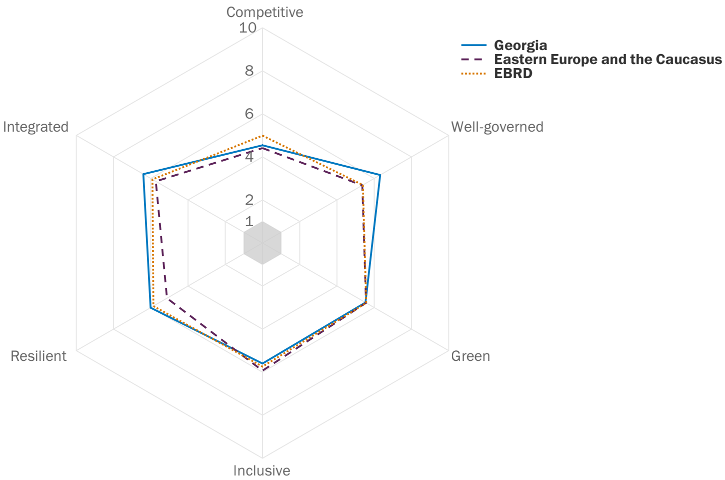
Macroeconomic performance

The economy is expanding at a brisk pace. GDP growth picked up from an average of 2.9 per cent in 2015-16 to 5.0 per cent in 2017, supported by an upswing in exports of goods and services and household consumption. Economic growth is estimated to have accelerated to 5.4 per cent in the first half of 2018, before slowing down to an estimated 4.0 per cent year-on-year in the third quarter. Exports of goods and services in nominal US dollar terms increased by approximately one-fifth in 2017 and in the first half of 2018, supported by the burgeoning hospitality sector. The influx of international travellers to Georgia increased sharply by 17.6 per cent in 2017 and by 11.2 per cent year-on-year in the first nine months of 2018. The inflow of money transfers increased by 19.8 per cent in 2017 and by 16.0 per cent in the first half of 2018 in US dollar terms, and amounted to approximately 9.1 per cent of GDP in 2017. The trade, construction and transport sectors were the largest contributors to GDP growth last year.

FDI remains the key source of external financing. On the back of strong export revenues and remittances, the current account deficit dropped to a still-significant 8.8 per cent of GDP in 2017 after averaging 12.9 per cent of GDP in 2015-16. This deficit was more than offset by FDI inflows reaching approximately 12.1 per cent of GDP in 2017 and directed mostly to infrastructure, financial intermediation and energy. The Georgian lari was stable against the US dollar in the first seven months of 2018, although more recently exchange rate pressures were triggered by volatility in large trading partners among other factors. Inflation slowed from an average of 6.0 per cent in 2017 to 2.7 per cent year-on-year in September 2018. In July 2018, the National Bank of Georgia (NBG) lowered its refinancing rate by 0.25 percentage points to 7 per cent.

Economic growth prospects are predominantly positive. With an extensive network of free trade arrangements, as well as its attractiveness as an investment and tourism destination, Georgia is well positioned to benefit from favourable external economic conditions. GDP growth is forecast at 4.5 per cent of GDP in 2018 and 2019. Downside risks stem from a possible deterioration in external economic conditions and geopolitical vulnerabilities.

Assessment of transition qualities (1-10)



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Major structural reform developments

Georgia is on track with implementation of the IMF-supported reform programme. As of September 2018, US$ 127 million has been disbursed out of US$ 285 million envisaged under the three-year Extended Fund Facility arrangement signed in April 2017. The main pillars of the programme include improvements to the fiscal framework and administration, strengthening financial supervision and regulation, and advancing growth-enhancing reforms, in particular those related to infrastructure and education. The second programme review was successfully completed in June 2018, with Georgia making notable progress according to the IMF. In October 2018, the IMF reached staff-level agreement with the authorities on the third review.

Macroprudential regulation was strengthened and steps were taken to promote responsible lending practices. In December 2017, the NBG introduced countercyclical capital buffers for the banking sector and additional capital requirements for three systemically important banks, which are to be phased in by 2021. New regulations for responsible lending came into force in May 2018, aiming for better alignment with the European directives, raising underwriting standards and improving loan portfolio quality. To enhance institutional capacity, the NBG has created a new financial stability department and strengthened the operational framework of the Financial Stability Committee. At the end of 2017, the NBG's supervisory powers were expanded to include microfinance institutions, credit unions, currency exchange units and money transfer agents.

Improvements in public finance management are under way. The changes are focused on streamlining the public sector wages bill and on optimisation of the Revenue Service (RS). In December 2017, civil service remuneration reforms were introduced, involving grade structures with a corresponding compensation grid, aiming to improve the link between performance and remuneration. In the first half of 2018, the authorities reorganised the RS and transferred all core functions from field offices to the headquarters. A specialised unit was created at the RS to review overdue VAT refund obligations.

A new PPP law has been adopted. The Parliament of Georgia adopted the PPP law in May 2018. The new law is a significant step towards more active participation of the private sector in the national infrastructure development agenda. It was developed according to the best practices and internationally accepted standards. Work is under way on reviewing and amending primary and secondary legislation. The PPP framework aims to scale up private sector involvement in infrastructure investments while keeping contingent fiscal liabilities at bay.

Pension reform is advancing. A pension reform law was adopted by the Parliament of Georgia in July 2018 with the aim of improving pension replacement rates for workers. This marks the transition to compulsory retirement savings, although the merits of the new system are yet to be tested. The new funded pillar will be additional to Georgia's existing universal basic pension coverage. Contributions into individual retirement accounts will become mandatory for the employed population under the age of 40 and will require monthly contributions from the employee, employer and the state, each in the amount of 2 per cent of gross salary. Contributions from the self-employed and those aged over 40 will be optional. The law also provides for setting up a dedicated pension agency. At the same time, Georgia's track record of macroeconomic volatility and its underdeveloped domestic capital market pose significant challenges for the new system's long-term viability.

The authorities have broadened tax initiatives for small businesses. Before the recent changes, small businesses were defined as companies with an annual turnover of up to 100,000 Georgian lari (approximately US$ 40,000) and were subject to a 5 per cent turnover tax. From July 2018, this tax regime has been applied to enterprises with an annual turnover of up to 500,000 lari (US$ 200,000), thus widening the spectrum of businesses eligible for favourable tax treatment. The turnover tax rate was lowered to one per cent and its advance payment was abandoned. Tax declarations and payments by small businesses are now performed monthly, based on simplified tax accounting.

GREECE

Highlights

- **Economic indicators are improving slowly.** The economic recovery that began in 2017 has continued into 2018, but at a relatively modest rate. The unemployment rate has dropped below 20 per cent for the first time since September 2011.
- **Greece has exited its Economic Adjustment Programme (EAP).** The exit in August 2018 took place on schedule and followed a sustained period of reforms. Further debt relief measures have been granted to help ensure debt sustainability over the medium term.
- **Privatisation is proceeding slowly.** While some flagship deals have been completed, others are encountering delays, sometimes due to circumstances beyond the government's control.

Key priorities for 2019

- **Agreed fiscal targets should be adhered to in the post-programme period.** This is vital for maintaining a stable macroeconomic framework and for bolstering investor confidence in Greece's economic recovery.
- **Greece should enhance cross-border links in the region.** The government's new growth strategy rightly recognises Greece's potential to develop closer links with neighbouring countries, and it will be important to capitalise on the new momentum by advancing important cross-border infrastructure and energy projects and breaking down barriers to trade.
- **Privatisation should be speeded up.** The current programme has seen some successes but delays to the process have also been relatively common, thus holding back vital investment flows.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	0.7	-0.4	-0.2	1.5	2.2
Inflation (average)	-1.4	-1.1	0.0	1.1	0.7
Government balance/GDP	-3.6	-5.7	0.6	0.8	0.5
Current account balance/GDP	-1.6	-0.2	-1.1	-0.8	-0.8
Net FDI/GDP [neg. sign = inflows]	0.1	0.2	-2.4	-1.7	-1.7
External debt/GDP	220.4	245.5	236.1	238.8	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	115.8	112.5	108.6	100.0	n.a.

*Greece is a member of the Euro area.

CONTINUES

Macroeconomic performance

Modest economic growth has continued in 2018. After marginally negative growth in 2016, the economy was boosted in 2017 by strong performances in the industrial sector, another excellent tourism season, and improved confidence following progress in the EAP, particularly after completion of the second review in June 2017. GDP growth in 2017 of 1.5 per cent has been followed by an acceleration in growth in the first half of 2018 to 2.2 per cent (year-on-year), with continued improvements in exports, the main driver of growth. Other economic indicators are also moving in a positive direction, including industrial production, employment, and consumer confidence, while unemployment (seasonally adjusted) has fallen to 19.0 per cent as of July 2018, the lowest level since mid-2011. Inflation has turned positive in 2018 but remains low at 1.1 per cent in September 2018 (year-on-year).

Investment is recovering from rock-bottom levels. By 2016, the level of gross fixed capital investment had fallen to just €20.5 billion, or a mere 12 per cent of GDP, versus €60.5 billion in 2007. Signs of a turnaround are apparent: there was a significant increase in gross fixed capital formation in 2017 by 9.6 per cent to €22.5 billion, due mainly to higher investment in transport and machinery equipment and weapons systems. However, net investment levels are still negative because of the ongoing depreciation of the existing capital stock. According to Eurostat estimates, between 2010, when net investment reached its peak, and 2017, the net capital stock of the country fell by 8.5 per cent in real terms, versus a rise of 7.2 per cent in the European Union (EU) as a whole.

Fiscal and external imbalances have been eliminated. Following Greece's exit from the EU's Excessive Deficit Procedure in July 2017, the government achieved a further primary surplus of 4.2 per cent of GDP in 2017, far exceeding the 1.75 per cent target agreed under the adjustment programme. Further short-term fiscal measures are in the pipeline, including reforms to pensions and personal income tax in 2019 and 2020, respectively, with both measures designed to yield savings of 1 per cent of GDP. The primary fiscal surplus is targeted at 3.5 per cent of GDP in 2018-22, as agreed with the European institutions, and at an average of 2.2 per cent for 2023-60. On the external side, there has also been a dramatic reduction in current account imbalances in recent years. The current account was in slight deficit in 2017 at -0.8 per cent of GDP. Exports of goods rose by 4.6 per cent (in real terms) in 2017, and there was a substantial increase in both travel receipts and receipts from shipping, of 10.5 per cent and 21.7 per cent, respectively.

Short-term growth is likely to continue. The improving trends in investment, employment and confidence are expected to strengthen through 2018 and 2019, leading to further growth of 2.2 per cent in 2018 and 2.3 per cent in 2019. Concerns about debt sustainability have been alleviated somewhat by debt relief measures announced in mid-2018 that reduce the payments schedule in the coming decade. However, the economic recovery is conditional on sustained reforms through the post-programme period, and any backtracking in reforms or increased uncertainty about the policy direction of the country could damage investor confidence and lower growth prospects.

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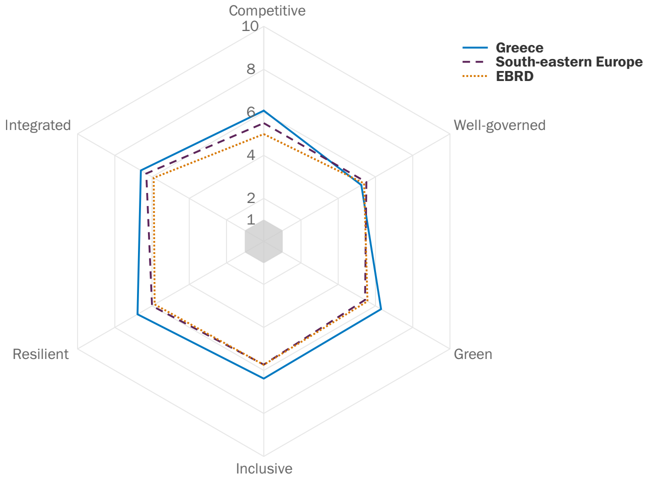
Assessment of transition qualities (1-10)



Major structural reform developments

Greece has exited its adjustment programme following significant reforms across the board. The exit from the three-year EAP, signed in August 2015, took place on schedule on 20 August 2018. Reform delivery stepped up once the third review of the programme was completed in early 2018. Discussions on the fourth and final review began in February 2018 concerning 88 key deliverables, starting with the adoption of the 2018-22 Medium Term Fiscal Strategy and including tax policy reforms, the full merger of social insurance funds, full implementation of pension reforms, healthcare expenditure rationalisation and centralisation, structural policies to support competitiveness and growth (including labour market reviews), and progress on the privatisation front. All 88 prior actions were successfully completed in time for the Eurogroup meeting on 21 June 2018. At this meeting, members agreed on the broad parameters of the post-programme framework which is one of "enhanced surveillance", and on further debt relief measures, some of which are conditional on positive reviews of reform implementation by the institutions during the post-programme period.

A new growth strategy has been adopted. The government first presented the strategy to international partners in April 2018. The strategy is wide-ranging, covering many policies designed to encourage inclusive growth, jobs and investment. The strategy also signals the authorities' intention to enhance Greece's role throughout the wider south-eastern European region by reducing barriers to trade and by developing cross-border infrastructure and energy projects.

Privatisation is advancing gradually. The privatisation strategy being implemented by the Privatisation and Investment Fund (the Hellenic Corporation of Assets and Participations) includes eight finalised privatisation projects and 22 ongoing projects. A significant deal under way in 2018 is the sale of 66 per cent of the gas transmission systems operator, DESFA. In April 2018, the preferred bidder was selected with an offer of €535 million. Other major projects in preparation and at an advanced stage include Egnatia motorway, the development of Hellenikon (site of the former Athens airport) and an extension of the concession agreement for Athens International Airport, but these and other projects have also met with significant delays, sometimes due to circumstances beyond the government's control.

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Financial sector stability is improving but asset quality remains a concern. The banking system is still burdened by an exceptionally high level of non-performing loans (NPLs), but all banks are addressing the problem using a variety of tools and according to targets agreed with the Bank of Greece. As of June 2018 the NPL ratio was 32.8 per cent of total loans, while the non-performing exposure (NPE) ratio – a broader measure of bad loans that also includes debts not expected to be paid in full without realisation of collateral – was 47.6 per cent. The volume of NPEs has dropped by more than 17 per cent since its peak in March 2016. In the second quarter of 2018 the reduction in NPEs was driven mainly by sales, while e-auctions are also increasingly being used following legislative changes introduced over the past year and the removal of legal and technical impediments to e-auctions of collateral backing NPLs.

Further improvements have been made to the business environment. Many of these reforms have been guided by the OECD's Toolkit recommendations and relate to the reduction or removal of regulatory barriers across a range of sectors. At the same time, Greece's ranking on the World Bank's ease of doing business assessment remains low by EU and OECD standards, at 72nd place out of 190 countries in the *Doing Business 2019* report, with persistently low rankings in registering property, enforcing contracts and getting credit.

Important governance reforms are being introduced. A key pillar of the three-year EAP was public administration reform and building a modern state. Important steps have been taken in the past year to improve the management of human resources in public institutions and the development of a more modern staff appraisal system.

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.

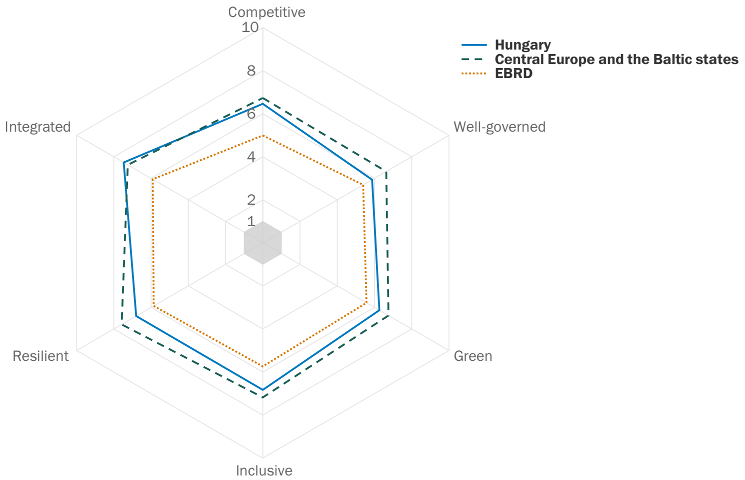
Banks' willingness to lend has improved, in particular to corporates. Following almost eight years of contraction, credit growth to the private sector started to recover in mid-2017. In the first half of 2018, corporate credit grew on average by 10 per cent year-on-year. At the same time, household borrowing 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.

JORDAN

Highlights

- **The economic situation failed to improve significantly in 2017.** Growth was modest, unemployment remains high, and inflation increased as a result of new rounds of subsidy removals.
- **The pace of fiscal consolidation was slower than planned, but the current account deficit widened.** Moreover, public debt is increasing, reserves are declining, and the dinar is strengthening in real terms, undermining competitiveness.
- **Structural reforms progress has stalled.** Public unrest in mid-2018 saw the Cabinet dismissed and long-awaited amendments to the income tax law withdrawn.

Key priorities for 2019

- **There is a need to create more employment opportunities.** The government should enhance the business climate to support the private sector's role in creating jobs. Key areas of reform that need to be tackled include: accessing credit, protecting minority investors, resolving insolvency, enforcing contracts and dealing with construction permits.
- **Further fiscal measures are needed.** Implementing the income tax law amendments and removing additional General Sales Tax (GST) and customs duties exemptions are vital steps for the economy to kick-start a recovery.
- **Social programmes targeting the most vulnerable segments of society should accompany structural reforms.** The government must ensure that the poor are well protected from the short-term economic impact of the reforms, through social welfare programmes that target family and children, housing, refugees and the host communities.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.1	2.4	2.0	2.0	2.2
Inflation (average)	2.9	-0.9	-0.8	3.3	4.5
Government balance/GDP	-2.3	-3.5	-3.2	-2.6	-2.9
Current account balance/GDP	-7.3	-9.1	-9.5	-10.6	-9.6
Net FDI/GDP [neg. sign = inflows]	-5.8	-4.3	-4.0	-4.1	-4.3
External debt/GDP	69.4	70.0	70.5	73.1	70.1
Gross reserves/GDP	39.3	37.7	33.3	30.6	38.8
Credit to private sector/GDP	73.0	72.8	77.6	81.9	n.a.

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Macroeconomic performance

The rate of growth in Jordan remained subdued in 2017 and the first half of 2018, at 2.0 per cent. This was below the average of 2.6 per cent recorded between 2010 and 2016, a period when the instability in Iraq and Syria and the presence of Syrian refugees – estimated at 1.6 million – had curbed growth. By comparison, average growth was 6.5 per cent between 2000 and 2009. In 2017, growth was driven by services, notably transportation and financial services. Tourism arrivals increased for the first time since 2010, by 7.8 per cent, signalling the best tourism season since the Arab uprising. The increase continued in the first four months of 2018, when arrivals grew by 4.9 per cent year-on-year. Labour market conditions deteriorated further; the unemployment rate continued to be high, reaching 18.7 per cent in the second quarter of 2018, and higher among women (26.8 per cent) and youth (35 per cent). The overall economic participation rate for women remains one of the lowest in the world, at 15.3 per cent.

Inflation has been increasing since the beginning of 2018. The inflation rate reached 5.7 per cent year-on-year in July 2018 as a result of energy and bread prices hikes, before declining to 4.4 per cent in September. In the 2018 budget, the government revised a range of General Sales Tax (GST) exemptions, part of the economic reforms planned by the government under the IMF-supported programme. Moreover, the arrival of Syrian refugees since 2011 has put pressure on services and increased prices on many goods, in addition to increases in housing prices. Real interest rates have been positive throughout the last five years (except for four months), as the fixed exchange rate remained an anchor for monetary policy.

The pace of fiscal consolidation was slower than expected, and the current account deficit widened. The central government's deficit declined to 2.6 per cent of GDP in 2017 from 3.2 per cent in 2016, reflecting stronger non-tax revenues and lower government consumption and subsidies, despite declining grants and lower tax revenues. But with continued Water Authority of Jordan losses, public debt remains elevated at 96.4 per cent of GDP as of the first quarter of 2018. The current account deficit reached 10.6 per cent of GDP in 2017, up from 9.5 per cent in 2016. Lower exports, grants and remittances (relative to GDP) and higher imports of goods were only partially offset by the increase in tourism receipts and the lower primary income deficit. International reserves have been decreasing since December 2017 and reached US$ 14 billion in May 2018, but they remain at comfortable levels, covering 7.1 months of imports.

A new US$ 2.5 billion economic support package to Jordan was promised by neighbouring Saudi Arabia, United Arab Emirates and Kuwait. In response to the public turmoil surrounding the amendments to the income tax law, a Gulf Cooperation Council (GCC)-Jordan summit was held in June. Assistance was promised to Jordan in the form of a central bank deposit, guarantees on loans from the World Bank, budgetary support, and financing for development projects.

The outlook remains broadly unchanged. Growth is expected to rise only modestly to 2.2 per cent in 2018 and 2.4 per cent in 2019, supported by stronger private consumption from the higher refugee population, the implementation of structural reforms, investment in the context of the government's programme to offer citizenship to foreign investors meeting certain requirements, and greater certainty and confidence stemming from fiscal consolidation. Moreover, exports will benefit from higher mining output, higher phosphate prices and the re-opening of the border with Syria and Iraq. Risks to the outlook include a slow-down – or reversal – in implementing reforms, an escalation of regional conflict and protracted conflict in Syria and Iraq (Jordan's main export markets), additional refugee inflows, tighter liquidity in the GCC, and a surge in the US dollar which would undermine competitiveness. On the upside, the involvement of Jordanian businesses in the reconstruction of Syria and Iraq would positively support growth.

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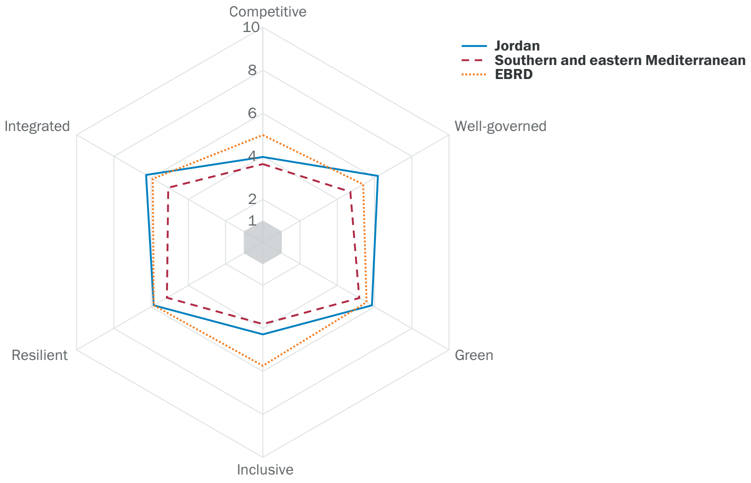
Assessment of transition qualities (1-10)



Major structural reform developments

The 2018 budget presented to parliament in November 2017 committed to removing remaining subsidies, including those on flour, which are the most politically sensitive. The authorities have also pledged social support to lower- and middle-income Jordanians to offset the impact of subsidies. The fiscal measures introduced included some tax changes and efforts to rationalise the public sector.

Proposed tax changes have encountered major opposition. In June 2018, major demonstrations took place in the country to protest against the new income tax law, which followed adjustments to the sales tax and subsidy system. The law allows for a larger tax base, since it is estimated that over 90 per cent of Jordanians do not pay income tax. The bill aims to reduce the income tax thresholds for individuals and families towards international standards, and increase the taxation of other sources of income. In addition, it unifies the corporate income tax rates for non-bank corporations, and aligns this unified rate with the maximum personal income tax rate. Tax revenues were expected to increase by around 1.1 per cent of GDP, a 7.0 per cent increase compared with 2017. The bill followed adjustments which had been made to the sales tax and subsidy system. These included raising levies on food and consumer items by unifying the general sales tax to 16 per cent, removing exemptions on many basic goods, and ending subsidies on bread on the basis that the majority of the subsidy was spent on refugees and foreign workers, thus not benefiting Jordanian nationals.

Measures to attract foreign investors have been introduced. In February 2018 the Cabinet approved a programme opening the way for foreign investors to apply for Jordanian citizenship. The initiative was based on a number of investment options to attract individuals with substantial resources to invest in Jordan, thereby reviving economic growth and reducing reliance on foreign aid in the medium term. These include making a zero-interest deposit at the Central Bank of Jordan (CBJ) of US$ 1.5 million for five years, buying Treasury bonds for no less than 10 years (US$ 1.5 million, at an interest rate to be decided by the CBJ), buying securities from an active investment portfolio (US$ 1.5 million), investing US$ 1 million in small and medium-sized enterprises (SMEs) for at least five years, investing US$ 2 million in any location in Jordan, or US$ 1.5 million if the project is registered in a governorate other than Amman, provided that it creates at least 20 job opportunities and remains operational for at least three years. Investors could also buy and retain property for a minimum of 10 years. The Jordan Investment Commission (JIC) received more than 50 applications from Iraqi, Lebanese, Syrian, Palestinian and Yemeni nationals. The decision is likely to create tension among some groups living in Jordan. Finally, pro-employment reforms have been implemented, including the reduction of the cost of formalisation of workers.

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Some improvements in the transport sector are already under way, but more needs to be done. The Bus Rapid Transit (BRT) system for Amman is due for completion by 2020, and there are plans to extend it to link Amman and the nearby city of Zarqa. Jordan has had some success in improving key transport-related infrastructure, notably with the completion of the upgrade and expansion of Queen Alia International Airport (QAIA) in Amman – a successful public-private partnership example – and the relocation of the Aqaba port in southern Jordan. However, the large increase in refugee immigration in recent years has added to urban transportation woes, and the transport sector's needs are complex. Given the current financial situation, Jordan will need the support of external donors and investors to move forward with such projects.

KAZAKHSTAN

Highlights

- **The economy continues to grow steadily.** GDP growth was 4.1 per cent in 2017 and a similar rate in the first three quarters of 2018, driven by oil output expansion and favourable commodity prices.
- **A new development plan was unveiled.** The 2025 Strategic Development Plan envisages reforms in the following key areas: human capital, technological innovation, promoting competitiveness, strengthening the rule of law, regional development and urbanisation, and increased efficiency of the public administration.
- **The Astana International Financial Centre (AIFC) has been launched.** The new centre will serve the needs of the financial services of neighbouring countries and beyond by providing regulatory and judicial standards that are typically available in developed markets.

Key priorities for 2019

- **Efforts to privatise state-owned enterprises (SOEs) need to step up.** Pre-privatisation activities including the improvement of management and governance structures of SOEs and aligning procurement practices with international standards need to continue. Privatisation of strategic enterprises should advance.
- **The authorities should accelerate the implementation of regulatory reform.** The short-term focus should be on key areas such as utilities tariff-setting and renewable energy.
- **The asset quality in the banking sector should be further improved.** Improvements in governance and risk management practices as well as further strengthening of the central bank's regulatory and supervisory capacities are needed.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.2	1.2	1.1	4.1	4.0
Inflation (average)	6.7	6.7	14.6	7.4	6.4
Government balance/GDP	1.7	-2.2	-1.6	-2.7	-2.0
Current account balance/GDP	2.8	-2.8	-6.5	-3.4	-1.5
Net FDI/GDP [neg. sign = inflows]	-2.1	-1.7	-9.7	-2.4	-3.0
External debt/GDP	71.2	83.2	119.2	105.1	n.a.
Gross reserves/GDP	13.2	15.1	21.6	19.3	n.a.
Credit to private sector/GDP	33.5	37.7	33.0	30.5	n.a

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Macroeconomic performance

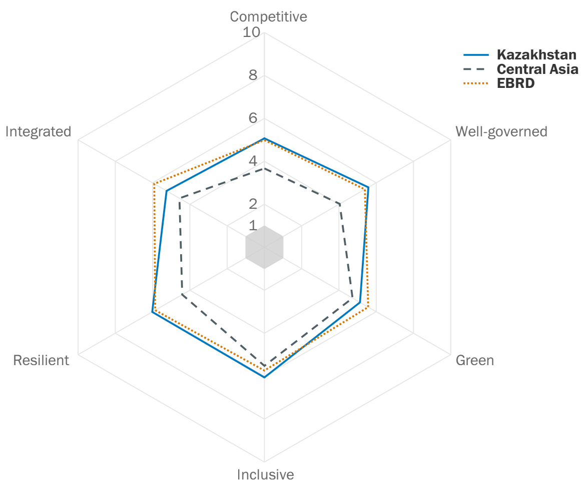
The economy continues to grow at a rate above 4 per cent. After a significant slow-down to 1.1 per cent in 2016, real GDP growth rebounded to 4.1 per cent in 2017 and remained at that level (year-on-year) in the first three quarters of 2018. Growth was supported by an acceleration of gross fixed capital formation (5.3 per cent year-on-year in the first half of 2018), growth of exports (8.9 per cent year-on-year in the first half of 2018) and a recovery in private consumption (4.5 per cent growth year-on-year in the first half of 2018), enabled by rising real wages. Oil output growth was 10.5 per cent in 2017 and reached 6.6 per cent year-on-year in the first three quarters of 2018. Credit expansion remains sluggish notwithstanding the decline in the non-performing loan (NPL) ratio from 12.8 per cent in July 2017 to 8.2 per cent in August 2018.

Despite increasing oil prices, the exchange rate came under pressure in 2018. While the exchange rate appreciated in late 2017 and early 2018, depreciation pressures returned in April 2018 following the depreciation of the Russian rouble. The tenge weakened against the US dollar by 8.5 per cent during the first nine months of 2018. Although annual inflation moderated from 7.9 per cent in January 2017 to 6.1 per cent by September 2018 (within the central bank's target of 5.0 to 7.0 per cent), inflationary pressures are on the rise as a result. This prompted the central bank to increase the base rate from 9.0 per cent to 9.25 per cent in October 2018, reversing a series of rate cuts since May 2016.

Fiscal adjustment is proceeding and the current account deficit has narrowed. As a result of sizeable government spending in 2017, which increased to 25.0 per cent of GDP in 2017 from 22.1 per cent in 2016 due to measures in support of the banking sector, the fiscal balance deteriorated from 5.5 per cent of GDP in 2016 to 6.3 per cent in 2017. From 2018 the authorities have embarked on a fiscal consolidation path. The government budget plan foresees the narrowing of the consolidated budget deficit to 1.5 per cent of GDP in 2018 as the guaranteed transfers from the oil fund will be cut. The current account deficit narrowed from 6.7 per cent of GDP in 2016 to 2.9 per cent in 2017 and continued shrinking in the first half of 2018, helped by rising exports.

Growth is expected to moderate slightly in the short term. GDP is currently forecast to grow by 4.0 per cent in 2018 and 3.5 per cent in 2019, due to slower oil output expansion. Large investment projects in oilfield development and gasification of the country will continue supporting growth. Domestic consumption will also likely recover somewhat after growing by a meagre 1.5 per cent in 2017, boosted by increases in real wages and an expansion of lending to households. Risks to the growth outlook stem mainly from banking sector difficulties and a possible slow-down in external demand for commodity exports.

Assessment of transition qualities (1-10)



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Major structural reform developments

The government has announced a new strategic plan. The “2025 Strategic Development Plan” was approved in February 2018. The plan rests on seven pillars: human capital, technological innovation, promoting competitiveness, strengthening rule of law, regional development and urbanisation, changing people’s mindset, and improvements in the public sector. The 2025 plan is supported by several specific programmes, such as the “Digital Kazakhstan 2018-22” state programme. In addition, five social initiatives were announced in March 2018 and are designed to promote sustainable and broad-based growth through the provision of affordable housing, lower tax rates for low-income groups, improved access to finance for small and medium-sized enterprises (SMEs), and the gasification of Astana and other regions. Furthermore, the State of the Nation Address by the President delivered in October 2018 envisages an increase in the minimum wage and the prolongation of state programmes supporting SMEs and developing infrastructure.

Several legislative changes were implemented to improve the business environment and the investment climate. A new tax code was adopted in December 2017 which aims to reduce the tax burden and simplify tax administration procedures. A new subsoil use code implementing international standards for minerals and hydrocarbons extraction came into force in June 2018. The Customs Code of Kazakhstan has been brought into compliance with the Customs Code of the Eurasian Economic Union. It focuses on the automation of customs processes, e-declaration and optimisation of customs procedures. The introduction of an electronic customs declaration system and reduction of customs administrative fees resulted in Kazakhstan’s advancement in the trading across borders score in the World Bank’s Doing Business 2019 report. Overall, Kazakhstan ranks 28th out of 190 countries in terms of ease of doing business, improving its position substantially from 2017, when it ranked 36th. The country comes first in protecting minority investors and performs relatively well in areas such as starting a business and enforcing contracts, but significant gaps remain in trading across borders, getting credit and getting electricity.

Financial sector development is advancing. An important development for regional financial sector development was the launch of the Astana International Financial Centre (AIFC) in July 2018. The new centre has already attracted over 80 financial and non-financial firms. Within the AIFC, the Astana International Exchange (AIX) started operating in January 2018 with Shanghai Stock Exchange and NASDAQ as its key strategic partners. To stimulate the development of the new stock exchange, various government decrees provide for conducting initial public offerings (IPOs)/secondary public offerings of several large state-owned companies on the AIX. Another important development includes the eligibility of government bonds and central bank short-term notes for the Clearstream system, which improves foreign investor access to Kazakh securities and helps build a yield curve. All of these measures represent important steps towards creating a more resilient financial system by promoting alternative and complementary sources of funding to the traditional banking sector.

Efforts to address banking sector weaknesses continue. The merger of two large banks – Halyk Savings Bank and Kazkommertsbank – was completed in July 2018. In 2017 the authorities provided financial support to five other banks through the purchase of their subordinated debt for 15 years, conditional on additional capital injections from shareholders and implementation of their specific plans to increase asset quality and reduce NPLs. The central bank revoked the licences of three smaller banks and extended a stabilisation loan to the second largest bank in August 2018. The banking sector as a whole continues to be hampered by insufficiently strong risk management and corporate governance practices. The still-high level of NPLs constrains banks from fully performing their roles as financial intermediaries. In order to stimulate credit growth, the National Bank of Kazakhstan started in August 2018 a programme to invest Tenge 200 billion (US$ 600 million) from assets of the Pension Fund into buying bonds of banks.

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Further steps have been taken towards the development of the green economy. In January 2018, the government re-launched the emissions trading system (ETS), which had been suspended since 2016. The system now includes new allocation methods, following the introduction of amendments to the Environmental Code in 2017. As part of the ETS, in February 2018 Kazakhstan started an online platform allowing greenhouse gas emitters to trade quotas and verify data on emissions. Another major initiative includes holding the first renewable energy auction in May 2018, which replaces the fixed tariff system with market-based pricing. This provides the basis for cost reduction in renewable energy projects and promotes further progress in tapping into Kazakhstan's large renewable energy potential. Additional legislative changes include the adoption of amendments to the Law on Natural Monopolies in December 2017, which envisages commercial tariff-setting in water and district heating from 2020.

SOE reform and privatisation are proceeding. The government reported that 502 of 887 state-owned enterprises had been offered for sale and 421 had been sold for Tenge 216 billion (US$ 584 million) as of the end of June 2018. The sale of assets of Samruk-Kazyna (SK), the national state holding company, made up more than 60 per cent of the proceeds. It is planned to sell another 87 assets by the end of 2018. Kazatomprom, the world's largest uranium producer, plans to sell a 25 per cent stake on the London Stock Exchange and on the AIX in late 2018 as part of an IPO. IPOs of Air Astana and Kazakhtelecom are also expected to take place on the AIX in the fourth quarter of 2018. Other blue chip assets under SK are in the process of transformation with a view to improving corporate governance practices and increasing operational efficiency. For instance, Kazakhstan Temir Zholy, a vertically integrated national railway transportation operator, and Samruk-Energy, a strategic energy holding company, adopted a new organisation structure and eliminated duplicated processes.

KOSOVO

Highlights

- **Robust economic growth is continuing.** GDP grew by 3.7 per cent in 2017, driven by investment and net exports. Unemployment has also continued its declining path, although the rate is still among the highest in Europe.
- **Plans to build a new coal-fired plant have advanced.** The government signed a contract with power generator ContourGlobal to build a 500 MW coal-fired power plant, with a value of €1 billion.
- **Cross-border transport infrastructure is being enhanced.** The reconstruction and development of Kosovo's major road and railway infrastructure network is taking place**.**

Key priorities for 2019

- **Privatisation should be re-energised. Little progress has been made in this area in recent years.** Attracting private ownership and investment into state-owned enterprises could give the economy a much-needed boost.
- **A major reform push in the energy sector is needed.** Renewable energy investments and energy efficiency measures can help mitigate power shortfalls, while enhancing environmental sustainability and energy security.
- **Implementation of key cross-border infrastructure projects needs to speed up.** Infrastructure development is key to Kosovo's continued integration within the region. Finalisation and rehabilitation of the main transport links to pan-European corridors would boost trade and investment with neighbouring countries.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.2	4.0	4.1	3.7	4.0
Inflation (average)	0.4	-0.5	0.3	1.5	0.8
Government balance/GDP	-2.4	-1.8	-1.3	-1.2	-3.4
Current account balance/GDP	-6.9	-8.6	-7.9	-6.6	-7.2
Net FDI/GDP [neg. sign = inflows]	-2.2	-4.7	-2.9	-4.0	-3.9
External debt/GDP	31.2	33.3	33.2	32.6	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	33.6	34.5	36.5	38.6	n.a.

*Kosovo uses the euro as its legal tender.

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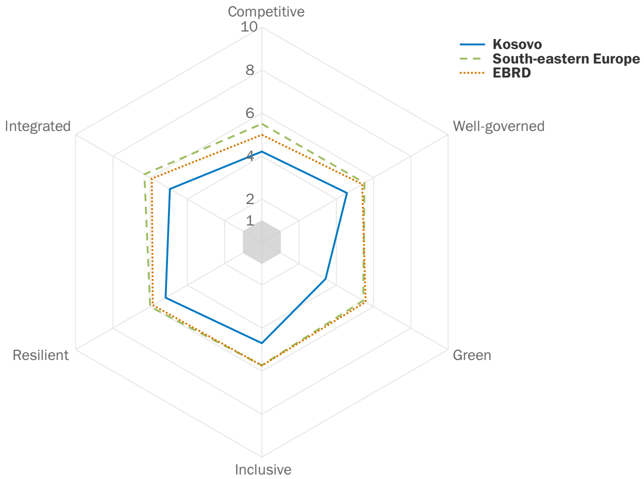
Macroeconomic performance

Robust growth has continued. GDP grew by 3.7 per cent in 2017, slightly below the level of the previous two years. Last year's growth was mainly investment driven, although net exports were also a positive contributor to growth. The unemployment rate continued its declining path over the last three years and now stands at 27.5 per cent, still very high by regional standards. The low rate of labour force participation, especially among women, represents a key bottleneck for further economic development. Growth has continued into 2018 with overall output rising 4.2 per cent year-on-year in the first half of the year. It was again mainly investment-driven, as construction of key transport infrastructure progressed, although private and government consumption were also positive contributors to growth. Inflation averaged 1.5 per cent in 2017.

Fiscal policy has remained moderate. Following the end of the IMF programme in 2017, the government has stuck to a prudent fiscal path, with the government deficit at 1.2 per cent of GDP in 2017. Public debt also remains exceptionally low by regional standards at just 17 per cent of GDP by the end of 2017 (excluding debt related to the Yugoslav era). The government is therefore staying well within the fiscal rule targets of a deficit below 2.0 per cent of GDP and public debt remaining below 30.0 per cent of GDP, although there have been signs of rising spending commitments in 2018. On the external side, the current account deficit remains large at 6.0 per cent of GDP in 2017, although partly balanced by inflows of foreign direct investment which amounted to 4.0 per cent of GDP.

Further growth is likely in the short term. The current forecast for GDP growth in 2018 is 4.0 per cent, with the same projection also in 2019, due mainly to a more favourable external environment and hence higher remittances and exports, as well as an anticipated acceleration of investment, including in public infrastructure. Future growth may also depend on the pace of implementation of the planned new 500 MW thermal power plant (see below), which would represent the biggest investment project in the country. Conversely, a failure to proceed with the project or to put in place alternative arrangements for an adequate power supply could have a serious negative impact on the economy.

Assessment of transition qualities (1-10)



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Major structural reform developments

The government has approved an action plan to meet EU requirements. The action plan, approved in April 2018, is designed to address the country's challenges as identified in the latest European Commission (EC) progress report. The EC noted that corruption remains an issue of concern, and suggested that the country step up the fight against the informal economy, which remains widespread, as well as against tax evasion. The report also recognised that the energy sector continues to face serious challenges and is a major bottleneck for economic development.

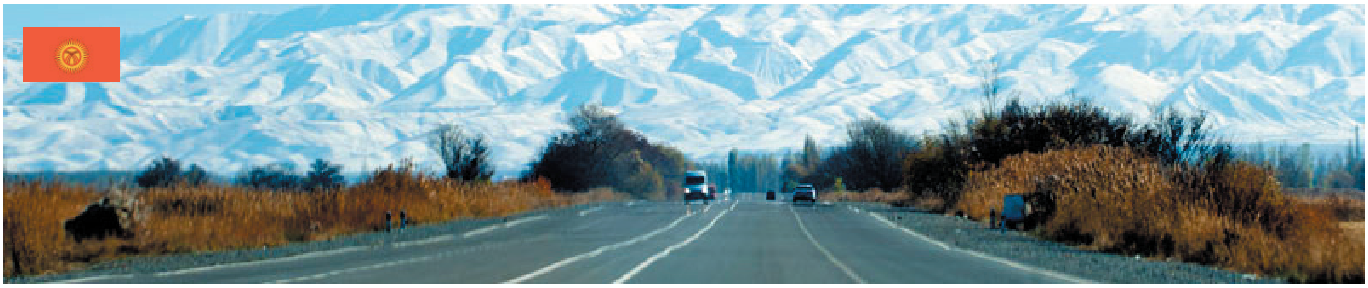
Steps are under way to revive the major mining complex Trepca. In May 2018, the government approved the statute for Trepca, almost two years after the complex was put under government control in a bid to save it from bankruptcy. This followed the decision by the parliament to settle the legal situation of the company by transforming it from a socially owned enterprise into a shareholding company, giving the state an 80 per cent stake and miners 20 per cent. Trepca's ownership structure has been disputed by Serbia, which claims the majority stake. The Trepca board is expected to proceed soon with the creation of all managerial structures and an operational plan.

Cross-border linkages with Albania are being strengthened. In June 2018, the parliament endorsed the implementation of the agreement between Kosovo and Albania on the unification of customs points between the two countries. The agreement is expected to facilitate the exchange of goods and the movement of people. Also, in parallel the parliament of Kosovo adopted a resolution on the removal of telephone roaming charges with Albania.

Progress in transport infrastructure is moving ahead slowly. In July 2018, the government approved plans to borrow €80 million from the European Investment Bank to finance the construction of the 30 km Pristina-Peja motorway segment (Kijeve-Zahaq), which leads to Montenegro. The project, which has a total value of €200 million, will be co-financed by the EBRD. The government has also decided to extend the deadline for the completion of the €600 million, 60 km highway that leads from Pristina to the Macedonian border until the end of 2018, built by the American-Turkish consortium Bechtel Enka. In the area of railways infrastructure, the European Union is providing a grant of €38.5 million to Kosovo to co-finance (with the EBRD) the modernisation of the country's railway infrastructure network, thus improving its connection with the Pan-European Corridors VIII and X. This project covers the three sections of the main railroad Route 10 connecting Kosovo with Serbia in the north and with FYR Macedonia in the south.

Plans to build a new coal-fired plant have advanced. In December 2017, the government signed a contract with power generator ContourGlobal to build a 500 MW coal-fired power plant, with a value of €1 billion. In June 2018 ContourGlobal called a pre-qualification tender for the construction of the plant, and in September 2018 the government of Kosovo and ContourGlobal jointly announced that four out of six applicants had pre-qualified for the next stage of the tender. Currently Kosovo relies mostly on two old coal-fired plants, Kosova A and Kosova B, both part of Kosovo Electricity Corporation (KEK), which are considered to be among the worst polluters in Europe. However, the proposed new project has been criticised by environmental groups who argue that the country should look to alternative fuel sources rather than investing in more coal capacity.

New legislation is being introduced in the financial sector. Currently the level of financial intermediation is well below that of neighbouring countries, but the banking system is well capitalised and has a very low level of non-performing loans, at just 3.1 per cent of total loans. The Law on Banks is expected to undergo amendments as regulations are harmonised with Basel and EU standards. The EBRD is assisting the central bank to review and amend the legal framework for the receivership and liquidation of financial institutions. A new draft law on microfinance institutions and non-bank financial institutions is also being discussed and is expected to enter into force by the end of 2018.



KYRGYZ REPUBLIC

Highlights

- **Economic growth decelerated in 2018.** In the first three quarters of 2018 the economy grew by 1.2 per cent year-on-year after reaching 4.6 per cent in 2017. A sharp drop in gold production was the main reason for the slow-down.
- **Regional cross-border linkages are deepening.** The Kyrgyz Republic and Uzbekistan are on track to resolve long-standing border issues, and ties with Kazakhstan are strengthening again.
- **A new long-term development strategy has been unveiled.** The new strategy focuses on measures to digitalise the economy, improve the effectiveness of the public administration, create better opportunities for education and training, and improve the business environment.

Key priorities for 2019

- **Fiscal policy should be tightened.** In 2017, pre-election spending delayed the authorities' efforts to reduce the budget deficit. The authorities need to pursue fiscal consolidation in line with the target deficit of 2.5 per cent of GDP agreed with the IMF.
- **Business climate challenges need to be tackled and access to electricity improved.** Business disputes over environmental protection and property rights issues need to be resolved. The authorities need to agree a stable and permanent framework for operations and ownership of the Kumtor gold mine and other mining investments to demonstrate their commitment to legal stability and ensure the attractiveness of the country for foreign direct investment.
- **The banking sector should be strengthened.** Non-performing loans (NPLs) and dollarisation continue to pose challenges for the economy. The central bank should further strengthen its supervisory and regulatory capacity.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.0	3.9	4.3	4.6	2.7
Inflation (average)	7.5	6.5	0.4	3.2	2.5
Government balance/GDP	-0.5	-1.4	-4.4	-3.2	-3
Current account balance/GDP	-16	-16	-11.6	-4	-6
Net FDI/GDP [neg. sign = inflows]	-4.6	-17.1	-9.1	-1.2	-0.7
External debt/GDP	99.0	115.3	116.3	107.3	n.a.
Gross reserves/GDP	26.2	26.6	28.9	28.7	n.a.
Credit to private sector/GDP	20.1	22.6	20.0	21.8	n.a.

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Macroeconomic performance

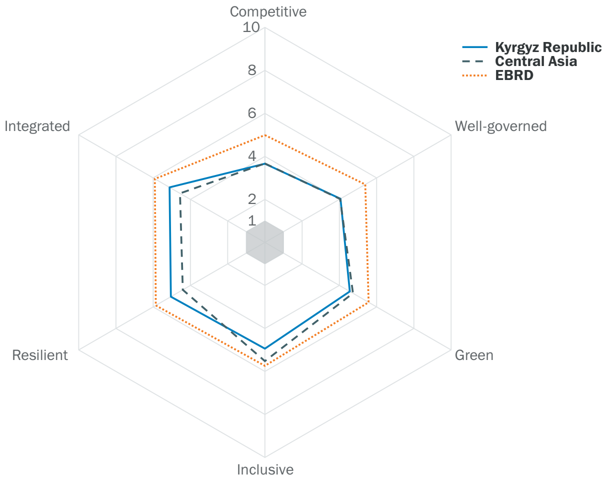
The economy grew strongly in 2017, but growth has slowed in 2018. After 4.6 per cent growth in 2017, real GDP increased by only 1.2 per cent year-on-year in the first three quarters of 2018, reflecting a sharp decline in Kumtor gold production. In the first half of 2018, output of gold from Kumtor shrank by 30 per cent year-on-year. While exports declined by 4.9 per cent in the first eight months of 2018, imports increased by 15 per cent. Excluding Kumtor, real GDP increased by 2.4 per cent year-on-year in the first three quarters of 2018, aided by the acceleration in growth in services and agriculture. Remittances have continued to grow also in 2018 after a strong recovery in 2017.

The exchange rate has been broadly stable. The som slightly appreciated in 2017, supported by the stabilisation of the Russian rouble and the recovery of remittances. However, exchange rate pressures in April and August 2018 related to the weakening of the rouble amid US sanctions against Russia prompted depreciation pressures on the som and a modest intervention by the central bank to control these pressures. The weakening of the som was thus limited, which has resulted in an effective appreciation against the rouble and the tenge. Inflation moderated from 3.7 per cent year-on-year in December 2017 to 1.2 per cent in September 2018. The NBKR reduced its policy rate from 5.0 per cent in 2017 to 4.75 per cent in May 2018.

Fiscal and external deficits have remained sizeable. Despite significant expenditure growth, the fiscal deficit narrowed to an estimated 3.3 per cent of GDP in 2017 from 4.6 per cent in 2016, mainly due to higher budget revenues on the back of the growing economy. Under the IMF's three-year Extended Credit Facility programme signed in April 2015, the Kyrgyz Republic had agreed to reduce the fiscal deficit further to 2.5 per cent of GDP in 2018. Public debt rose from 57 per cent at the end of 2017 to 58 per cent of 2017 GDP at the end of August 2018, indicating increasing fiscal vulnerability. The current account deficit narrowed to 4.0 per cent of GDP in 2017 from 11.6 per cent in 2016 thanks to strong export growth and higher external transfers. However, it almost doubled to US$ 515 million in the first half of 2018 from US$ 270 million a year earlier.

Short-term growth is projected to be moderate. Real GDP is expected to grow by 2.7 per cent in 2018 and 3.2 per cent in 2019. Growth will likely be rather moderate due to weak mining output. However, remittance inflows and relatively low inflation will stimulate growth in real wages and improve household demand. Non-mineral exports should grow thanks to further Eurasian Economic Union integration. Downside risks include a slower than assumed recovery in mining output and weaker than assumed growth of the Russian economy.

Assessment of transition qualities (1-10)



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Major structural reform developments

The business environment remains challenging despite the government's efforts to stimulate private sector development. Recent policies for private sector development focused on tax administration reforms, improvement of customs regulation, and reforming antitrust laws as outlined in the Programme for Private Sector Development for 2015-17. The Kyrgyz Republic ranked 70 out of 190 countries in terms of ease of doing business, according to the World Bank's *Doing Business 2019* report. This is a slight improvement from 2018 but the country still scores below the regional average (Europe and Central Asia), with large gaps remaining in paying taxes, getting electricity, and enforcing contracts.

A new ambitious development strategy is being designed. The draft of a "Sustainable Development Strategy of the Kyrgyz Republic for 2018-2040" was adopted by the National Council for Sustainable Development under the President of the Kyrgyz Republic in November 2017 and was reviewed by the council in August 2018 after public consultations. The strategy rests on programmes for the transition to the digital economy, the enhancing of the effectiveness of the public administration, creating better opportunities for education and training, and improving the business environment.

Uncertainties related to major projects have re-emerged. In September 2017 Centerra Gold, the operator of Central Asia's largest gold mine Kumtor, signed an agreement with the government, which settled an environmental dispute and allowed the subsidiary company to transfer cash to the parent company in Canada. However, as of August 2018 the agreement had not come into force as several conditions still need to be satisfied. The deadline for enforcing the agreement is being postponed by the Kyrgyz authorities, who have indicated they may want to review it. Another project – the construction of the Upper-Naryn cascade of hydropower plants – is also delayed by legal complications regarding compensation claims by RusHydro, a Russian power generation company. In 2016, the agreement with RusHydro to build the hydropower stations was terminated by the government because of concerns about the ability of the Russian government to follow through on proposed investment in the project.

Relations with other Central Asian countries are being strengthened. In October 2017, Uzbekistan and the Kyrgyz Republic ratified a long-awaited agreement to demarcate 85 per cent of the shared border, which represents a major step in improving bilateral ties. Uzbekistan also expressed its support for the building of a large-scale hydroelectric dam on the Naryn river in the Kyrgyz Republic, discarding its previous concerns over disruption of the water flow required for Uzbekistan's agricultural sector. Relations with Kazakhstan are improving too after the two sides settled disputes in December 2017 concerning Kazakhstan's imposition of tightened border controls.

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).

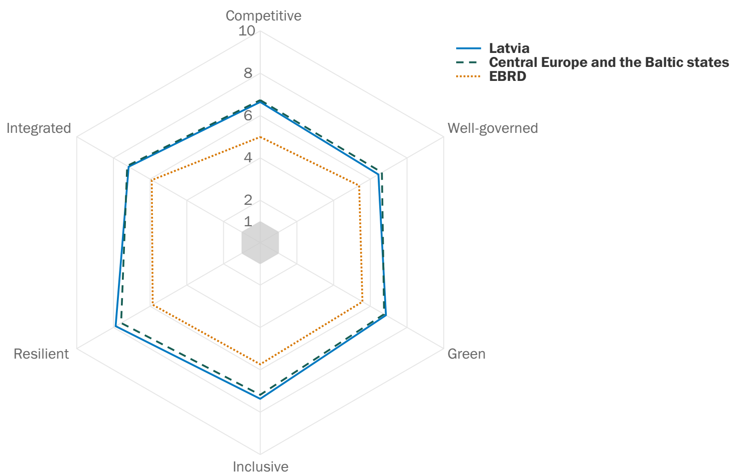
Robust household consumption, at 5.1 per cent growth in 2017, continued to be supported by a tightening labour market, which saw average real wage growth of 4.8 per cent. Only strong investment-driven imports weighed somewhat on the robust recovery of GDP growth.

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.

LEBANON

Highlights

- **Lebanon has remained in a protracted period of low growth since 2011.** Since the start of the Syrian conflict, growth averaged 1.7 per cent, compared with 5.6 per cent in the decade before. The fiscal and external positions are deteriorating further.
- **The Capital Investment Programme (CIP) was adopted by the Cabinet and presented at the Paris IV conference.** The total cost of the phases of the programme until 2025 is estimated at US$ 17.3 billion and over one-third of the first phase has the potential to be fulfilled by the private sector.
- **Reforms progressed in 2017 in some areas, but lag behind in others.** Completed reforms in 2017 and early 2018 included passing the public-private partnership (PPP) law, new decrees regulating oil and gas exploration, new licences for a consortium of three international oil companies to start exploratory drilling, and adoption of a new electoral law.

Key priorities for 2019

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

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.0	0.2	1.7	1.5	1.1
Inflation (average)	1.1	-3.8	-0.8	4.5	6.5
Government balance/GDP	-6.3	-7.9	-9.6	-6.0	-9.7
Current account balance/GDP	-23.9	-16.7	-20.5	-22.8	-25.6
Net FDI/GDP [neg. sign = inflows]	-3.4	-1.8	0.0	-4.3	-4.0
External debt/GDP	167.5	168.4	182.6	182.4	183.3
Gross reserves/GDP	76.9	73.6	78.1	75.0	63.3
Credit to private sector/GDP	143.8	147.4	147.1	n.a.	n.a.

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Macroeconomic performance

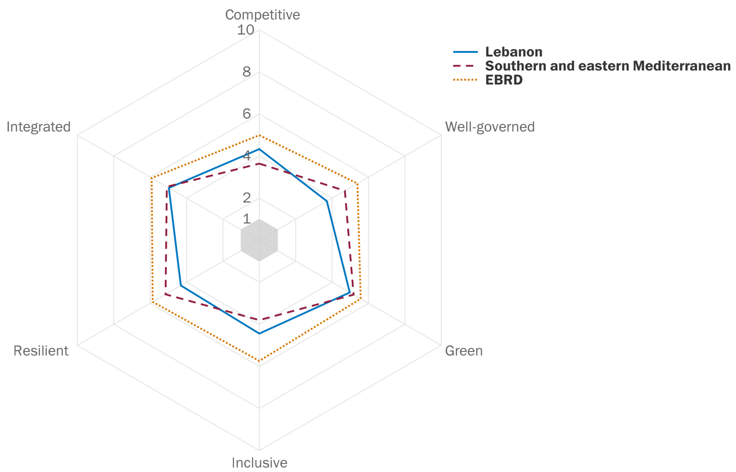
The economy remains in a protracted period of low growth. GDP growth averaged 1.7 per cent in 2011-17, compared with 5.6 per cent in the decade before, due to declining investment and exports and subdued private consumption and tourism. This is a result of political and security conditions, both domestic and regional, which affected traditional growth drivers – tourism, real estate and construction. The economy grew by 1.5 per cent in 2017, driven mainly by private consumption – sustained by remittances from the Lebanese diaspora – and exports. In per capita terms, GDP has been increasing at a mere 0.2 per cent per year on average since 2010, compared with 8.4 per cent in the six years before the Syrian crisis.

The fiscal situation is increasingly challenging. The fiscal deficit remained large in 2017, as subsidies to the electricity company – Electricité du Liban (EdL) – increased due to rising oil prices, and interest payments continued to increase, accounting for half of revenues and crowding out more productive forms of spending. At the same time, one-off revenues from taxing higher bank profits prevented the deficit from widening further. Meanwhile, public debt, the third highest in the world (relative to GDP), is now close to 150 per cent of GDP.

The external situation has worsened. The current account deficit widened to over 20 per cent of GDP in 2017 owing to the impact of regional conflict on key trading partners and routes, and the economy remains largely dependent on remittances (which account for 13.4 per cent of GDP) and deposits from non-residents (14.6 per cent of GDP). Reserves remain comfortable at over US$ 43 billion, covering around 14 months of imports and providing stability to the economy.

Growth is expected to rebound but remain subdued. GDP is forecast to grow at 1.1 per cent in 2018 and a range of 1.5 to 1.9 per cent in 2019 depending on the recovery in the construction and financial sectors, and the extent of reconstruction in Syria. Meanwhile, sizeable vulnerabilities and risks remain, including from internal political uncertainty, regional turmoil and increased spending pressures.

Assessment of transition qualities (1-10)



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Major structural reform developments

A new budget has been passed, the first for many years. The resolution of the political deadlock paved the way for the passage of the first budget since 2005, as well as the country's first parliamentary elections in nine years. In March 2017, Cabinet approved a draft 2017 budget, and in October 2017 it passed through parliament. In March 2018, parliament approved the 2018 budget, a few days before the CEDRE donor conference in Paris. The 2018 budget included a commitment to reduce current spending by 20 per cent, although this commitment did not materialise when executing the budget. Also, the Cabinet adopted a new electoral law based on proportional representation, which governed the recent parliamentary elections in May 2018.

The Capital Investment Programme (CIP) was approved by the Cabinet in March 2018. The total cost of the government's ambitious plan during the first two phases of the programme (2018-21 and 2022-25) is estimated at US$ 17.3 billion. The first phase is estimated at US$ 10.8 billion (including expropriation costs), of which around 38 per cent has the potential to be financed fully from private investment in cycle 1. The programme is expected to be an effective tool to help reinforce Lebanon's depleted infrastructure, thereby supporting a boost in economic growth.

The Public-Private Partnership (PPP) law has been ratified. The law, adopted in August 2017, introduced a new legal regime for PPP projects in Lebanon, to improve transparency, competitiveness and accountability standards. The PPP law grants the renamed High Council for Privatization and Partnerships (HCPP) the power to assess and evaluate potential PPP projects. Nevertheless, the PPP law includes certain gaps that remain to be bridged. For example, there are no clear criteria on what projects should be implemented as PPPs instead of traditional public procurement, the role of the Ministry of Finance is limited, the institutional set-up for PPPs appears complicated and geared toward the promotion of PPPs, without appropriate risk management, and the dispute resolution mechanism is insufficient.

The government has already begun to address some of the key factors that have caused delays in project start-up. All loans approved by lenders as of the end of 2017 have been signed or approved for signing by the Cabinet, and parliament ratified about US$ 400 million of loans over the past year. With regards to counterpart funds for projects for which foreign loans have already been provided, the government decided, in consultation with the central bank, to issue bonds worth US$ 700 million for the financing of land acquisition and other counterpart funds required, although this has not materialised to date.

Parliament approved a set of regulations to jump-start the oil and gas sector. The petroleum-income tax law—a necessity to complete the Lebanese petroleum fiscal regime—was enacted in October 2017, two years after it was first drafted. Four other important laws in this sector are currently at the initial stages of the parliamentary process. They cover the establishment of a petroleum asset-management department, a sovereign wealth fund and a national oil company, as well as prospects for onshore exploration. In addition, last year's Right of Access to Information Law, the Petroleum Transparency Law—which is reaching the final stages in parliament committees – and the plan to join the Extractive Industries Transparency Initiative should all contribute to greater transparency in the sector.

Concrete measures have been taken to solve the solid waste crisis. The Cabinet decided in January 2018 on measures to resolve the crisis including: the expansion of landfill facilities, the construction of a composting plant and upgrading of sorting plans, and the construction of waste to energy plants. At the same time, responsibility for solid waste management will be decentralised to municipalities. A Framework Law setting forth the mechanism for developing solid waste strategies and plans is currently under final consideration by parliament.

The public consultation process is being enhanced amid concerns about wage policy. A Socio-Economic Council has been reinstated in January 2018 after it was first formed in 2000. The Council serves as a consultative body on economic and social policy and is tasked with creating an efficient space for dialogue between the main actors of the public and private sector and contributes to the public governance in Lebanon. The Cabinet also passed the public sector's salary scale bill, which had been held up for years, although its uneven implementation has sparked ongoing protests, in addition to having a large fiscal cost, with insufficient revenue measures to finance it, and causing the ballooning of pension payments.

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

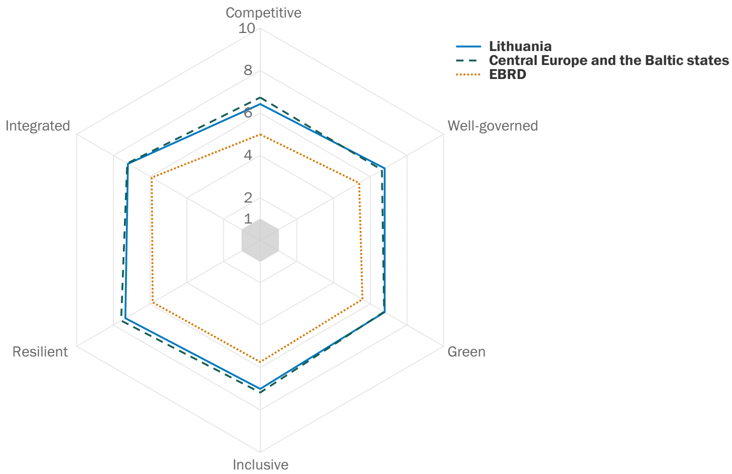
GDP growth has been fuelled by strong private consumption and a recovery in investment. Real GDP growth reached 4.1 per cent in 2017, followed by 3.8 per cent growth year-on-year in the first half of 2018. Robust private consumption has been accompanied by a strong pick-up in investment (by about 8.0 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.

MOLDOVA

Highlights

- **Economic output has been growing steadily.** GDP grew by 4.5 per cent in 2017 supported by a favourable external economic environment and a recovery in household consumption. In the first half of 2018 growth continued at a similar pace.
- **Foreign investors have entered two systemically important banks**. The recent acquisitions of a 39.2 per cent stake in Victoriabank and a 41.09 per cent stake in Moldova Agroindbank by fit and proper investors are steps towards transforming the banking sector. These also mark the first entries since 2007 of foreign bank investors into Moldova.
- **Recent business environment reforms include welcome improvements but have also raised concerns.** New tax simplification and deregulation measures should contribute to a more enabling business environment, but an amnesty regarding previous offences may obstruct the administration of justice.

Key priorities for 2019

- **Shareholder fitness should be restored at one of the country's systemic banks as soon as possible.** In order to shore up financial stability, the removal of opaque shareholders needs to be finalised in the second largest bank which remains under the temporary administration of the National Bank of Moldova.
- **IMF programme implementation should continue without delays.** Implementation of structural reforms and macroeconomic policies agreed under the programme is crucial for maintaining investor confidence and for receiving financial support from international development partners.
- **Supervision of the non-bank financial sector should be enhanced.** To mitigate migration of risks from the banking sector, more needs to be done to strengthen supervision of non-bank financial institutions, as well as to enhance the capacity of the financial sector regulator.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	4.8	-0.4	4.3	4.5	4.0
Inflation (average)	5.1	9.7	6.4	6.6	3.6
Government balance/GDP	-1.9	-2.3	-2.1	-1.0	-3.5
Current account balance/GDP	-7.1	-7.1	-4.2	-5.9	-7.4
Net FDI/GDP [neg. sign = inflows]	-3.8	-3.2	-1.2	-1.6	-2.8
External debt/GDP	80.9	93.1	91.4	72.8	n.a.
Gross reserves/GDP	27.0	27.0	32.6	29.3	n.a.
Credit to private sector/GDP	36.4	31.2	25.8	18.9	n.a.

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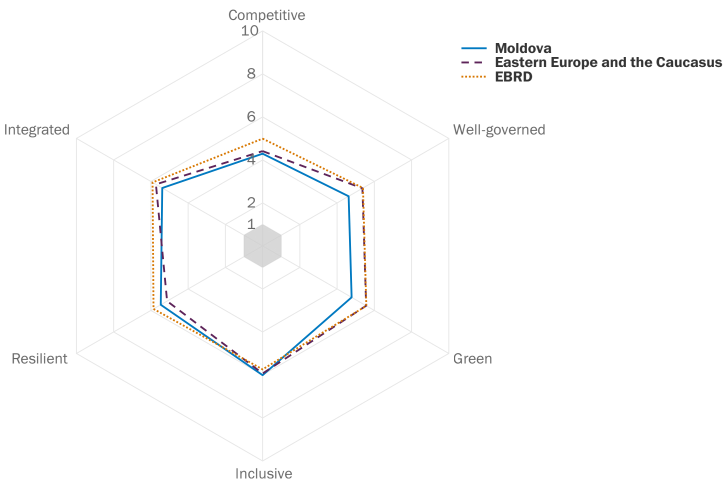
Macroeconomic performance

Robust economic growth has continued. Real GDP grew by 4.5 per cent in 2017, supported by a favourable external economic environment. Exports of goods and services continued to expand in 2017 on the back of growing exports to the European Union (EU). The volume of agricultural output increased by 7.9 per cent in 2017. Rising remittances and real wages have bolstered household consumption which, in turn, increased by 5.3 per cent in 2017. After contributing negatively to GDP growth in 2015-16, gross fixed capital formation rebounded in 2017, expanding by 5.2 per cent in real volume terms. GDP continued to grow by 4.5 per cent year-on-year in the first half of 2018.

Economic stabilisation is aided by a benign external environment. The current account deficit widened from 4.2 per cent of GDP in 2016 to 5.9 per cent of GDP in 2017, reflecting consumption-driven import growth. At the same time, remittances to Moldova increased by 12.8 per cent and exports of goods and services by 18.9 per cent in nominal US dollar terms. The expansion of Moldova's international trade was driven chiefly by increased cross-border flows with EU countries under the supportive framework of the Deep and Comprehensive Free Trade Agreement (DCFTA) signed in 2014. The Moldovan leu appreciated by 16.8 per cent during 2017 and by a further 1.4 per cent by the end of September 2018. International reserve assets of the National Bank of Moldova (NBM) increased from US$ 2.2 billion at the end of 2016 to US$ 3.0 billion in September 2018, covering approximately six months of imports. Inflation slowed from an average of 6.6 per cent in 2017 to a more manageable 3.7 per cent in the first nine months of 2018. At 1.0 per cent of GDP in 2017, the fiscal deficit was lower than projected as delays in external financing and the reorganisation of ministries led to under-execution of spending.

Structural and demographic challenges may act as a drag on potential growth. The economy is forecast to grow by 4.0 per cent in 2018 and in 2019. The lack of diversification in the economy is a key constraint holding back medium-term growth prospects. Agriculture's significant weight in economic value creation leads to volatility of growth and low overall productivity. Population ageing and the outflow of migrants are also key challenges that, if not addressed, will dampen the economy's long-term potential.

Assessment of transition qualities (1-10)



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Major structural reform developments

Reforms committed to under the IMF programme are on track. In June 2018 Moldova completed the third review of the IMF's Extended Credit Facility and Extended Fund Facility arrangements, signed in November 2016, which remain an important facilitator of reforms. To satisfy programme conditionalities, significant strides were made in a number of areas, including steps to instil shareholder transparency in the banking sector, improve the regulation of the non-banking sector and adjust the electricity tariff-setting methodology.

Major governance reforms have advanced in the banking sector. Procedures for share cancellation, issuance and sale of newly issued shares were amended in December 2017 to enable the removal of unfit shareholders. This was followed by the replacement of the non-transparent shareholder with fit and proper investors in two of the systemic banks. In January 2018, a strategic investor from Romania acquired a 39.2 per cent equity stake in Victoriabank, which was the third largest bank by assets at the time of the transaction. The new shareholder has launched a modernisation of the bank by, inter alia, introducing sound corporate governance as well as risk management standards and practices. In October 2018, a consortium of international investors acquired a 41.09 per cent stake in Moldova Agroindbank, the largest commercial bank in Moldova. At the same time, shareholder fitness in the third systemic bank remains to be restored.

The financial sector's legal, regulatory and supervisory framework has been further strengthened. A new anti-money laundering (AML) law was adopted in February 2018. All banks were instructed to conduct self-assessments of corporate governance practices. In April 2018, the NBM approved the list of related party exposures for the three largest banks and the time-bound plans for unwinding related party exposures were submitted and agreed with the NBM. The NBM completed onsite inspections and shareholder checks in non-systemic banks in May 2018. The government published a report on the findings of the independent investigator of the 2014 bank fraud and in March 2018 submitted it to the Anti-Corruption Prosecutor's Office which, in turn, developed a strategy to recover assets containing time-bound actions. The Central Securities Depository, responsible for the registration, book-keeping and settlement of financial securities issued by legal entities, became operational in July 2018. In the same month, the deposit guarantee ceiling was increased from approximately US$ 1,200 to US$ 3,000, risk-based banks' contributions were set up, and conditions under which the NBM or the Ministry of Finance could finance the guarantee fund were clarified.

The authorities are setting up a regulatory and supervisory framework for non-bank credit organisations. The aim is to prevent migration of risks from the banking sector to the non-bank financial sector. The law on non-bank credit organisations came into force in March 2018. It sets the regulatory framework and introduces capital requirements for these entities. Organisations covered by the law will be subject to a minimum capital requirement of 5 per cent of assets. If book value of assets exceeds 25 million lei (approximately US$ 1.5 million), such organisations will be required to perform an external audit of financial statements. The register of non-bank organisations is to be held at the National Commission for Financial Markets.

Pro-business tax measures have been adopted, along with reduced penalties for economic crimes. The package of business reforms was introduced in July 2018 to lower the regulatory and tax burden on businesses, but it also includes an ill-conceived capital amnesty and legislative revisions to reduce criminal liability for certain economic crimes. Progressive personal income tax rates of 7 per cent and 18 per cent were replaced by a single flat rate of 12 per cent. The employer social contribution rate was lowered from 23 per cent to 18 per cent. The value added tax rate for hotels, restaurants and cafes was cut to 12 per cent. A capital amnesty introduced by the package allows for registration of financial means and property without the need to provide documents attesting their origin until the end of 2018, conditional on paying 3 per cent of the asset value. This possibility does not apply to public officials. Furthermore, the package reduces the severity of punishment for a range of economic crimes in exchange for higher monetary fines. A reform of the state control function adopted in the second half of 2017 reduced the number of control institutions from 70 to 18 and streamlined procedures. In July 2018, the government launched a single window for issuing permits.

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A new methodology for calculating electricity tariffs is in place. The revised version was developed, adopted and published by the regulator (ANRE) and agreed with the Energy Community Secretariat, and is consistent with the new energy law. The methodology provides for annual setting of tariffs via established rules for determining costs, capital investment and profitability.

MONGOLIA

Highlights

- **The economy continues to grow dynamically.** Growth accelerated to 6.3 per cent in the first half of 2018 after reaching 5.1 per cent in 2017. Copper exports and mining-related investment are major growth drivers, with domestic consumption also picking up.
- **Reform implementation has been largely on track, although with delays in some areas.** The quantitative benchmarks for foreign exchange reserves and fiscal balance under the IMF programme have been met, but some fiscal accounts and financial sector reform measures have been delayed.
- **The results of the Asset Quality Reviews (AQRs) in the banking sector were better than expected.** The AQRs revealed an aggregate capital need in the sector of 2 per cent of GDP, well below earlier projections. Banks need to meet the targeted capital levels by the end of 2018.

Key priorities for 2019

- **Fiscal consolidation needs to continue in line with the IMF programme.** Given the high level of public debt, equal to 84.6 per cent of GDP in 2017, government spending should be restrained and the efficiency of public spending enhanced. The management of public finances needs further improvement, especially the granting of concessions and public investment.
- **The banking sector should be strengthened.** Among the main short-term priorities in order to improve financial resilience and reduce borrowing costs are the recapitalisation of the banking sector and the adoption and enforcement of the non-performing loan (NPL) resolution framework.
- **The investment climate in the mining sector needs to improve.** To increase investor confidence, greater transparency, predictability and certainty in administration and enforcement of existing legislation in the mining sector are key.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	7.9	2.4	1.2	5.1	6.1
Inflation (average)	12.9	5.9	0.5	4.6	7.0
Government balance/GDP	-11.3	-8.5	-17.0	-1.9	-3.5
Current account balance/GDP	-11.3	-4	-6.3	-10.4	-9.0
Net FDI/GDP [neg. sign = inflows]	-2.8	-0.8	37.2	-13.1	-14.0
External debt/GDP	178.7	193.3	220.7	246.9	n.a.
Gross reserves/GDP	13.5	25.6	11.6	27	n.a.
Credit to private sector/GDP	59.3	53.9	56.9	52.9	n.a.

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Macroeconomic performance

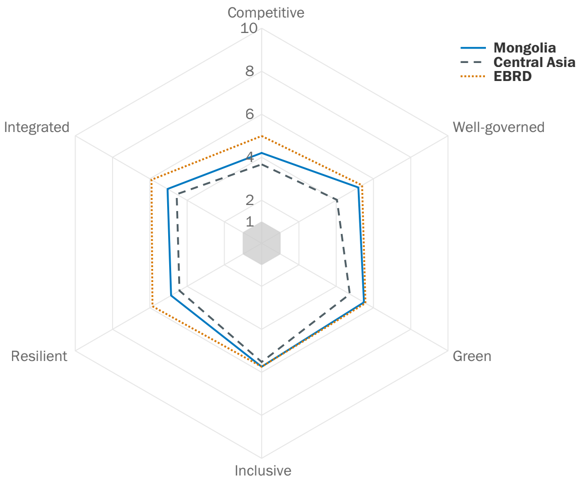
Economic growth has strongly accelerated. Real GDP grew by 5.1 per cent in 2017 after only 1.2 per cent in 2016, and continued growing by 6.3 per cent year-on-year in the first half of 2018. GDP growth was supported by rising commodity exports and foreign direct investment (FDI) in the mining sector. Domestic consumption has also begun to pick up. Stronger domestic demand induced inflation to accelerate from an average of 0.6 per cent in 2016 to 5.7 per cent year-on-year in September 2018. This is, however, still below the central bank's 8.0 per cent target.

External buffers are being rebuilt. Exports rose by 27.2 per cent year-on-year in US dollar terms in the first nine months of 2018, driven by copper exports, while imports rose by 45.8 per cent in the same period. A surge in FDI-related imports and repatriated profits led to a widening of the current account deficit from 6.3 per cent of GDP in 2016 to 10.4 per cent of GDP in 2017. However, this was more than compensated by FDI inflows, incoming donor funds and proceeds from bond issues in 2017, and resulted in a build-up of foreign exchange reserves from US$ 1.1 billion in January 2017 to US$ 2.9 billion in August 2018, equivalent to eight months of imports of goods and services. As a consequence, exchange rate pressures were alleviated and the currency appreciated slightly during 2017 and the first six months of 2018. This allowed the Bank of Mongolia (BoM) to cut the policy rate stepwise from 14.0 per cent in January 2017 to 10.0 per cent in March 2018. The tugrik has weakened slightly since mid-year 2018, along with other emerging market currencies, but not sufficiently to prompt the central bank to change its policy rate.

Fiscal consolidation measures and strong economic growth markedly improved the fiscal balance. The general government deficit narrowed from 17.0 per cent of GDP in 2016 to 1.9 per cent of GDP in 2017, performing substantially better than targeted under the IMF programme. Public finances improved as a result of rising tax receipts as exports strengthened and corporate incomes grew. Substantial reductions in capital expenditures also contributed to the better fiscal performance. Public debt decreased from 87.6 per cent of GDP in 2016 to 84.6 per cent of GDP in 2017.

Real GDP growth is forecast to stay around 6.0 per cent in the short run. The economy is projected to grow by 6.1 per cent in 2018 and 6.0 per cent in 2019. Mining-related FDI and a continued recovery in domestic consumption are expected to be key drivers. However, a slow-down in the implementation of reforms would expose the economy to risks, as Mongolia still faces a high external debt burden of 247 per cent of GDP and remains vulnerable to Chinese import policies and fluctuations in copper and coal prices.

Assessment of transition qualities (1-10)



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Major structural reform developments

Business environment reforms have been mixed. Mongolia ranked 74th out of 190 countries in terms of ease of doing business according to the World Bank's *Doing Business 2019* report. It scored relatively highly in getting credit, protecting minority investors, dealing with construction permits, but poorly in such areas as getting electricity, resolving insolvency and trading across borders. In the past two years progress has been made in enforcing contract and strengthening access to credit by setting up a new collateral registry. However, the unstable legal environment continues to be a constraint to FDI flows. In addition, amendments to the corporate income tax law effective from January 2018 have introduced a payment of a 30 per cent tax rate on gross assessed value of transfer of licence for land use, including exploration and extraction licences for mining, which further increases the costs of doing business for investors. Under pressure from businesses, particularly in the mining sector, the rate was subsequently lowered to 10 per cent of the assessed net value of the transfer rights.

Important reforms have progressed, but with delays in some areas. The overall reform agenda is anchored by a three-year Extended Fund Facility (EFF) with the IMF, signed in May 2017. The fifth Review of the EFF was completed in October 2018 with all end of September 2018 quantitative targets achieved. International reserves have increased substantially and the primary fiscal balance showed a surplus, mostly driven by positive external demand which has boosted tax revenues. Total disbursements under the IMF programme have so far reached around US$ 217.33 million out of the approved US$ 434.3 million. Stable programme performance is also paving the way for unlocking further disbursement funds of external donors. At the same time, structural reform progress has been lagging in some respects, with slower-than-expected implementation of fiscal reform and financial sector benchmarks.

Asset Quality Reviews have been completed and banks are required to take action by the end of 2018. The reviews revealed a capital shortfall in the banking system of around 2.0 per cent of GDP at the end of 2017, well below earlier IMF projections of a shortfall of 7.0 per cent of GDP. Capital adequacy was estimated at 13.7 per cent and liquidity coverage at 45.0 per cent. Banks are now working with the BoM on their respective action plans. Those banks that fail to meet capital requirements will have to sell assets or attract new capital. If some systemic banks are unable to close the capital shortfall, they will receive public funds.

The institutional, supervisory and regulatory framework of the central bank is being strengthened. Important changes to the Central Bank Law and Banking Law were adopted in January 2018. The new Central Bank Law enhances the independence of the BoM by restricting budgetary operations unrelated to its purpose, reduces the governor's voting power in favour of collective decision-making, and subjects the bank's operations to annual external audits. It also provides the BoM with greater power to conduct macro-prudential policies. The Banking Law was revised to introduce requirements to disclose the ultimate owners of banks, adopt corporate governance rules and restrict banks from setting up subsidiaries or affiliates for the purpose of circumventing bank regulation.

Fiscal and tax reforms have advanced, but several earlier measures were not followed through. Budget expenditures calculation has been modified to include net lending to the Development Bank of Mongolia, which used to finance off-budget investment projects. The fiscal target set by the IMF will apply to the combined outlay. Furthermore, amendments to the general tax law have been submitted to parliament. The new law envisages tax refunds of 90 per cent of income tax paid by small and medium-sized enterprises with annual sales income of less than MNT 1.5 billion (US$ 600 million equivalent). Taxpayers who cannot pay taxes on time, but who prove they can pay fully later, will be allowed an extension period of up to two years. However, in response to increased government revenues and rising public discontent, measures to introduce a progressive income tax, increase fuel excise tax and increase the pension age have not been implemented in line with the legislation adopted in April 2017.

A platform for public-private dialogue was established to improve the investment climate and ensure better investor protection. A Public Private Consultative Committee was set up under the Investment Protection Council in December 2017. The main task of the committee is to facilitate information sharing and the dialogue between authorities and the private sector about investment policies and regulations.

MONTENEGRO

Highlights

- **Further progress has been made towards eventual EU membership.** The new European Commission (EC) Enlargement Strategy, published in February 2018, has set 2025 as the year when Montenegro could be ready for membership, provided it makes further progress in reforms.
- **The government has begun implementing a fiscal adjustment strategy.** The strategy is intended to boost the sustainability of the public finances, which have been put under severe pressure because of costs associated with the financing of major road infrastructure.
- **The main power utility is being brought back into almost full public ownership.** The government and Italian utility company A2A have agreed on the accelerated execution of the put option for the company's stake in the power utility EPCG.

Key priorities for 2019

- **Fiscal stabilisation is crucial for economic growth.** Having developed a credible fiscal strategy the government should stick to agreed targets, even if economic growth slows, in order to restore fiscal balance and reduce public debt.
- **Renewable energy projects should be further developed.** Montenegro has significant potential in this area and further development would help the country's green economy transition and improve its energy resilience.
- **Further improvements are needed on economic governance.** Areas of focus in the coming year should include the development of the government's e-governance programme and strengthening of the framework for competition policy.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	1.8	3.4	2.9	4.7	4.2
Inflation (average)	-0.7	1.5	-0.3	2.4	2.8
Government balance/GDP	-0.7	-6.2	-6.2	-7.0	-4.6
Current account balance/GDP	-12.4	-11.0	-16.2	-16.3	-16.8
Net FDI/GDP [neg. sign = inflows]	-10.2	-16.9	-9.4	-11.4	-11.4
External debt/GDP	163.1	161.8	158.8	160.2	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	54.1	52.6	51.6	51.4	n.a.

*Montenegro uses the euro as its legal tender.

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Macroeconomic performance

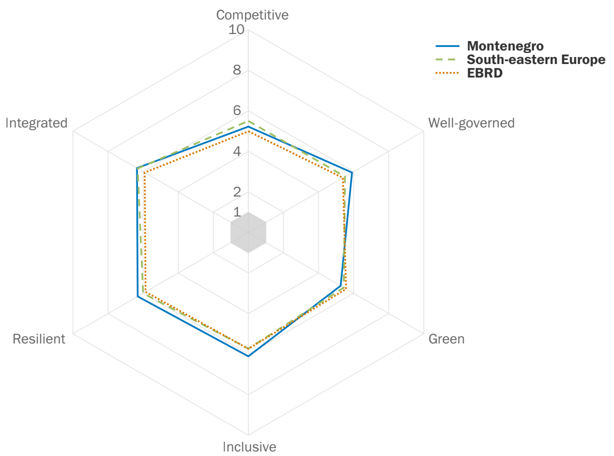
The economy out-performed expectations in 2017. GDP grew by 4.7 per cent, well above the 2.9 per cent growth rate recorded in the previous year. The key drivers of this growth were investment, particularly in the major highway project connecting the port of Bar with the Serbian border and in some flagship tourism developments on the coast; and private consumption, driven by the relatively high rate of lending. However, high imports, as a component of both investment and private consumption, fuelled a large current account deficit of more than 16 per cent of GDP and acted as a drag on growth. The Montenegrin economy depends heavily on tourism (one-fifth of annual GDP), and foreign tourist arrivals in 2017 were up by more than 10 per cent, boosted by new airline connections with EU countries. The unemployment rate as of the second quarter of 2018 was 14.4 per cent, while long-term unemployment is very high, at about 65 per cent of total unemployment. The economy has continued to power ahead in 2018, with growth in the first half of 2018 estimated at 4.8 per cent year-on-year, again with similar drivers as in 2017.

The government has begun implementing a medium-term fiscal adjustment strategy. The sustainability of the public finances is a significant concern, and is among the biggest risks the country is facing. To combat growing fiscal pressures, a new Fiscal Strategy (2017-20) was adopted in June 2017 containing a number of measures, including an increase of VAT and excise duties, a reduction in the salaries of senior public employees, improved tax collection, and the cancellation of benefits to mothers of three or more children introduced the year before by parliament. The main goal of the strategy is to achieve a primary budget surplus from 2019, and an overall budget surplus from 2020. This should put the public debt, which has been rising rapidly in recent years to over 70 per cent of GDP, on a downward trajectory.

In April 2018 the government placed a seven-year, €500 million Eurobond. The interest rate was 3.375 per cent, a record low for the country, implying a positive reaction from the financial markets for the recent fiscal consolidation measures. The country's credit rating, as of October 2018, is B+ by Standard & Poor's and B1 by Moody's, with a stable outlook in the former and a positive outlook in the latter. Further financing will be needed in the coming years to meet significant Eurobond redemptions in the period 2019-21.

Growth is likely to moderate in the short term. The fiscal austerity measures adopted in the past year are expected to bite further, while current construction activities are slowing, as the construction and financing of the remaining highway sections remain unclear. Therefore, GDP growth is projected at 4.2 per cent in 2018 and 3.0 per cent in 2019. The economy will continue to be mainly investment-driven and supported by public investment in transport and energy infrastructure (where construction of the highway continues to be the key project) and flagship foreign direct private investments, particularly in the tourism sector. The main risks include the high level of public debt and limited fiscal space.

Assessment of transition qualities (1-10)



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Major structural reform developments

Further progress has occurred on EU approximation. As of October 2018, Montenegro had opened 31 negotiating chapters (out of 33) of the EU's *acquis communautaire*, including two critical chapters related to the rule of law, and had provisionally closed three: Science and Research; Education and Culture; and External Relations. The chapters on Competition Policy and Environment still remain unopened. Montenegro launched EU accession negotiations in 2012. The new EC Enlargement Strategy, published in February 2018, has set 2025 as an indicative timeline for the country's EU membership, noting that Montenegro (and Serbia) could be ready for membership by 2025 provided it makes further progress in reforms.

Progress on privatisation has been minimal in the past year. The only concrete achievement was the agreement on the 30-year lease of Ulcinjska Rivijera with Karisma Hotels Adriatic Montenegro, the only bidder on the tender. Meanwhile the tender for the concession of the port of Bijela is in its final phase. A consortium comprising the Dutch company Damen and Adriatic Marinas, the company which operates the country's flagship investment Porto Montenegro, had expressed interest in obtaining the concession for the port for 30 years, aiming to convert it from a former shipyard into a place for yacht building and repair. At the same time, the process of renationalisation of EPCG, the country's state-owned power utility, has begun, as the minority shareholder Italian A2A has started its exit from the company. In August 2018 the government published a draft concession agreement for the two international airports. The plan is to offer a concession contract on the two airports for 25 to 30 years. The preparation and implementation of public tenders for the privatisation of the health institute in Igalo and the hotel group Budvanska Rivijera are part of the 2018 privatisation plan.

The government and Chinese construction company CRBC have signed a Memorandum of Understanding (MoU) on further motorway construction. The MoU was signed in March 2018 on the possible establishment of a public-private partnership to handle the construction of further sections of the Bar-Boljare highway, which connects the Adriatic port of Bar in Montenegro with the Serbian border. CRBC is already the lead contractor for the construction of the 42 km-long priority section of the highway, worth US$ 1.1 billion, set for completion by the end of 2019. However, in addition to this priority section, the highway includes another four sections – two northern and two southern – with an additional estimated total construction cost of approximately €1.7 billion. In parallel, in April 2018 the government appointed a team to negotiate with interested companies the construction of the two northern stretches of the motorway, leading to the Serbian border. The team's goal is to propose to the government a model for the construction of these stretches as well as to define criteria for tendering them. The team should also assess the gathered offers and start talks with the preferred company or consortium.

The power utility is being brought back into almost full public ownership. In April 2018 parliament approved the agreement on an accelerated execution of the put option that gives A2A the right to sell its 42 per cent stake in power utility EPCG for €250 million (the government has a 57 per cent stake, while the remainder belongs to smaller shareholders). Following parliament's approval, the put option should be executed within two years instead of the originally planned seven years. In line herewith, the government had adopted a budget revision in March 2018 allocating €70 million for the purchase of A2A's shares in EPCG. A2A is exiting EPCG mainly because it disagrees with the government's project to extend the capacity of the country's sole thermal power plant Pljevlja, which now has only one unit of 210 MW.

A second wind park is being developed. The 46 MW Mozura wind park on Montenegro's coast will start operations in the fourth quarter of 2018 after China's Shanghai Electric Power Company has completed the installation of 23 turbines. The project is being carried out by the Maltese state-owned company Enemalta and Shanghai Electric. This is the second wind park project to be developed in Montenegro, following the launch of the 72 MW EBRD co-funded Krnovo wind park last year.

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Financial sector legislation is being strengthened. To address remaining legislative shortcomings in the financial sector, a number of new laws and related directives have recently been introduced. These include a Central Bank Act, a Law on Financial Institutions, and an all-encompassing non-banking financial institutions law covering factoring, leasing, micro-crediting and credit guarantee operations, all adopted by parliament in October 2017. The Law on Voluntary Financial Restructuring adopted some years ago has been extended again, this time to May 2019. Also, the authorities are currently amending a number of pieces of legislation, including the Deposit Insurance Law, the Banking Law and the Law on Recovery and Resolution of Banks, to improve banking supervision and resolution frameworks and make them consistent with the Basel Core Principles for Effective Banking Supervision and the EU's Bank Recovery and Resolution Directive.

MOROCCO

Highlights

- **Growth has slowed in the first half of 2018 due to a drop in agricultural output.** Fiscal consolidation continued and the fiscal deficit narrowed, but public debt remained above 60 per cent of GDP at the end of 2017.
- **Morocco's car industry is growing.** Affordable labour, political stability, access to the European market and a series of tax incentives have attracted European carmakers since 2012, and the industry is now the major source of exports.
- **Structural reforms have advanced, albeit with some delays.** The transition to a more flexible exchange rate regime and to inflation targeting, originally planned for 2017, started in January 2018.

Key priorities for 2019

- **Conditions for private sector investment should improve.** Adopting a clear strategy to promote investments is essential, targeting both local and foreign companies. In addition, appointing all the members of the Competition Council should be a priority in order for it to start functioning.
- **Diversifying the country's economic activity is essential.** The current reliance on agriculture often results in macroeconomic volatility. Morocco should use its proximity to Europe and explore more export opportunities.
- **Policy interventions are needed to lessen the socioeconomic divide between rural and urban communities.** Health, unemployment and poverty are major sources of insecurity for citizens and should be addressed by the government through decentralisation, promoting access to services, and promoting sustainability in agriculture and infrastructure.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.7	4.5	1.1	4.1	3.0
Inflation (average)	0.4	1.6	1.6	0.8	2.4
Government balance/GDP	-5.2	-4.5	-4.2	-3.5	-3.2
Current account balance/GDP	-6.0	-2.2	-4.2	-3.6	-4.3
Net FDI/GDP [neg. sign = inflows]	-2.8	-2.6	-1.5	-1.6	-1.7
External debt/GDP	33.3	33.9	34.6	33.5	34.6
Gross reserves/GDP	19.8	22.8	25.0	23.0	23.3
Credit to private sector/GDP	83.9	80.2	81.3	82.1	n.a.

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Macroeconomic performance

The economy is slowing in 2018. GDP grew by 2.8 per cent in the first half of 2018, down from 4.0 per cent in the same period in 2017. Falling agricultural output was the main factor behind the lower growth rate. Nevertheless, total economic production grew, aided by a 3.1 per cent growth in the non-agricultural sector in the same period. In per capita dollar terms, GDP continued to grow steadily by 1.4 per cent on average per year, but Morocco remains a lower-middle-income country. In the first quarter of 2018 the unemployment rate decreased to 10.5 per cent, from 10.7 per cent a year earlier.

Fiscal consolidation continued. The fiscal deficit narrowed to 3.5 per cent of GDP in 2017 – down from 4.2 per cent in 2016 – thanks to stronger tax revenues and a contained wage bill combined with lower public investment, and despite weaker non-tax revenues and grants and higher spending on subsidies and transfers. This trend continued in the first quarter of 2018 due to a 2.4 per cent drop in total spending, despite lower tax revenues. Meanwhile, public debt marginally decreased to 64.5 per cent of GDP at the end of 2017, the lowest by regional standards.

Inflation has accelerated during 2018. The inflation rate rose to 2.7 per cent in April, the highest level since 2013, before easing to 1.7 per cent in August. The acceleration was driven by the impact of the review of the consumer price index (CPI) basket structure in March as well as significant increases in volatile food and regulated prices. The central bank's decision to keep interest rates unchanged since March 2016 at 2.25 per cent led real interest rates to turn negative between March and June 2018, before edging positive again to 0.5 per cent in August.

The current account deficit declined to 3.6 per cent of GDP in 2017, down from 4.2 per cent in 2016. This was due to increased exports following Europe's strong economic recovery, increases in remittances and higher grants from the Gulf Cooperation Council. Moreover, the number of foreign tourists arriving in Morocco increased by 10 per cent year-on-year in the first seven months of 2018, partially due to the alleviation of visa requirements for Chinese citizens which started in mid-2016, allowing a 90-day stay on entry. On the capital account, foreign direct investment also rose slightly to 1.6 per cent of GDP, from 1.5 per cent in 2016, and was highly concentrated in the automotive sector; it remains lower than its historical levels, but better than Morocco's peers.

Growth is expected to slow in 2018. The current forecast is 3.0 per cent GDP growth in 2018, influenced by the negative base effect following favourable weather conditions for agriculture in 2017. In 2019 growth is forecast to rise to 3.5 per cent, supported by a number of factors, including the continued recovery in tourist arrivals, an increase in foreign direct investment, greater competitiveness from the move to a more flexible exchange rate regime, a rebound in services and manufacturing, stronger export growth – especially in the automotive and aeronautics industries-, and expanded mining capacity. The sustained growth is predicated on continuing reforms to improve the business environment and boost productivity, and diversifying the economy away from agriculture. Downside risks include delays in implementing reform, possible declines in the prices of phosphates, wheat and vegetables, weak growth in trading partners, and the vulnerability of agricultural activity to weather and price developments.

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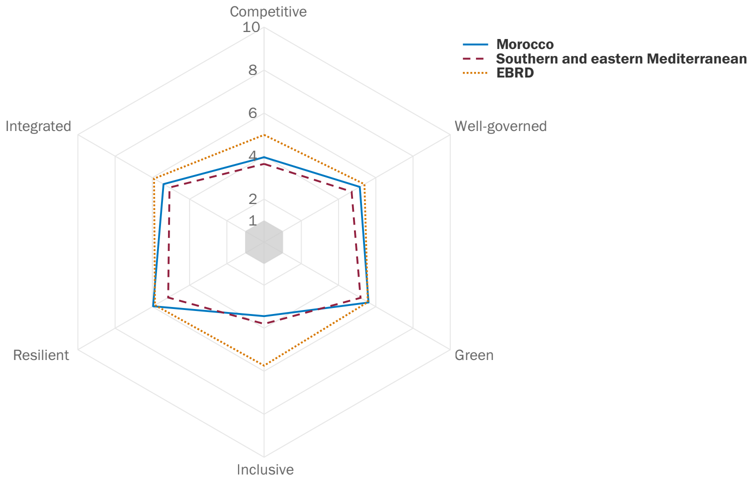
Assessment of transition qualities (1-10)



Major structural reform developments

A new central bank law has been introduced. The new law passed in July 2018, having been approved by the government a year earlier. The law will enhance the central bank's independent status and improve communication between the central bank and the Ministry of Finance, with the aim of bringing about a more harmonious monetary policy.

The central bank adopted a more flexible exchange rate. From January 2018 the dirham has been allowed to fluctuate within a 5.0 per cent band (±2.5 per cent), much higher than the former 0.3 per cent band. This move comes as part of the government's monetary policy reform aimed at improving the competitiveness of the economy and is in line with the IMF programme.

Sugar subsidies are being reduced. As part of the 2018 budget the government announced the progressive removal of sugar subsidies by 2019, saving an estimated 0.3 per cent of GDP. The government has reiterated 2020 as the target date to replace across-the-board subsidies on all remaining products with a targeted compensation mechanism, which at this stage remains fragmented across different social transfer programmes. The shift to a unified transfer programme will be based on the implementation of a national population register, a centralised social register and the assignment of a unique identification number to all nationals to better target transfers.

Morocco and the European Union (EU) have initialled a new fisheries agreement. The agreement was initialled in July 2018 after three months of negotiations, five days after the expiry of the precedent agreement. The new agreement should come into force by the end of 2018. It allows EU vessels to access the Moroccan fishing zone. The level of mandatory landings and fishing categories will remain unchanged.

The Moroccan government announced tax breaks to new industrial firms. In July 2018 the government announced exemptions from corporate tax for five years for firms established after June 2017. The measure covers 24 sectors, including manufacturing, food, textiles and pharmaceuticals, and aims to encourage investment, especially in the slowly growing, non-agricultural sector.

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Morocco continued to develop its economic and political ties with sub-Saharan Africa. In June 2018 the Moroccan and Nigerian governments signed a joint declaration detailing the next steps for the finalisation of a 5,660 km gas pipeline project launched in 2016. Morocco has been expanding its political and economic influence in sub-Saharan Africa over the past decade. The presence of Moroccan firms in this area is growing; a local subsidiary of a Moroccan renewable energy company will soon start to build the first photovoltaic solar plant in Côte d'Ivoire, an opportunity to expand to a market where solar power could prove a valuable tool in mass electrification.

Morocco's car industry is growing. Since Renault's investment in 2012, the sector, which was non-existent in the 2000s, has benefited from affordable labour, political stability, access to the European market, and a series of tax incentives. In July PSA Peugeot-Citroën announced a new production line in Morocco, set to produce up to 90,000 cars by 2020. The car production industry has been strengthening in recent years, with automotive exports now outstripping phosphates, historically the major source of foreign exchange.

Several obstacles continue to hinder Morocco's business environment. These include shortages of highly skilled labour and inefficient bureaucracy, which continue to slow the pace of project implementation. Moreover, regional disparities and non-inclusive economic growth risk are exacerbating social tensions, including over-high levels of unemployment.

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

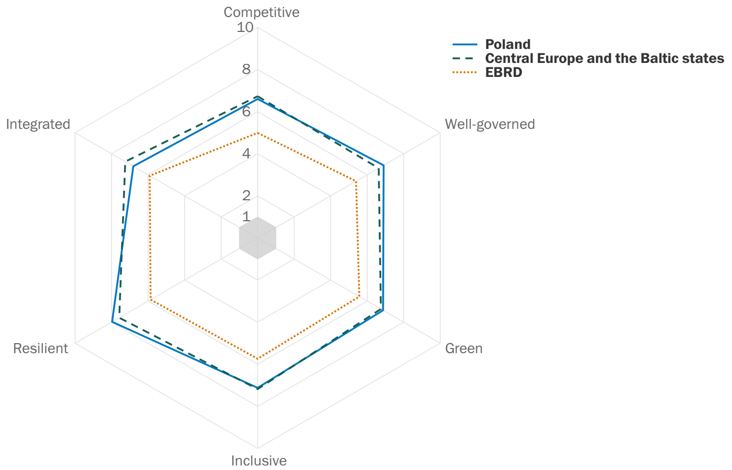
GDP growth has remained strong. The economy grew by 4.8 per cent in 2017 and the economic expansion accelerated further to 5.1 per cent year-on-year in the first half of 2018, amid continuously robust household consumption and improved investment, the latter rising by 3.4 per cent in 2017 and accelerating 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.

ROMANIA

Highlights

- **Following rapid growth in 2017, the economy is slowing down.** Romania recorded one of the fastest growth rates in the European Union (EU) in 2017 at 7.3 per cent, driven by strong private consumption and investment. However, growing fiscal and external imbalances have been accompanied by tighter monetary policy and a slow-down of growth so far in 2018.
- **The resilience of the banking system improved as the decline in non-performing loans (NPLs) continued.** Successive sales of NPLs and fast loan growth have brought the ratio of NPLs down to 5.7 per cent, from a high of 22.0 per cent in 2013.
- **Progress in structural reforms has been uneven.** Some modest progress occurred in implementing the Cooperation and Verification Mechanism (CVM) recommendations, but other measures adopted by the government have prompted concerns about judicial independence and the government's commitment to fighting corruption.

Key priorities for 2019

- **Further reforms to strengthen judicial independence and transparency should be undertaken.** Progress in this area would help to alleviate concerns surrounding the independence of the judiciary and the government's anti-corruption commitment.
- **Privatisation of state-owned enterprises (SOEs) needs to be prioritised. SOEs remain dominant in some sectors such as energy and transport.** Privatisation of these enterprises through initial public offerings (IPOs) would attract investors and increase market capitalisation, thereby helping to upgrade Romania from frontier market to emerging market status.
- **Business environment reforms should be prioritised.** Difficulty in accessing skilled labour, inadequate transport infrastructure and inefficient government bureaucracy constitute the highest reform priorities. In particular, growing labour shortages need to be addressed by retaining and attracting qualified workers.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.1	4.0	4.8	7.3	4.2
Inflation (average)	1.4	-0.4	-1.1	1.1	4.7
Government balance/GDP	-1.9	-1.5	-2.4	-2.9	-3.0
Current account balance/GDP	-0.7	-1.2	-2.1	-3.4	-3.5
Net FDI/GDP [neg. sign = inflows]	-1.9	-2.4	-3.3	-2.3	-2.9
External debt/GDP	56.8	55.6	52.9	45.3	n.a.
Gross reserves/GDP	21.6	21.8	21.4	20.1	n.a.
Credit to private sector/GDP	31.1	29.9	28.2	26.4	n.a.

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Macroeconomic performance

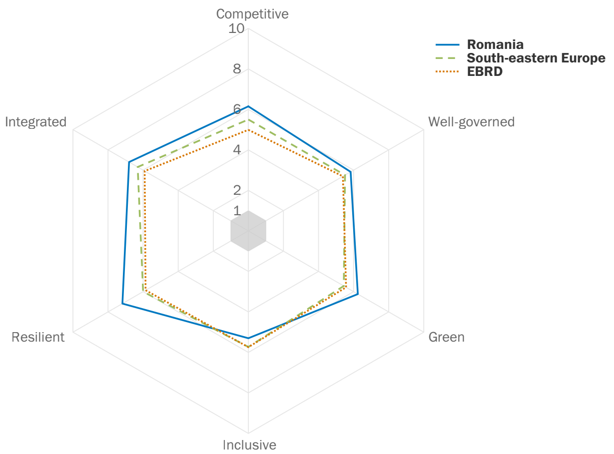
Romania's growth rate of 7.3 per cent was one of the highest in the EU in 2017. Private consumption was the main driver of growth in 2017, supported by a pro-cyclical fiscal policy including cuts in VAT and other consumer taxes. Strong wage growth and low unemployment, at 4.1 per cent in September 2018, also boosted consumption growth. After declining during the previous year, investment also picked up in 2017, fuelled by increased absorption of EU funds. There are signs in the first half of 2018 that the economy is slowing down, with the growth rate for this period reaching 4.0 per cent year-on-year.

To address growing overheating concerns, the central bank has started to tighten monetary policy. The tightening labour market and rising household consumption drove inflation to 5.4 per cent in June, the highest figure since 2013 and well above the central bank's upper target of 3.5 per cent. Consequently, the central bank has started to tighten its monetary policy, raising its main policy rate three times so far in 2018 from 1.75 to 2.50 per cent. Further increases are likely given the continued inflationary pressure and monetary tightening in the USA.

Fiscal and external imbalances have increased. The current account deficit rose to 3.4 per cent of GDP in 2017, driven by rising imports, and continued to grow in the first half of 2018. Meanwhile, the budget deficit reached 2.9 per cent of GDP in 2017 and may exceed 3.0 per cent of GDP in 2018 on the back of continued loose fiscal policies. On the positive side, general government debt is low by regional standards, at 35 per cent of GDP as of the end of 2017, and has been declining.

GDP growth is likely to moderate in 2018-19. Growth is projected to moderate to 4.2 per cent in 2018 and 3.6 per cent in 2019, due to weakening policy stimulus and tighter monetary policy, although growth will continue to be supported by investment linked to EU funds. Downside risks, including the exacerbation of the current labour shortages, changes in global investor sentiment and domestic political and reform uncertainty, may hamper growth 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 60 per cent of the EU average) should allow growth rates of around 4 per cent to be sustained, provided further structural reforms are undertaken.

Assessment of transition qualities (1-10)



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Major structural reform developments

Romania's investment environment is better than regional peers, although challenges remain. In the World Bank's *Doing Business 2019* report, Romania ranked 52nd out of 190 countries, a deterioration of seven places over the previous year. The slide in performance is in part due to the introduction of new value added tax regulations making starting a business more difficult. Other areas that are particularly challenging include obtaining construction permits and getting electricity, but Romania performs best among the countries surveyed in trading across borders.

Progress under the Cooperation and Verification Mechanism (CVM) continues to be uneven. The coalition's ongoing attempts to pass amendments to several justice laws are a cause for concern – as was the dismissal in July 2018 of the head of the National Anti-Corruption Directorate (DNA) – as they could weaken the fight against corruption.

Plans to privatise state-owned enterprises remain stalled. SOEs remain dominant players in the energy and transportation sectors, weighing on public finances. However, uncertainty surrounding the legitimacy of the Sovereign Wealth Fund for Development and Investment (FSDI), established to hold the state's participation in profitable SOEs, means that prospects for privatisation of these entities remain unclear.

Romania is close to reaching emerging market status, which would have a positive effect on investment. Romania meets most of the criteria required for being upgraded from frontier to emerging market status by the market index maker MSCI. Low liquidity is the main limiting factor, which highlights one of the potential benefits to be gained from privatising SOEs through IPOs. An upgrade to emerging market status could result in a significant increase in inflows to Romanian capital markets.

There was considerable progress in reducing the share of NPLs. Banks continue to clean up their balance sheets and restructure their loan portfolios. The combination of NPL sales and strong credit growth has pushed the NPL ratio down to 5.7 per cent in June 2018, from a peak of 22.0 per cent at the end of 2013. While still above the EU average of around 4.0 per cent, NPLs are expected to further decline over the coming year on the back of further sales.

RUSSIA

Highlights

- **Russia's economy has returned to modest growth.** After a two-year recession, GDP grew by 1.5 per cent in 2017 and 1.6 per cent year-on-year in the first half of 2018. Growth has been driven primarily by recovering household consumption and exports.
- **Inflation fell to an historical low, but picked up recently.** The strong disinflationary trend continued in 2017 on the back of falling food prices and the strengthening rouble, with inflation reaching a record low (since 1993) of 2.2 per cent in January 2018. However, following the rouble depreciation, inflation accelerated somewhat in the third quarter of 2018.
- **The country has embarked on several structural reforms.** The government has begun tax and pension reform, and is initiating significant new investments in infrastructure over the coming years.

Key priorities for 2019

- **The recovery of oil prices should not delay further business environment reforms and diversification of the economy.** These reforms include limiting the state footprint on the economy, ensuring fair competition, as well as improving regulatory frameworks.
- **SMEs' (small and medium-sized enterprises') access to finance should be improved.** Enhanced financial inclusion and better access to financial products, including leasing and factoring, would be important steps forward.
- **Banking sector supervision should be stepped up in light of recent bank failures.** The clean-up of the banking system has progressed significantly in recent years but further efforts are needed to reduce systemic risks from the concentration of assets, especially among large state-owned banks.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	0.7	-2.5	-0.2	1.5	1.5
Inflation (average)	7.8	15.5	7.1	3.7	2.8
Government balance/GDP	-1.1	-3.4	-3.6	-1.5	2.0
Current account balance/GDP	2.8	4.9	1.9	2.2	6.2
Net FDI/GDP [neg. sign = inflows]	1.7	1.1	-0.8	0.5	1.0
External debt/GDP	28.8	37.8	39.5	32.8	n.a.
Gross reserves/GDP	18.5	26.8	29.1	27.4	n.a.
Credit to private sector/GDP	53.5	56.4	53.4	52.7	n.a.

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Macroeconomic performance

The economy has started to expand moderately. After a recession in 2015-16, GDP started to recover in 2017, growing by 1.5 per cent. This was driven by domestic demand on the back of rising oil prices, improved economic confidence and falling inflation. The FIFA World Cup, hosted by Russia in 2018, also contributed to a temporary increase in public investment. However, stronger domestic demand, together with the rouble appreciation, fuelled the rise in imports (17 per cent) leading ultimately to a negative contribution of net exports to overall growth. In the first half of 2018, the economy grew 1.6 per cent year-on-year. The main drivers were exports and private consumption, the latter boosted by several favourable developments (lower inflation, faster real wage growth, a falling unemployment rate, and credit growth).

The rouble has decoupled from oil price movements. The recovery of oil prices was accompanied by the rouble's appreciation against the US dollar in 2017 (around 15 per cent) and in early 2018. However, foreign exchange interventions set by the new fiscal rule, together with the new US sanctions against Russia (which triggered a sell-off of Russian financial assets), have exerted downward pressure on the exchange rate since April 2018. In September 2018 the rouble was around 16 per cent weaker than six months earlier. In August 2018, the Central Bank of Russia (CBR) decided to temporarily suspend foreign exchange purchases on behalf of the Ministry of Finance.

Monetary tightening has started amid rising inflationary pressures. The broad-based disinflation process advanced, supported in 2017 by the strengthening rouble, as well as favourable weather conditions and a record-beating harvest. In mid-2017 the inflation rate slid below the central bank target of 4.0 per cent, reaching 2.2 per cent in January 2018, the lowest rate since 1993. In the following months it rose only slightly (to 2.3 per cent in June), but picked up in the third quarter, to 3.4 per cent in September. Falling inflation and lower inflation expectations enabled continuation of monetary easing by the CBR until March 2018. In September 2018, the CBR raised the key policy rate by 25 basis points, to 7.5 per cent.

Higher oil prices have alleviated fiscal pressures. Recovering growth and oil prices have supported the reduction in the budget deficit from 3.6 per cent of GDP in 2016 to 1.5 per cent in 2017. While government revenues increased on the back of growing oil and gas receipts, expenditures were reduced due to lower defence spending as well as the extension of the freeze in pension contributions and civil servant salaries. The new fiscal rule, adopted in 2017 and devised to act as a buffer against oil price volatility, has been slightly softened in the draft budget framework (2019-21), to be adopted in autumn 2018. Under the new framework, the structural primary budget deficit is limited to 0.5 per cent of GDP (originally 0 per cent). In February 2018, Standard & Poor's upgraded Russia's sovereign rating to BBB-, primarily on the back of new fiscal rules. It was the second rating agency after Fitch to rate Russia at investment grade.

Moderate short-term growth will likely continue while long-term growth prospects remain heavily dependent on structural reforms. In 2018 and 2019, the growth rate is expected to stay at the same level as in 2017 (1.5 per cent). It will be driven by recovering private consumption and investments, and supported by higher oil prices, with a negative effect from the US and EU sanctions. Without significant reforms, however, Russia's long-term economic growth may remain stuck at around 1 to 2 per cent annually due to outdated production capacities and low investments, as well as unfavourable internal structural factors (weak demographics, obsolete infrastructure and discouraging institutional characteristics of the economy).

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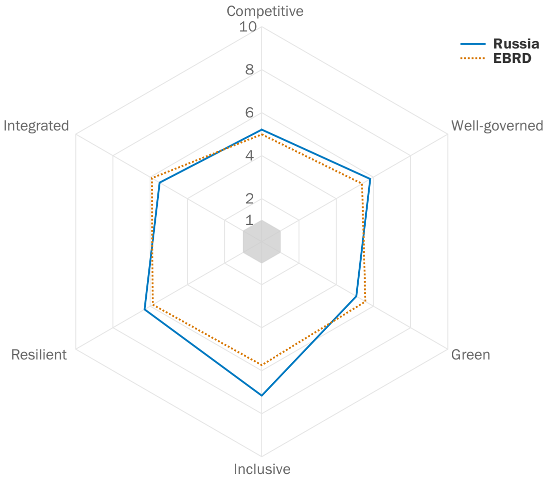
Assessment of transition qualities (1-10)



Major structural reform developments

The business environment has improved slightly. Russia climbed four positions in the World Bank *Doing Business 2019* report and now ranks 31st out of 190 countries. The biggest improvement has been in the area of construction permits (thanks to the faster process of obtaining permits and improved quality control during construction), where the country now ranks 48th (versus 115th last year). Progress has also been made in getting electricity (faster and less expensive) and trading across borders (shorter times to import and export), but the country still scores worst in the latter (99th). Russia's rating also improved slightly in the World Economic Forum's *Global Competitiveness Report 2018*. Russia ranks 43rd out of 140 countries[1] (up two places from the previous year), with the weakest areas being the financial system (especially with regard to financing SMEs), product and labour markets, and institutions.

Tax reforms have advanced. In July 2018 the parliament approved a VAT rate hike and oil sector reform, effective from 2019. The VAT rate has been increased to 20 per cent from 18 per cent, while the reduced rate (10 per cent) remains in place for the same goods as previously (that is, food, children's products, books, medicines). The measure is expected to bring around Rb 3.5 trillion (around US$ 52 billion) to the federal budget over the next six years, which may be used to finance some spending envisaged by the May 2018 presidential decree "on National Goals and Strategic objectives of the Russian Federation through to 2024".[2] The bill also foresees measures to speed up VAT reimbursement and simplify procedures. The second major revenue-boosting measure is related to the bill on oil sector taxation, adopted in July 2018. This bill provides for the gradual elimination of the oil export duty (from 30 per cent currently) and its replacement by a higher natural resource tax, shifting (and effectively widening) the tax base from oil exports to oil production. The reform would add Rb 1.3 to Rb 1.6 trillion (US$ 19 to US$ 24 billion) to the federal budget over the next six years, according to official projections.

A pension reform bill has been adopted. Another reform announced after the May presidential decree was pension reform, consisting primarily of the increase in the retirement age. According to the bill, adopted in October 2018, the retirement age will be gradually raised from 60 to 65 for men (by 2028) and from 55 to 60 for women (by 2034). Despite the last-minute softening, the changes to the pension system are in the right direction as Russia is facing the challenges of a shrinking workforce and an increasing number of retirees.

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[1] The rating for 2017 reflects the change in the methodology. According to the old methodology, Russia was ranked 38th in 2017.
[2] The decree implies implementation of a wide range of measures across multiple areas (including infrastructure, health care, education, small and medium-sized enterprises, digital economy, demography), with the aim of improving citizens' quality of life and advancing the socioeconomic development of the country.

The new economic programme calls for higher spending on infrastructure. The government has announced the creation of a new development fund of Rb 3.5 trillion (US$ 52 billion), which will be financed from additional domestic borrowing of Rb 500 to Rb 600 billion (US$ 7.4 to US$ 8.9 billion) annually. The goal is to invest Rb 6.3 trillion (US$ 97 billion) over the next six years in transport infrastructure. Another fund to support investments is the existing Russian Fund for Direct Investments (RFDI) but it remains to be seen if it would be able to attract significant investment from other sovereign wealth funds and private investors into infrastructure projects.

The CBR has continued to close banks with weak performance and poor corporate governance. In September 2018, there were around 508 banks operating in Russia, 66 fewer than in September 2017 and around 450 fewer than in mid-2013. The overall capitalisation rate of the Russian banking sector (at 12.2 per cent in August 2018) remains above the regulatory minimum, but non-performing loans were relatively high at 10 per cent as of the end of 2017. New bank resolution rules from mid-2017 enabled the CBR to acquire troubled banks and recapitalise them via the Bank Consolidation Fund before re-selling. Accordingly, in August, September and December 2017 the CBR acquired control over three large private banks (Otkritie Bank, Binbank and Promsvyazbank, respectively), recapitalised them and provided them with deposits. By June 2018, the CBR had used over US$ 45 billion (or 3 per cent of GDP) to support the three banks. The CBR plans to continue the process by moving bad assets from all banks under rehabilitation towards the “bad” bank, while good assets will go to Otkritie and Binbank, which should merge by 1 April 2019, with the rehabilitated bank sold back to the private sector in three to five years. As a result of bank closures and resolutions, the share of state-controlled banks (including those under rehabilitation) in total bank assets was over 70 per cent at the beginning of 2018, up from around 50 per cent in 2013.

SERBIA

Highlights

- **Growth is recovering in 2018.** After modest growth in 2017, the economy grew by 4.9 per cent in the first half of 2018 on the back of faster domestic demand growth, primarily investment.
- **Further progress has been made towards eventual EU membership.** The new European Commission Enlargement Strategy for the Western Balkans, published in February 2018, has set 2025 as the year when Serbia could be ready for EU membership, provided it makes further progress in reforms.
- **Non-performing loans (NPLs) have declined to below 7 per cent.** This significant reduction over the past year is mostly a result of the National Bank of Serbia's decision to make the write-offs of fully provisioned NPLs mandatory.

Key priorities for 2019

- **Public sector reforms, including privatisation and restructuring of state-owned enterprises (SOEs), should be advanced.** Significant contingent fiscal risks still stem from large, unreformed SOEs. Better SOE management could also contribute to stronger growth performance and increased resilience to shocks.
- **Small and medium-sized enterprises (SMEs) need better access to finance and clear rules.** SMEs would benefit greatly from the development of non-bank financial institutions and improved tax-related practices, including simplified tax procedures, lower para-fiscal charges, and better predictability of tax decisions and services to tax payers.
- **Further efforts are needed to support market transactions in NPLs.** Efforts should focus on easing access to information for potential investors on NPL portfolios, improving out-of-court restructuring and conducting more efficient judicial processes.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-1.8	0.8	3.3	2.0	4.2
Inflation (average)	2.1	1.4	1.1	3.0	2.1
Government balance/GDP	-6.6	-3.7	-1.3	1.2	0.7
Current account balance/GDP	-6.0	-3.5	-2.9	-5.2	-5.5
Net FDI/GDP [neg. sign = inflows]	-3.7	-5.1	-5.2	-6.2	-6.0
External debt/GDP	77.1	78.3	76.5	69.5	n.a.
Gross reserves/GDP	29.7	29.1	27.8	25.4	n.a.
Credit to private sector/GDP	43.4	43.4	43.4	43.0	n.a.

CONTINUES

Macroeconomic performance

Growth slowed in 2017, but has accelerated in 2018. GDP growth decelerated to 2.0 per cent in 2017, from 3.3 per cent in 2016. The slow-down was mainly a consequence of a fall in agricultural production due to the summer drought and some difficulties in mining and electricity generation. On the expenditure side, growth was led by rising private consumption and investment, the latter being supported by strong foreign direct investment (FDI) inflows. However, higher domestic demand translated into a fast rise in imports (around 11 per cent), offsetting the strong export performance and resulting in a negative contribution from net exports and a rise in the current account deficit to 5.7 per cent of GDP. Growth recovered strongly in the first half of 2018, reaching 4.9 per cent year-on-year. It was a result of continuing recovery of domestic demand with offsetting effects from net exports due to the continued strong growth in imports. Higher frequency indicators point to stable manufacturing growth, a stagnation in mining, and recovery in electricity production in the first half of the year.

After years of deficits, Serbia has started to record fiscal surpluses. In February 2018, Serbia completed its three-year Precautionary Stand-By Arrangement with the IMF. The programme was marked by significant fiscal over-performance over the whole period. In 2017, the general government registered a surplus of 1.2 per cent of GDP (versus 1.3 per cent deficit in 2016) on the back of higher tax revenues and lower current spending. Developments in the first seven months of 2018 (namely, higher revenues from social security contributions, taxes and excises) point to the possibility of another year of fiscal surplus. In view of the achievements so far, the government has continued to relax austerity measures. This includes a hike of public sector wages by 5 to 10 per cent, depending on the sector, and a 5 per cent increase of pensions from January 2018, as well as a one-off bonus of RSD 10,000 (around €85) to the security forces in December 2017. In addition, the law on reduction of above-average pensions was abolished at the end of September 2018. However, a ban on new hiring in the public sector, introduced in 2013, has been extended until the end of 2018. Public debt fell to 63 per cent of GDP at the end of 2017 and to 60 per cent of GDP at the end of June 2018. However, due to its currency structure (75 per cent in foreign currencies, close to 40 per cent of which is in US dollars), the debt is quite sensitive to exchange rate developments, including euro-dollar movements.

Amid low inflationary pressures, monetary easing continued. After undershooting the target (3±1.5 per cent) for two years, inflation picked up to 3 per cent year-on-year in 2017 on average. This acceleration came on the back of the rise in food and energy prices but was also supported by the increase in domestic demand and foreign inflation (notably in the euro area). However, in the first nine months of 2018 inflation moved to the lower half of the target band, mainly due to low food prices and the high 2017 base effect. The National Bank of Serbia (NBS) responded by lowering the key policy rate to a historic low of 3 per cent in April 2018.

Growth is expected to accelerate to 4.2 per cent in 2018 and slow down to 3.5 per cent in 2019. Faster growth is to be supported by further strengthening consumption and investment, with offsetting effects from higher imports. The risks to the projection are balanced, the main ones relating to the implementation of reforms envisaged under the IMF's Policy Coordination Instrument (PCI) and further pace of eurozone growth.

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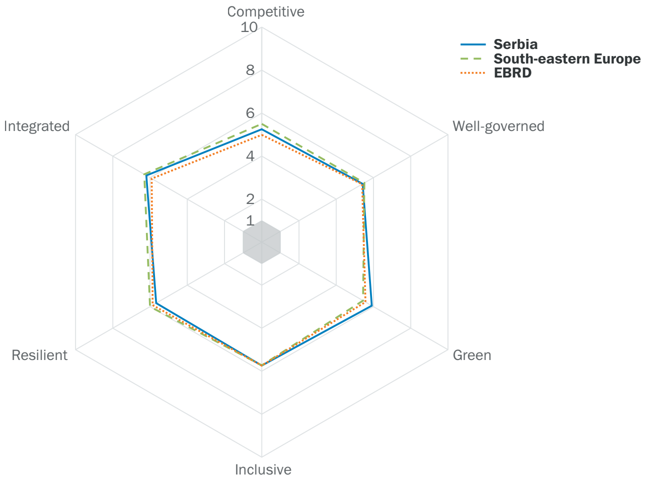
Assessment of transition qualities (1-10)



Major structural reform developments

The business environment remained broadly unchanged. In the World Bank's *Doing Business 2019* report Serbia ranked 48th out of 190 economies. Although it improved dealing with construction permits further (ranking 11th), by reducing time for processing permit applications, it did not make much progress in other areas, resulting in a decrease of five positions from last year's report. Enforcing contracts, resolving insolvency and protecting minority investors are still the most problematic areas for doing business. On the other hand, Serbia has slightly improved its standing in the World Economic Forum's *Global Competitiveness Report 2018*, ranking 65th out of 140 countries (up five places from the previous one).[1] As earlier, market efficiency, institutions and innovation capacity show the biggest gaps.

Serbia has signed a 30-month Policy Coordination Instrument (PCI) with the IMF. This non-financing instrument, signed in July 2018, is to support continued efforts for macroeconomic stability and structural reforms, following the successful conclusion of the three-year Standby Arrangement in February 2018. The new programme is centred around three areas: (i) fiscal policy (that is, safeguarding the fiscal adjustment; and reforming tax policy, tax administration, public employment and wage systems); (ii) monetary and financial sector policies (that is, strengthening the coordination of liquidity management between the National Bank of Serbia and the Ministry of Finance; promoting dinarisation; further reducing NPLs; reforming state-owned financial institutions; aligning financial regulatory and supervisory frameworks with EU standards; addressing identified weaknesses in the AML/CFT framework); and (iii) structural and institutional reforms (that is, tackling the large shadow economy and improving labour force participation; completing restructuring and/or privatisation of SOEs).

Reforms of the public administration have advanced slowly. Following legislation adopted in December 2017, pay levels are to be set across government departments in a more market-oriented, fair and transparent manner. Despite the announcement that coefficients under the new wage system will be applied from January 2019, in November 2018 the government decided to postpone their application to January 2020. "Rightsizing" of the state administration remains a key government priority and, since 2015, the number of public employees has been reduced by close to 30,000, as planned. However, merit-based recruitment and dismissal procedures have not been implemented, and problems remain with political influence in hiring and the high turnover of senior civil servants.

CONTINUES

[1] The rating for 2017 reflects the change in the methodology. According to the old methodology Serbia was ranked 78th in 2017.

Tax administration reform shows mixed progress. In December 2017 the government adopted a new Tax Administration (TA) Transformation Action Plan (2018-23) in order to create a modern tax administration that uses e-business processes, improved taxpayer services and a risk-based approach to compliance. The plan also envisages the removal of the TA's non-core activities and consolidation of core activities into fewer sites. In April 2018 the changes to the Law on Tax Procedure and Tax Administration were adopted. The goal was to reduce tax evasion by broadening the responsibilities for tax payments, extending the competences of tax inspectors, restricting the rights of taxpayers, and securing more efficient tax collection. The amendments also introduce tax services that will be provided by the TA to help the taxpayers settle their taxes in proper amounts and within the deadlines. However, more consultation with all relevant stakeholders in future would be needed since the practical application of some of the rules (including the new VAT Rulebook from October 2017) is unclear.

Privatisation and restructuring of SOEs has progressed somewhat. After several unsuccessful attempts to privatise the company, the government sold its 93.7 per cent stake in the drug-maker Galenika (one of 17 strategic SOEs) in November 2017. In September 2018, two other strategic SOEs were resolved (the Belgrade agricultural company PKB by privatisation and the copper mining and smelting complex RTB Bor by entering into a strategic partnership with a Chinese gold producer). The privatisation of Komercijalna banka has been postponed to 2019, while the resolution of three major loss-makers (all chemical companies) is progressing slowly. In total, around 115 companies (including 10 strategic SOEs) accounting for nearly 45,000 employees in the portfolio of the former Privatisation Agency, remain to be resolved. The restructuring of large public utilities (EPS, Srbijagas) is moving ahead slowly. Following the launch of a concession procedure a year earlier, in March 2018 the government signed a 25-year concession deal for Belgrade airport.

The NPL ratio has fallen significantly. In August 2017 the NBS adopted a Decree on the Accounting Write-Off of Bank Balance Sheet Assets, stipulating the mandatory write-off for loans covered in full by allowances for impairment. As a result, banks have intensified the writing-off of NPLs, which led to the NPL ratio almost halving from September 2017 to 6.5 per cent in August 2018. However, there is still further room for accelerating NPL sales and, eventually, restructuring the debtor companies. The main obstacles relate to strict bank secrecy rules, preventing potential buyers from getting adequate information on NPL portfolios, restrictions on retail NPL sales and NPL sales to foreign entities, as well as inefficient judicial processes.

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

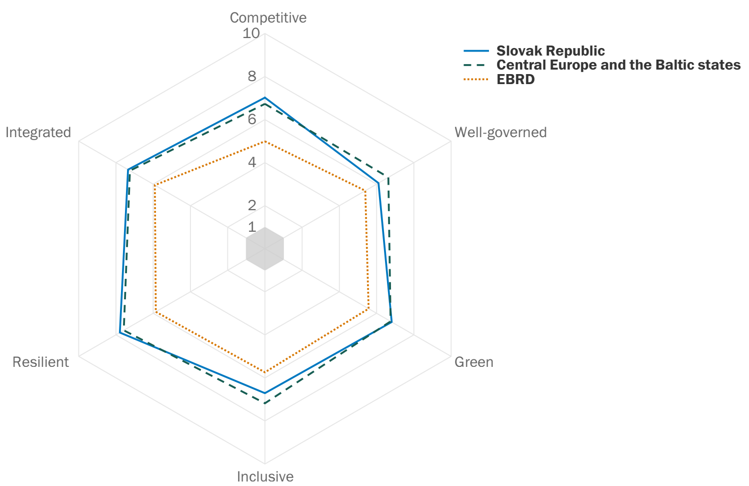
Household consumption and investment are keeping GDP growth strong. The economic expansion of recent years accelerated to 3.2 per cent in 2017 and to 3.9 per cent in the first half of 2018. GDP growth has been fairly balanced, underpinned by a further strengthening of household consumption and buoyant 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.

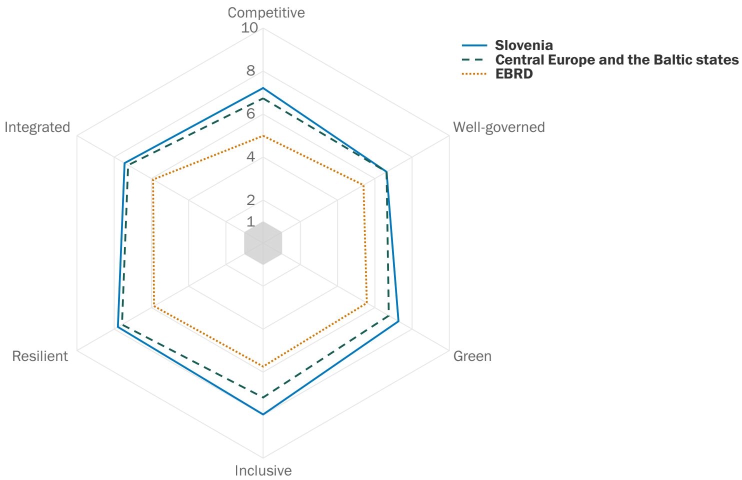
Labour shortages have become more prevalent. Economic recovery led to a fall in the unemployment rate to below 6.0 per cent in the first half of 2018 (from around 10.0 per cent in 2014), while employment growth averaged 2.8 per cent in 2017, the highest rate since 2007. As a result, the share of enterprises 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.

TAJIKISTAN

Highlights

- **Tajikistan shows strong growth figures, but significant weaknesses remain.** Growth of more than 7 per cent in the first half of 2018 has been supported by rising public investment related to the construction of the Roghun hydroelectric power plant. Nevertheless, vulnerabilities remain due to difficulties in the banking sector and fiscal risks.
- **Fiscal space is narrowing.** Following a Eurobond issue in 2017, public debt rose from 44.8 per cent of GDP in 2016 to 51.7 per cent at the end of 2017, further breaching the now-removed legal debt ceiling of 40 per cent of GDP.
- **Unbundling in the power sector has advanced.** A decree signed in April 2018 to unbundle the vertically integrated electricity company Barqi Tojik will pave the way for a more efficient operation of the energy sector.

Key priorities for 2019

- **The main short-term priority is to resolve challenges in the financial sector and restore public trust in banks.** Policy actions are required to handle the two troubled banks, Agroinvestbank (AIB) and Tojiksodirotbank (TSB). In addition, improvements are needed to central bank supervisory functions and corporate governance in banks. System-wide measures to reduce non-performing loans (NPLs) should also be implemented.
- **Administrative hurdles discouraging business activities should be removed.** Specifically, the authorities should focus in the next year on reducing the burden of tax administration, further cutting arbitrary inspection practices, and easing currency convertibility restrictions.
- **Further steps should be taken to implement energy sector reform.** This includes ensuring adequate oversight of Barqi Tojik companies and close adherence to the tariff methodology adopted in mid-2017.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	6.7	6.0	6.9	7.1	6.1
Inflation (average)	6.1	5.8	5.9	7.3	6.3
Government balance/GDP	0.3	0.8	-1.7	-0.3	-3.8
Current account balance/GDP	-2.8	-6.0	-5.2	-0.5	-3.2
Net FDI/GDP [neg. sign = inflows]	-3.3	-5.4	-3.5	-2.8	-2.0
External debt/GDP	56.0	60.5	68.8	77.3	n.a.
Gross reserves/GDP	5.5	6.3	9.4	18.0	n.a.
Credit to private sector/GDP	21.5	22.7	19.2	13.7	n.a.

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Macroeconomic performance

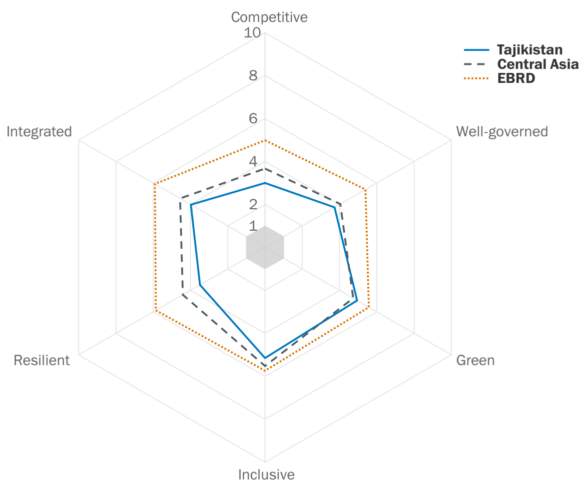
The economy continues to grow strongly but tensions are rising. Real GDP growth was 6.9 per cent in 2016, and accelerated to 7.1 per cent in 2017 and 7.2 per cent year-on-year in the first half of 2018. Growth in 2017 was supported by a recovery in remittances from Russia, which rose by 32 per cent year-on-year in US dollar terms in 2017, following a decline of 13.1 per cent in 2016. In 2018 growth has been enabled by rising fixed investment, which grew by 33 per cent in the first half of 2018, primarily due to higher government spending. Imports rose by 18 per cent year-on-year in the first nine months of 2018 while exports contracted by 10 per cent in the same period, leading to a widening of the trade deficit. Despite strong headline growth, the economy faces significant structural weaknesses in the banking sector and heightened fiscal pressures.

The currency weakened but inflation nevertheless moderated. After depreciating by 10.5 per cent against the US dollar in the first five months of 2017 the somoni was broadly stable until April 2018, when the gap between the official and parallel exchange rates reached 3.4 per cent. The official exchange rate then started weakening and overall depreciation was6.3 per cent in the first 10 months of 2018. Despite the currency depreciation and high growth, inflation decelerated from 6.8 per cent in September 2017 to 5.0 per cent in September 2018, which is well below the central bank's target of 7.0 per cent. This allowed the NBT to cut its policy rate stepwise from 16.0 per cent since March 2017 to 14.0 per cent in March 2018, reversing rate hikes that began in December 2016.

Public debt is rising. It rose from 44.8 per cent of GDP in 2016 to 51.7 per cent in 2017, amounting to US$ 3.67 billion. Under the national foreign borrowing programme for 2018-20, the government intends to borrow an additional US$ 850 million on external markets from bilateral and multilateral partners over the next three years. The proceeds are envisaged to finance projects in agriculture, health care, education, energy and transport. The fiscal deficit narrowed in 2017 but significant fiscal pressures remain, related mainly to financing large infrastructure projects such as the Roghun power station.

Economic growth is projected to reach 6.1 per cent in 2018 and 5.0 per cent in 2019. This growth is expected to be achieved due to continued strong public investment and a further increase in remittances. The first unit of the Roghun hydroelectric power plant is to begin operating in November 2018, which will also support growth. However, downside risks associated with fiscal and banking sector vulnerabilities remain significant.

Assessment of transition qualities (1-10)



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Major structural reform developments

The investment climate and business environment remain challenging despite the government's efforts to encourage entrepreneurship. In his annual address in 2017, the President of Tajikistan acknowledged the burden of frequent intrusive inspections from various agencies on businesses and called for a two-year moratorium on the inspection of businesses, effective from January 2018. However, the moratorium applies only to businesses operating in manufacturing, and inspections continue to hamper the development of small and medium-sized enterprises outside this sector. Although several sector-specific tax benefits were introduced over 2017-18, the tax burden remains high owing to distortive tax collection practices implemented to fulfil revenue targets. Tajikistan ranks 126th out of 190 countries in terms of ease of doing business according to the World Bank *Doing Business 2019* report. The country performs relatively well in protecting minority investors but rather poorly in getting electricity, accessing credit, trading across borders and paying taxes. Within indicators, Tajikistan has progressed most in trading across borders by streamlining customs clearance with Uzbekistan.

The institutional framework for central bank operations has been strengthened. In August 2018, amendments to the Law on the National Bank of Tajikistan and the Law on Banking Activities were adopted. The new amendments provide for an increase in the authorised capital of the National Bank of Tajikistan (NBT) from 20 million somoni (US$ 2.1 million) to 500 million somoni (US$ 53 million) with a view to ensuring an adequate level of capital to effectively implement monetary policy. The NBT has further continued its transition to inflation targeting, as outlined in the Monetary Policy Strategy for 2016-20. In this regard, the NBT has made some progress in strengthening transmission channels and in better communication of the decision-making process.

Banking sector weaknesses persist. Since 2015 significant steps were made by the NBT in strengthening the legal base and regulation practice for the supervision of the financial sector. However, further banking sector reform and improvement of corporate governance practices in the sector are needed. NPLs remained elevated at 24.5 per cent in July 2018, according to official statistics, and credit is contracting. Following the bail-out in 2016, AIB and TSB are now required to buy back their shares from the Ministry of Finance according to a pre-defined timeline and are seeking to attract investment to increase capital. While TSB is on track with payments, AIB failed to repurchase 5 per cent of its shares from the government by the end of 2017.

Regional connectivity prospects are improving. The ties between Tajikistan and Uzbekistan have improved significantly during 2017 and 2018. During the first official presidential visit to Tajikistan in March 2018 in 18 years, the President of Uzbekistan renounced his country's opposition to the construction of the Roghun hydroelectric power plant along the river bordering the two countries. Uzbekistan also expressed its willingness to participate in the project, although it remains unclear in which capacity. In April 2018 Tajikistan started supplying electricity to Uzbekistan through the regional power grid, which was shut down in 2009 when Uzbekistan withdrew from it. The revival of the electricity grid also presents an opportunity for Tajikistan to start exporting electricity to other Central Asian countries which do not border with Tajikistan.

Energy sector reform has advanced. The Power Sector Financial Recovery Action Plan, adopted in June 2017, outlines measures to improve the commercial viability of Barqi Tojik, including through gradually bringing tariffs to cost-recovery levels, reducing losses and increasing revenue collections. In April 2018 the government signed a long-awaited decree which envisages splitting Barqi Tojik into three separate entities responsible for generation, transmission and distribution of electricity and heat. These measures are expected to enhance the business operations of the company. However, delays have occurred in the consistent implementation of the new tariff methodology and in improving oversight of the sector. These delays have built-up losses, which amounted to US$ 2.6 billion in 2017 according to World Bank estimates, resulting from operating inefficiencies, currency depreciation and below cost-recovery tariff levels.

TUNISIA

Highlights

- **Growth is slowly picking up.** The economy grew 2.7 per cent in the first half of 2018, up nearly a percentage point on 2017 growth, on the back of agriculture, agribusiness, food production, manufacturing, in addition to tourism and financial services.
- **Inflation has reached its highest level in decades.** In mid-2018, inflation reached 7.8 per cent, the highest level in more than 26 years, because of the depreciation in the dinar, the VAT rate increase in January 2018, and several rounds of subsidy removals.
- **Some reforms have passed amid domestic tensions.** The law to allow public banks to write off non-performing loans (NPLs) was passed and the Tunisia Investment Authority and the Strategic Investment Council were formed, but other key reforms have been delayed.

Key priorities for 2019

- **Increasing the employability of the youth is essential.** There is a need to create a better link between education and vocational training and the skills needed by employers. Moreover, policies are needed to encourage women to increase their participation in the labour market.
- **Further economic reforms should be prioritised.** The authorities should focus on modernising monetary policy, completing energy subsidy reforms, introducing anti-corruption mechanisms, and completing a census on the vulnerable segments of society to improve targeted social safety nets.
- **The business environment for the private sector needs to improve.** Top priorities to encourage private sector activity and job creation include accelerating the opening of the renewable energy sector to the private sector, developing public-private partnerships (PPPs) for infrastructure, and gradually facilitating access to foreign currencies for Tunisian companies for their internationalisation and expansion.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	2.3	1.1	1.0	1.9	2.8
Inflation (average)	4.9	4.9	3.7	5.3	8.1
Government balance/GDP	-5.0	-4.8	-6.1	-6.1	-5.2
Current account balance/GDP	-9.1	-8.9	-8.8	-10.3	-9.6
Net FDI/GDP [neg. sign = inflows]	-2.2	-2.2	-1.5	-2.0	-2.0
External debt/GDP	63.7	68.5	74.7	83.8	82.6
Gross reserves/GDP	17.6	17.8	15.4	14.2	15.3
Credit to private sector/GDP	69.3	70.1	72.2	74.7	n.a.

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Macroeconomic performance

The economy is picking up in 2018. Real GDP growth accelerated to 2.7 per cent year-on-year in the first half of 2018 from 1.8 per cent in the same period of 2017, the fastest growth since 2014. Growth was driven by the rebound in agriculture, notably olive oil and dates, which reached record highs amid favourable weather conditions. The rebound in agriculture in turn supported agribusiness and food production industries, and consequently manufacturing. Services – mainly tourism and banking – continued to support growth, while non-manufacturing industries contracted, due to a decline in oil and gas extraction, construction and mining. Unemployment remained high at 15.4 per cent in the first quarter of 2018, and higher among women. Due to rapid population growth, GDP per capita has been declining since 2009 by 2.4 per cent per year on average, and the country has been reclassified by the World Bank as a lower middle income country since June 2016.

Inflation has been elevated, necessitating central bank policy tightening. The inflation rate peaked at 7.8 per cent in June, the highest level since 1991, before moderating slightly to 7.5 per cent in July and August. The dinar's depreciation, the VAT rate increase in January 2018, and the increase in prices of certain products (for example, fuel, tobacco and telecommunications) have all contributed to rising prices. As a result, real interest rates have been negative for all but two out of the 19 months since December 2016. In March 2018, the central bank raised its benchmark interest rate by 75 basis points for the first time in almost a year, in an attempt to tame the inflationary pressures. Another rate hike, of an unprecedented 100 basis points, followed in June 2018.

The fiscal deficit remained unchanged in 2017 but the current account deficit has widened. Stronger revenues from corporate income tax, VAT and oil, combined with lower public investment, were offset by lower subsidies and income tax revenue, yielding a fiscal deficit of 6.1 per cent of GDP, the same as in 2016. Meanwhile, public spending on wages remained high at 14.6 per cent of GDP, among the highest ratios in the world. Public debt has continued its upward trend since 2010 and reached 69.9 per cent of GDP in 2017. On the external side, the current account deficit widened to 10.3 per cent of GDP in 2017 from 8.8 per cent of GDP in 2016, the first time the economy has recorded a double-digit deficit since 1984. The widening was led by the increase in imports of goods, despite the pick-up in exports of goods (agricultural, food and energy) and in tourism receipts. Meanwhile, the dinar continued to depreciate in relation to the euro, and as of May 2018, it had lost one-quarter of its value compared with 2016. The expanding current account deficit, exacerbated by the rising international prices of oil and the slowly recovering tourism inflows, has been eroding foreign reserves, which continued to decline, covering less than three months of imports in August 2018.

Growth is expected to increase gradually. GDP is forecast to rise by 2.8 per cent in 2018 and gradually pick up to 3.0 per cent in 2019, driven by a continued recovery in tourism and investment, stronger growth in major export markets in Europe, and the implementation of structural reforms. Risks stem from the 2019 election-related uncertainties and the possibility that socioeconomic protests will disrupt production in the phosphate and hydrocarbon sectors. The depreciation of the dinar and the reintroduction of a mechanism that adjusts fuel prices in line with fluctuations both in currencies and in international oil prices may further raise inflationary pressures. Furthermore, a faster-than-anticipated normalisation of monetary policy in the United States of America could lead to a stronger US dollar and amplify debt vulnerabilities, given that two-thirds of public debt is denominated in foreign currency.

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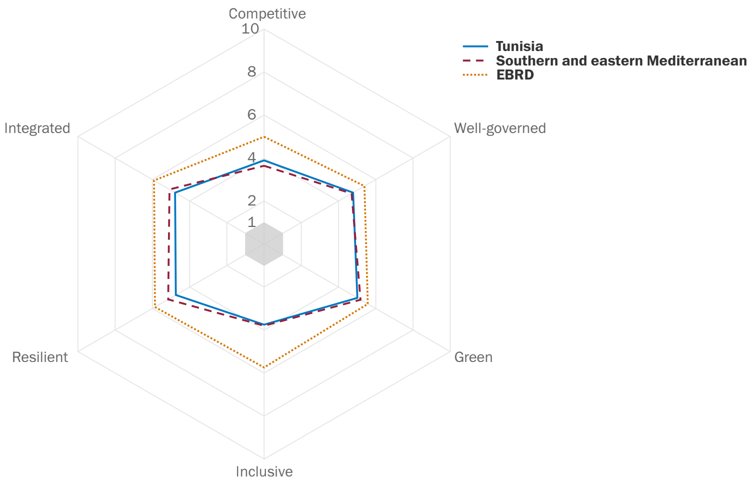
Assessment of transition qualities (1-10)



Major structural reform developments

New fiscal measures are in place. In December 2017, parliament passed the 2018 budget which included a package of fiscal measures to cut the budget deficit. MPs approved new articles, including the enlargement of the 35 per cent corporate tax rate scope to include car dealership activities, shopping centres and franchises. Another article stipulates the simplification of conditions for granting tax benefits in terms of reinvestment of revenues and profits in the subscription of the companies' capital. The 2018 budget also raises customs taxes on some imported products to cut the trade deficit. The parliament approved a rise of 1 percentage point in value-added tax and imposed a new 1 per cent social security tax on employees and firms. Taxes on bank profits will rise from 35 to 40 per cent. The 2018 budget also limited new recruitment into the civil service to graduates of state training schools. Consistent with the civil service reform strategy, hiring will be capped below 3,000 civil servants for 2018.

Foreign investment rules have been liberalised. In June 2018, the government announced that foreign investors would be allowed to acquire property in foreign currency. Tunisia continues to impose restrictions on foreign land and property buying, including a ban on purchasing agricultural land or social housing, but has amended the legislation for foreign investors in order to stimulate investments. The authorities also established a one-stop shop for large investors and adopted a restricted list of eight sectors that remain subject to investment authorisations, while freeing all other sectors from prior approval.

New agencies are being established. During the past year the government established the Tunisian Investment Authority, the Strategic Investment Council and the High Anti-Corruption and Good Governance Authority (HACGGA). The new Investment Law has now entered into force, with the Tunisia Investment Authority close to becoming fully operational. The HACGGA will become functional once its board members are appointed by parliament following consultations among political parties. Moreover, the General Committee on Taxation, Public Accounts and Collections was created in December 2017, tasked with combating tax fraud and smuggling. This committee was set up following the merger between the General Directorate of Taxes and the General Directorate of Public Accounting and Collections.

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Non-performing loans are being tackled. In February 2018 the Council of Ministers passed a new legal framework to facilitate the resolution of non-performing loans (NPLs) in public banks. Parliament voted the new framework into law in May 2018. The law allows public banks to write-off and resolve NPLs in the same way as private banks. Before this amendment, NPLs were disproportionately concentrated in public sector banks, mostly in the tourism industry. As of the end of 2017, NPLs were 13.9 per cent and higher in public banks, which until recently faced legal discrimination in managing NPLs portfolios, thus constraining growth and access to finance.

A new initiative is encouraging entrepreneurship. In April 2018, parliament passed the Start-up Act to incentivise local entrepreneurs to initiate and operate their ventures. As part of the government's 'Digital Tunisia 2020' plan, the new act aims to increase the number of Tunisian start-up companies, primarily in the tech industry, with the aim of boosting innovation and the country's international competitiveness. One of the major advantages of this legislation is the appeal to the youth, thus tackling one of Tunisia's lingering economic problems of youth unemployment.

The government is targeting assistance to vulnerable groups. In January 2018, the government announced a US$ 70 million package for poor and vulnerable families. This support, which became effective in April 2018, includes a 20 per cent increase in the cash transfer amount, as well as an increase in the minimum pensions of retirees.

TURKEY

Highlights

- **The economy risks a hard landing.** Measures undertaken by the government to revive consumption and investment led to a surge in domestic demand in 2017 and early 2018, but overheating concerns became evident as inflation surged to 15-year highs in 2018 and the current account deficit expanded to over 6 per cent of GDP.
- **The lira has depreciated substantially and remains volatile.** Concerns over macroeconomic imbalances and geopolitical tensions led the lira to depreciate by over 40 per cent at one point since the start of 2018. While aggressive monetary tightening has reversed some of the depreciation, the currency has remained volatile.
- **There has been limited progress in structural reforms.** Over the past year, economic policy has mainly focused on reviving consumption and investment. The recent New Economic Programme (NEP) sets out credible proposals for structural reform for the coming three years, but the government's commitment to implementation remains to be seen.

Key priorities for 2019

- **Efforts to achieve macroeconomic stability and rebalance the economy need to be sustained and structural reforms prioritised.**Coordination between fiscal, macroprudential and monetary policies needs to be ensured and structural reforms aiming to increase domestic savings, productivity and exports need to be reinvigorated.
- **Competitiveness of the private sector needs to improve.** Despite increasing resources being devoted to research and development, the innovative capacity of the private sector remains moderate. Designing policies and devoting more resources to improve commercialisation, strengthen access to finance and train and retain qualified research personnel would increase the competitiveness of the private sector.
- **Labour market reforms should be reinvigorated, in particular those promoting regional, gender and youth inclusion.** Turkey's young, entrepreneurial population is an unexploited asset. It has large geographic disparities, high numbers of refugees, low female labour force participation and high youth unemployment. Expanding education and training opportunities and access to finance would enhance long-term growth prospects and inclusion.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	5.2	6.1	3.2	7.4	3.6
Inflation (average)	8.9	7.7	7.8	11.1	15.0
Government balance/GDP	-1.1	-1.0	-1.1	-1.5	-3.4
Current account balance/GDP	-4.7	-3.7	-3.8	-5.6	-5.7
Net FDI/GDP [neg. sign = inflows]	-1.4	-2.1	-1.5	-1.3	-1.3
External debt/GDP	43.5	46.7	47.8	53.3	n.a.
Gross reserves/GDP	12.9	12.6	13.7	13.0	n.a.
Credit to private sector/GDP	59.9	62.9	65.7	66.5	n.a.

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Macroeconomic performance

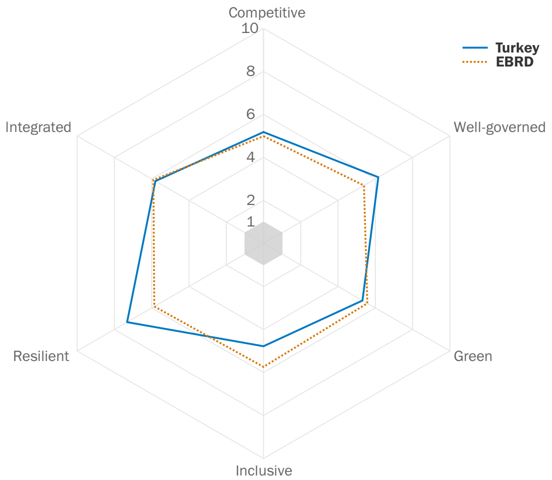
The economy grew rapidly in 2017 and early 2018 through stimulus measures. The Turkish economy grew by 7.4 per cent in 2017 and by 6.2 per cent in the first half of 2018, on the back of various stimuli provided by the government, including an expansion of government-backed credit guarantees to small and medium-sized enterprises (SMEs) under the TRY 250 billion (US$ 40 billion) Credit Guarantee Fund (CGF) and major public infrastructure projects. This led to a surge in private consumption and investment, raising overheating concerns as inflation rose to a 15-year high of almost 25 per cent in September 2018 and surging imports drove a steep decline in net exports.

Domestic and external imbalances have increased. The current account deficit grew despite the depreciating currency, as stimulus-driven domestic demand and rising oil prices pushed up imports. Gross external financing needs are around 25 per cent of GDP in 2018, leaving the country exposed to changing global liquidity conditions. Fiscal loosening in the run up to the elections in June 2018 caused concern among investors, so it is important that the significant tightening proposed in the NEP is implemented.

The Turkish lira has been extremely volatile in 2018. A heavy dependence on foreign capital, a wave of tightening monetary policy in advanced economies, a lack of domestic policy clarity and geopolitical tensions all led to rapid depreciation of the lira, which at one point lost around 40 per cent of its value against the dollar since the start of 2018. Stock markets have also taken a hit, with the BIST 100 index at one stage falling 25 per cent below the record highs attained earlier in 2018.

Growth is expected to slow down in the short term and a hard landing is increasingly likely. The lira's depreciation and interest rate hikes are likely to impact consumption and investment, despite some positive contribution from net exports. A sharp slow-down in the second half is expected to bring growth in 2018 down to 3.6 per cent, followed by 1.0 per cent in 2019. The key risk to the outlook is uncertainty regarding the banking sector but other risks include the direction of economic policy, the ongoing moderation in global liquidity and further depreciation of the lira. Important and long-overdue structural reforms need to be undertaken to improve competitiveness and to achieve external rebalancing to generate sustainable growth.

Assessment of transition qualities (1-10)



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Major structural reform developments

Reform progress has been limited, but new measures are in the pipeline. The government has been preoccupied with bureaucratic reorganisation amid the transition from a parliamentary to presidential system following the June 2018 elections, while economic policies have focused on containing the impact of the currency crisis. In September the government announced the NEP, which outlined reforms for increasing flexibility and inclusion in the labour market, improving the stability of the financial system and the efficiency of the justice system.

The government is taking steps to improve the business environment. A reform bill focusing on improving elements of the business environment, such as starting a business, enforcing contracts, paying taxes and resolving insolvency, was introduced in early 2018. This has helped Turkey improve its ranking in World Bank's *Doing Business 2019* report by 17 places to 43rd out of 190 countries compared with the previous year. Meanwhile, the government announced plans to considerably expand the scope of e-government applications by the end of 2018.

The government has introduced targeted incentives to the manufacturing sector. In March 2018 the government introduced a comprehensive incentives package for 23 investment projects in sectors or products with high trade deficits, in order to reduce the current account deficit in the medium term. The supported projects are in metallurgy, defence, petrochemicals, renewable energy and machinery and are eligible for a large range of support measures including tax exemptions, interest rate subsidies and land allocation support.

Employment incentives have been expanded. The government has increased the social security and tax incentives provided to firms for new hires, with an emphasis on female, young or disabled employees, in an effort to promote inclusion of vulnerable groups. Meanwhile, efforts to increase labour market flexibility and domestic savings by updating the existing severance pay system have run into problems with labour unions and are currently stalled.

The regulatory framework on foreign exchange borrowing has been tightened and the government has introduced a number of restrictive measures to address currency instability. The government has adopted a more restrictive approach in order to address potential risks arising from foreign currency mismatch of SMEs borrowing in currencies other than Turkish lira. The regulatory agency has introduced regulations to limit short-selling of the lira by investors. Legislation requiring exporters to convert transaction revenues into lira was introduced. Lastly, a presidential decree aiming to reduce dollarisation has introduced significant restrictions to foreign currency-denominated contracts between Turkish residents.

Reforms of the banking sector and capital markets continue. Regulation has been introduced to allow publicly owned banks to sell non-performing loans to asset management companies. Also, the Capital Markets Board reduced the minimum share of stocks required to be offered to institutional investors in initial public offerings, which is expected to encourage companies to list domestically instead of listing abroad in countries with more flexible regulations. Moreover, the government has also presented plans to set up a higher agency for financial regulation in the new parliamentary term starting in October 2018.

TURKMENISTAN

Highlights

- **Official GDP growth remains strong but masks significant challenges.** Growth has decelerated slightly in the first half of 2018 but remains above 6 per cent according to official figures. However, the economy is exposed to considerable external and fiscal pressures.
- **A partial recovery in export earnings in 2018 has been insufficient to ease foreign exchange scarcity.** This is reflected in the rapid depreciation of the unofficial exchange rate to between 16 and 17 manats per US dollar (September 2018) versus the official peg of 3.5 manats to the dollar.
- **The construction of alternative gas export routes is progressing slowly.** Work has started in 2018 on Line D of the Central Asia-China pipeline and the Afghan section of the Turkmenistan-Afghanistan-Pakistan-India pipeline. Further progress remains complicated by the lack of financing as well as security concerns. However, officials of Russia's Gazprom have announced the renewal of Turkmen gas exports to Russia from 2019 onwards.

Key priorities for 2019

- **Adjustment of the official exchange rate and termination of exchange rate rationing are key priorities.** Foreign and local businesses are significantly constrained in accessing foreign exchange for the import of required goods and services, payments are seriously delayed even for services rendered under government contracts. Corrective measures should be implemented while taking into account the effect on the socially disadvantaged portion of the population.
- **Fiscal policy should be tightened and public financial management should be strengthened.** Future government investment should be undertaken based on cost-benefit analysis to ensure optimal use of strained public finances.
- **Measures should be taken to significantly improve the business environment.** The main priority in this area is to reduce state interference in private sector business decisions. This will facilitate private sector growth and increase foreign investor confidence and investment.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	10.3	6.5	6.2	6.5	6.2
Inflation (average)	6	7.4	3.6	8	9.5
Government balance/GDP	0.9	-0.7	-2.4	-2.8	-1.2
Current account balance/GDP	-6.1	-15.6	-19.9	-11.5	-8.0
Net FDI/GDP [neg. sign = inflows]	-8.8	-8.5	-6.2	-5.5	-4.5
External debt/GDP	16.8	21.8	23.1	25.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	n.a.	n.a.	n.a.	n.a.	n.a.

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Macroeconomic performance

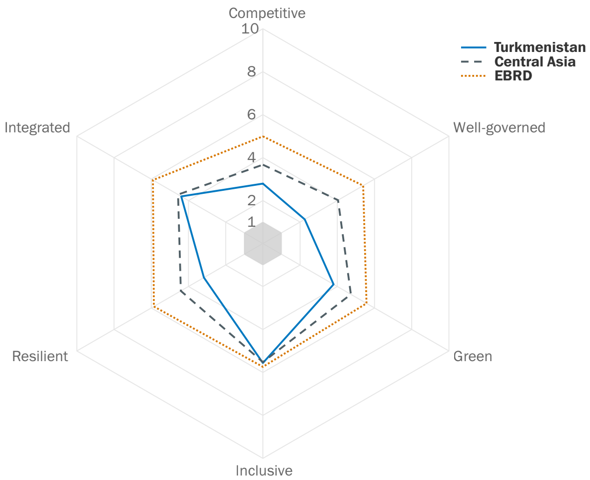
Turkmenistan continues to report strong growth, but macroeconomic pressures are rising. In the first three quarters of 2018 officially reported real GDP growth was 6.2 per cent year-on-year, following 6.5 per cent growth in 2017. Fixed investment fell by 20.2 per cent year-on-year in the first half of 2018, from its previously very high levels. Industrial production grew by 4.2 per cent year-on-year in the first three quarters of 2018. While exports rose in the first half of 2018 by 43.4 per cent year-on-year, they still remain well below their peak in 2014 following declines in the past three years. Import substitution policies led to a reduction of imports by 43.5 per cent in the same period. Despite the high official growth rates, the economy faces an array of challenges reflected in a severe foreign exchange scarcity, rising food prices, and high unemployment. Inflation accelerated from 6.2 per cent year-on-year in December 2016 to 10.4 per cent year-on-year in December 2017. Prices have officially grown further by 8.9 per cent between December 2017 and June 2018, elevating officially reported inflation to an estimated 15.7 per cent year-on-year in June 2018.

The exchange rate is under severe pressure. While the official peg is maintained at 3.5 manats per US dollar, the exchange rate in the parallel market reached 16 to 17 manats per dollar in September 2018, significantly up from 6.6 manats in September 2017. Foreign exchange continues to be heavily rationed, with the government prioritising the allocation of foreign exchange for projects deemed to be of highest importance. Lower imports of investment goods contributed to a narrowing of the current account deficit from around 20.0 per cent of GDP in 2016 to 11.5 per cent in 2017, according to IMF estimates.

The fiscal position remains weak. The state budget deficit widened from 2.3 per cent of GDP in 2016 to 2.8 per cent of GDP in 2017. Revenues reached 14.9 per cent of GDP in 2017, up from 11.7 per cent in 2016 while expenditures rose to 17.7 per cent of GDP in 2017 from 14.1 per cent in 2016. Revenues of the state budget for 2018 were set 8.0 per cent lower than in the 2017 budget. Expenditures in 2018 are planned at the same amount as revenues, which is 9.0 per cent below the 2017 budget plan. In the first half of 2018, state budget revenues fell by 8.8 per cent year-on-year, and expenditures by 3.9 per cent. Revenues were thus 3.0 per cent above plan, and expenditures 15.0 per cent below plan. The reduction in both spending and revenues relative to 2017 indicate difficulties in the public finances. External debt was 25.1 per cent of GDP in 2017, up from 23.1 per cent in 2016.

GDP growth is forecast to slow to 6.2 per cent in 2018 and 5.6 per cent in 2019. Growth will be weighed down by relatively small export growth, a further contraction of domestic consumption and fiscal consolidation efforts. The dependence of Turkmenistan's exports on China remains a major vulnerability to the economy. If, however, significant gas exports to Russia resume, it would ease the economic situation.

Assessment of transition qualities (1-10)



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Major structural reform developments

Some reforms have been announced but implementation plans remain unclear. Among recently announced measures, a "State Programme on Support of Small and Medium Entrepreneurship for 2018-2024" was approved by the President in March 2018 and a small and medium-sized enterprise (SME) fund was created. The President also approved a "State Programme on Energy Saving for 2018-2024", which among other things envisages the construction of solar power stations, industrial wind generators and biogas plants. The authorities are preparing reforms such as medium-term budgeting, transition to GFSM2001 fiscal data reporting, and a financial regulatory overhaul, which would introduce elements of Basel principles into local regulations. However, the announced reforms in many cases lack detail, and it remains to be seen in what way and how fast they will be implemented.

Construction of gas pipelines is progressing but at a slow pace due to financial, security and technical challenges. In February 2018, the construction of the Afghan section of the Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas line project was formally launched. TAPI intends to supply 33 billion cubic metres of gas from Turkmenistan to Afghanistan, Pakistan and India. However, the completion of the TAPI pipeline is still under question because of security issues in Afghanistan and Pakistan. The construction of the Tajikistan part of the Line D of the Central Asia-China pipeline, through which Turkmenistan intends to further increase gas deliveries to China, began in January 2018, but the future of the pipeline will depend on how much gas China is actually willing to purchase. Turkmenistan's economy is highly dependent on China as its major gas export market, after halting its gas exports to Russia and Iran in 2016-17.

A new cargo and passenger seaport on the Caspian Sea has been opened. The seaport, which cost US$ 1.5 billion, was opened in May 2018 with the aim of establishing Turkmenistan as a transit hub connecting Europe and China. Construction of the port started five years ago. The government expects that the port will allow Turkmenistan to handle 17 to 18 million tonnes of cargo a year, bringing the total handling capacity (including an existing port) to 25 to 26 million tonnes. This complements Turkmenistan's efforts to upgrade transport infrastructure following the opening of the new US$ 2.5 billion airport in September 2016 designed to handle 14 million passengers and 200,000 tonnes of cargo annually. While these investments have high passenger and cargo potential, the lack of accompanying soft infrastructure enablers limits the utilisation of these investments.

Russia plans to resume gas imports from Turkmenistan in 2019 but a gas dispute with Iran is unresolved. After halting gas imports from Turkmenistan in 2016, Gazprom representatives indicated in October 2018 that gas purchases from Turkmenistan would start in January 2019. This is long-awaited news for Turkmenistan which currently depends on China as its sole gas export market. Turkmenistan also used to export gas to Iran in return for goods and services until January 2017. However, it stopped supplying gas to Iran because of claims of outstanding debt of US$ 1.8 billion for gas imported in 2007-08. In August 2018 the case went to the International Court of Arbitration but there is no notable progress to date.

UKRAINE

Highlights

- **The economy is on a moderately paced recovery path.** Economic output expanded by 2.5 per cent in 2017, with domestic demand as the main driver, and the pace of growth has picked up so far in 2018.
- **Progress in the legislative reform agenda has been mixed.** The parliament has adopted a number of milestone laws, including on establishment of an anti-corruption court, privatisation, currency and currency operations, corporate governance in state-owned banks, and creditors' rights protection. These legislative changes, however, have yet to yield tangible results.
- **Cooperation with the IMF is to be extended under a different arrangement.** If approved and duly implemented, the new 14-month Stand-By Arrangement will help to address Ukraine's external financing needs and maintain macroeconomic stability during the programme period.

Key priorities for 2019

- **Ukraine needs to preserve macroeconomic stability.** Cooperation with the IMF remains vital. The country will require continued IMF and donor support, and consistent access to international capital markets to address foreign exchange debt payment liabilities falling due in 2018-20.
- **Ukraine should step up implementation of recently adopted energy sector laws.** Unbundling of the gas transmission system operator from Naftogaz and implementation of its corporate governance action plan, together with the establishment of the gas exchange, are priorities. The Public Sector Obligation (PSO) of Naftogaz and its subsidiaries requires an overhaul to phase out subsidisation and incentivise payment discipline by utility companies.
- **Reform of the state-owned banks should be vigorously pursued.** Emphasis should be placed on the execution of the corporate governance reform and transformation of the state-owned banks, thus leading to their privatisation.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	-6.6	-9.8	2.4	2.5	3.5
Inflation (average)	12.1	48.7	13.9	14.4	10.9
Government balance/GDP	-4.5	-0.9	-2.1	-1.3	-2.1
Current account balance/GDP	-3.4	1.8	-1.4	-2.2	-3.1
Net FDI/GDP [neg. sign = inflows]	-0.2	-3.3	-3.5	-2.3	-2.1
External debt/GDP	94.6	130.4	121.7	103.9	n.a.
Gross reserves/GDP	5.6	14.6	16.6	16.8	n.a.
Credit to private sector/GDP	64.3	49.4	41.9	34.1	n.a.

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Macroeconomic performance

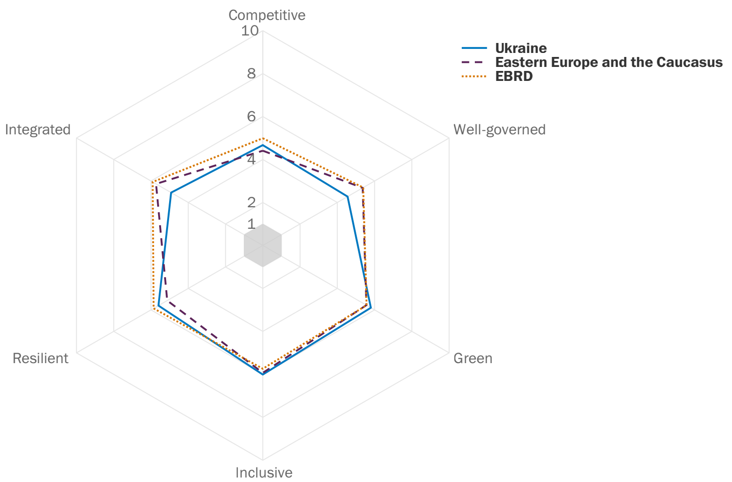
Growth has gained some momentum but remains modest. GDP growth accelerated from 2.5 per cent in 2017 to an estimated 3.5 per cent (year-on-year) in the first half of 2018. Household consumption increased by 8.4 per cent in 2017 on the back of a strong real wage recovery, an increase in the average pension and a rise in the inflow of remittances from abroad. In 2017, investment in fixed assets increased by 18.2 per cent. In the same period, exports of goods and services also grew modestly in real volume terms following five consecutive years of contraction. Consumer price inflation has slowed from the peak levels of 2015 but remains elevated at 11.4 per cent year-on-year in the first nine months of 2018. The National Bank of Ukraine (NBU) raised its key policy rate six consecutive times from 12.5 per cent in October 2017 to 18.0 per cent in September 2018 to counter the inflationary pressures.

The emigration of working-age people has intensified. This has led to labour market pressures and is dragging down industrial output growth. At the same time, outward labour migration has led to an increased inflow of remittances from abroad. According to the recently revised methodology of the NBU, personal remittances are estimated to have increased from US$ 7.0 billion (approximately 7.6 per cent of GDP) in 2015 to US$ 9.3 billion (8.3 per cent of GDP) in 2017. Real wages increased by 12.8 per cent year-on-year in the first nine months of 2018.

The IMF's four-year Extended Fund Facility (EFF) is set to be replaced with a shorter, smaller-scale Stand-By Arrangement (SBA). In October 2018, the authorities and the IMF reached a staff-level agreement on a new 14-month SBA for the total amount of US$ 3.9 billion. If approved by the IMF Executive Board and duly implemented, the new SBA will help to address Ukraine's near-term external financing needs and to maintain macroeconomic stability throughout the electoral cycle next year. Following the staff-level agreement with the IMF, Ukraine returned to international capital markets in October 2018, issuing a dual-tranche Eurobond for the total principal amount of US$ 2 billion. Since April 2018 international reserves have been on a declining path, falling from US$ 18.4 billion to US$ 16.6 billion (approximately 2.9 months of imports) as of September 2018, although this trend is expected to be reversed after the renewal of cooperation with the IMF.

Growth prospects depend on the speed of implementation of key structural reforms and on addressing external refinancing needs. Ukraine's GDP is forecast to grow by 3.5 per cent in 2018 and by 3.0 per cent in 2019, although the political economy context may become less conducive for structural reforms ahead of the new election cycle in 2019. Ukraine needs to refinance foreign exchange public debt liabilities falling due in 2018-19 without draining foreign exchange reserves to maintain the confidence of investors and strengthen the medium-term outlook. Continuation of engagement with the IMF remains vital in this respect.

Assessment of transition qualities (1-10)



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Major structural reform developments

State-owned enterprise reform is moving forward slowly. A draft of the SOE corporate governance law that paves the way for independent boards with broad statutory powers at the SOEs has been prepared and submitted to the parliament. A revised Nomination Policy for SOE board members and CEOs was approved by the government in March 2018. This was followed by progress in appointing independent board members at a number of strategically important SOEs. The law on privatisation of state property, adopted in January 2018, has rectified shortcomings in the privatisation process and introduced the notions of small- and large-scale privatisations. According to the law, privatisation of small-scale state assets (up to approximately US$ 9.4 million in value) is to be made through the online state auction platform (Prozorro.Sale). The bylaws supporting the new law on privatisation were developed and approved by the Cabinet of Ministers in May 2018, but no major privatisation has taken place so far.

The stage has been set for reforming the state-owned banks (SOBs). In February 2018, the authorities approved the key principles of strategic reform of the state-owned banking sector, which accounts for approximately 55 per cent of total banking assets. Four major priorities were identified: implementation of strategies to restore commercial soundness and profitability; improvements in corporate governance, discipline and strategy execution; measures to improve the quality of assets and strengthen balance sheets; and exit of the state from the ownership of banks in the medium term. A law on improving the functioning of the financial sector in Ukraine was approved by the parliament in July 2018. It introduces independent professional supervisory boards appointed on a competitive basis. By law, the boards will have wide powers such as approval of key strategies and appointment of the executive management. Corporate governance standards set by the new law aim to increase operational efficiency, insulate the SOBs from undue political influence, and prepare them for eventual privatisation.

The new law on currency and currency operations replaces obsolete regulations. Adoption of the law in July 2018 marks a shift from an outdated, fragmented and cumbersome set of currency regulations and controls to a modern system compliant with EU directives and Ukraine's obligations under the Association Agreement. The currency operations are to be carried out without restrictions, unless provided otherwise by applicable anti-money laundering laws, national security laws, applicable international treaties or measures introduced by the central bank. The NBU remains authorised to abolish restrictions on foreign exchange operations or the movement of capital depending on macroeconomic conditions, but also to establish temporary protective measures at its discretion in case of identified threats to financial stability. The capital control and foreign exchange restrictions remaining in Ukraine are expected to be gradually lifted on the implementation of the law and contingent on satisfactory macroeconomic conditions.

Progress in energy sector reforms has been mixed and delays have occurred. The new majority-independent Supervisory Board of Naftogaz was selected in November 2017, after independent members of the previous board tendered their resignation while pointing to delays in the implementation of reforms. In December 2017, the government approved resolution on the monetisation of housing and utilities subsidies (HUS) at the utility level, introducing improvements to the HUS settlement process. Further work is needed to move the HUS monetisation further down to the level of households. In April 2018, the government established the Energy Reform Coordination Council (ERCC) in an effort to enhance delivery of energy sector reforms through strategic guidance and improved coordination between the government, Naftogaz and development partners. The ERCC is to focus on the three energy reform priorities that have experienced considerable delays: unbundling of gas transmission from production and supply functions; reforming the Public Sector Obligation (PSO) – Naftogaz's responsibility for the supply of natural gas to households and district heating utilities under regulated prices; and better targeting and monetisation of HUS. In May 2018 the President of Ukraine appointed five new Commissioners of the Energy and Utilities Regulator from the list pre-selected by the Independent Nomination Commission, reinstating the quorum and clearing the way for the regulator to make decisions.

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Investment climate reforms have advanced but significant challenges remain. In November 2017, the parliament adopted legislation that limits the powers of law enforcement agencies in carrying out criminal proceedings against businesses. The law requires all searches of enterprises by law enforcement agencies to be recorded on video with the right of an attorney to be present at any stage of the process. The law also limits the possibility of unwarranted seizure of business-critical computer hardware from private companies, among other measures. In February 2018, the parliament passed a law to establish an NBU-based centralised credit registry to foster information exchange and credit risk assessment by banks. A number of gaps undermining creditors' rights protection were targeted by the law on resumption of lending, adopted in July 2018. The landmark legislation for the establishment of the High Anti-Corruption Court was adopted in June 2018, despite strong political resistance. At the same time, asset declaration requirements for non-governmental organisations and board members of SOEs have not been abolished. The National Anti-Corruption Bureau of Ukraine (NABU) continues to face pressures and attempts to compromise its investigative activities. A moratorium on agricultural land sales was extended until January 2019. Ukraine ranks 71st out of 190 economies in the World Bank *Doing Business 2019* report, moving up in the rankings compared with the previous year. However, weaknesses in Ukraine's business environment are reflected in the low scores with respect to resolving insolvency, getting electricity, trading across borders and protecting minority investors.

UZBEKISTAN

Highlights

- **GDP growth remains robust, although below the figures reported for 2016.** The growth rate eased from the official 7.8 per cent in 2016 to a more realistic 5.3 per cent in 2017 and 5.2 per cent year-on-year in the first three quarters of 2018. Growth was driven by expansion in services, industrial production and construction.
- **The authorities continued to implement major reforms.** Progress has occurred in a number of areas in the past year, including foreign trade liberalisation, progress on fiscal and tax reform, changes in the customs regime, the abolition of annual state-investment programmes and a reduction in state-directed lending.
- **Connectivity with other Central Asian countries is being significantly improved.** Initiatives led by Uzbekistan over 2017-18 resulted in the opening of new border crossings with Kazakhstan, border demarcation with the Kyrgyz Republic, reopened rail and road connections with Tajikistan, and the resumption of electricity exports from there.

Key priorities for 2019

- **Commercialisation, restructuring and privatisation of state-owned enterprises (SOEs) are key priorities.** Restructuring of SOEs to remove their non-core activities, address their strained balance sheets, and improve governance mechanisms and advance their further commercialisation should all be accelerated along with potential privatisations. This needs to be accompanied by tariff reforms and should result in the transformation of core sectors of the Uzbek economy, such as energy and transportation.
- **Additional financial sector reforms are required.** Uzbekistan needs a market-oriented banking sector that offers a broad range of financial services and improved access to finance for small and medium-sized enterprises (SMEs) and the private sector. The quality of banking supervision also needs to be strengthened.
- **The business environment should be further improved.** Short-term priorities include legislation to improve tax and customs efficiency, further streamlining of licensing and other business regulation, further transition to e-government solutions, and more streamlined customs regulation.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	8.0	7.9	7.8	5.3	5.0
Inflation (average)	9.1	8.5	8.0	12.5	18.0
Government balance/GDP	0.2	0.1	-0.1	-3.0	-1.0
Current account balance/GDP	1.7	0.7	0.6	3.5	-4.0
Net FDI/GDP [neg. sign = inflows]*	-1.2	-0.1	-0.2	-0.2	-1.0
External debt/GDP*	14.5	18.5	20.3	41.3**	n.a.
Gross reserves/GDP**	38.2	38.7	37.8	57.5**	n.a.
Credit to private sector/GDP	n.a.	n.a.	n.a.	n.a.	n.a.

*Using the official exchange rate for GDP calculation, which was strongly overvalued until the currency liberalisation in September 2017.
**Calculated at the exchange rate of 8000 sum/US$ the external debt was 49 per cent of GDP in 2017 and gross reserves were 69 per cent of GDP.

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Macroeconomic performance

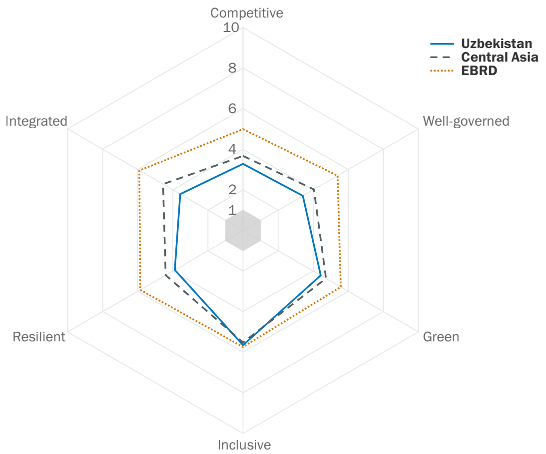
Economic growth has eased in 2017 and 2018. GDP growth slowed from the officially reported rate of 7.8 per cent in 2016 to 5.3 per cent in 2017 and 5.2 per cent in the first three quarters of 2018, reflecting improved data accuracy and also some slowing of private consumption and a widening foreign trade deficit. Exports contracted by 0.3 per cent year-on-year in US dollar terms in the first three quarters of 2018, whereas imports surged by 33.3 per cent, facilitated by trade liberalisation policies. Fixed investment rose by 20.4 per cent in 2017 and 13.4 per cent year-on-year in the first half of 2018. Remittances from Russia continued to increase in the first two quarters of 2018 following a marked recovery in 2017.

Inflation has continued to accelerate. Average inflation rose from 8.0 per cent in 2016 to 12.5 per cent in 2017. In August 2018 inflation reached 15.7 per cent year-on-year. Inflation is expected to remain in double digits in 2018 and 2019 because of further price liberalisation and the resulting adjustment in relative prices. Credit growth reached 44.1 per cent year-on-year in the first three quarters of 2018. In response to rising inflationary pressures, the central bank increased the policy rate from 14.0 per cent, where it had been since June 2017, to 16.0 per cent in September 2018.

Fiscal and external positions remain strong. Uzbekistan's consolidated budget deficit is estimated to have remained below 1 per cent of GDP in 2017. However, the augmented fiscal deficit (including off-budget funds, primarily the Fund for Reconstruction and Development) increased substantially from 0.6 per cent of GDP in 2016 to 3.3 per cent of GDP in 2017 as a result of measures taken to stabilise the economy during the currency liberalisation and implementation of reforms, Public debt is relatively low, and stood at about 25 per cent of GDP at the end of 2017. The balance of payments, published in June 2018 by the central bank for the first time, shows a US$ 1 billion current account deficit in the first half of 2018 although the growing trade deficit was partially offset by remittances inflows. Net international reserves stood at US$ 26.4 billion as of 31 July 2018, covering 24 months of imports.

Real GDP growth is projected to slightly moderate in the short term. Growth is projected to reach 5.0 per cent in 2018 and 4.5 per cent in 2019 due to a further slow-down in private consumption and falling net exports. Increased investment, supported by structural reforms and the improved business environment, will likely underpin growth. Public infrastructure spending is also expected to continue.

Assessment of transition qualities (1-10)



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Major structural reform developments

Further measures were taken to improve the business environment. Uzbekistan ranks 76th out of 190 countries in the World Bank's *Doing Business 2019* report. After making substantial progress with reforms in 2017, Uzbekistan improved its score by 1.08 percentage points in the latest report thanks to improvements in all indicators except for getting credit and enforcing credit, where the scores were unchanged. In particular, Uzbekistan strengthened minority investor protections by clarifying the ownership and control structures of listed companies, reduced costs of paying taxes by introducing new classification criteria for enterprises, and accelerated trading across borders by introducing an electronic application and payment system for several export certificates.

The institutional and economic framework of the central bank is being strengthened. A new Decree on Improvement of the Central Bank Activity, adopted in January 2018, sets out price stability, stability and development of the banking system, and stability and development of the payment systems as the main goals of the Central Bank of Uzbekistan (CBU). The CBU is no longer accountable to the Cabinet of Ministers but instead to the Senate. In March 2018, the central bank developed a concept for the development and implementation of monetary policy for 2018-21 which envisages transition to an inflation targeting regime. The central bank will work closely with the Ministry of Finance on the issuance of government securities to activate open market operations, and will launch a single electronic interbank market for the provision of short-term liquidity.

A concept for improving Uzbekistan's tax policy was approved. The new policy, approved by the President in June 2018, is aimed at the reduction of the tax burden, elimination of the gap between taxation of payers of general and simplified taxes, and the improvement of tax administration. Changes will take effect in January 2019. The concept includes optimisation of the number of taxes through their unification, the reduction and simplification of tax reporting, and the minimisation of operating expenses. A new Tax Code is expected to be drafted by December 2018 with the help of the IMF, the World Bank and other international institutions.

Significant steps have been taken to improve connectivity. Progress was made on implementation of the Uzbekistan-Kyrgyzstan-China railway project, which has been under consideration for 22 years, during a tripartite meeting in December 2017 in Uzbekistan. Intergovernmental agreement on the construction of the railway is expected to be signed by the end of 2018. Electricity connectivity with Tajikistan was re-established in April 2018, after Uzbekistan had withdrawn from the regional power grid in 2009. In addition, in July 2018 Uzbekistan introduced simplified visa procedures, abolished visas for up to 30 days for citizens of some countries, and launched an electronic entry visa system.

Further trade liberalisation measures have been introduced. In June 2018, the President signed a resolution to streamline foreign trade activity and enhance the system of customs and tariff regulation. Under the resolution, import duties and excise taxes on imported goods are reduced to the level adopted by the Eurasian Economic Union countries, the time needed for issuing permits for export and import operations is reduced, and customs procedures are significantly simplified. In addition, Uzbekistan and Afghanistan are currently drafting an agreement to establish a free trade zone, according to which goods from Afghanistan will be exempt from customs duties and other trade restrictions. The process of WTO accession, which started in 1994 but came to a standstill after 2005, was resumed in late 2017. Uzbekistan aims to complete the process in four to five years.

A presidential decree initiating the "Programme of transformation of state enterprises and other entities with majority state ownership" was announced in May 2018. The decree aims at the reduction of the participation of government officials in the management bodies of SOEs and calls for enhancing the transparency of decision-making and improving SOE governance. The programme refers to SOEs that are key for the performance and the structure of main industries and was intended to be implemented in 2018-20. Although some provisions of the decree have been renounced since, and the progress might take longer than originally envisioned, the decree demonstrated the dedication of the authorities to proceed with SOE reform.

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Energy sector reform is advancing. A resolution of the President, "On measures of improving the management system of the oil and gas industry," adopted in June 2017, changes the organisational and legal form of Uzbekneftegaz, the national oil and gas company, and its main subsidiaries into joint stock companies in order to improve the management system and the organisational structure of the industry. There are reform activities ongoing in Uzbekenergo. In November 2017 the President also signed a resolution, "On measures to ensure the rational use of energy resources". These measures include a requirement to utilise energy-efficient and energy-saving technologies in the design and construction of government buildings and adoption of flexible electricity tariffs depending on the time of the day, among other factors.

There have been marked improvements in the availability and quality of statistics. Uzbekistan joined IMF's Enhanced General Data Dissemination System (e-GDDS) under a presidential decree dated 12 December 2017. The main macroeconomic and financial statistics have become accessible through a single source – the National Summary Data Page – starting from May 2018. The CPI methodology was updated in January 2018, and statistics on the balance of payments and the international investment position were published for the first time in June 2018. In addition, a roadmap for the improvement of statistics is currently being developed by the Statistics Committee, together with the CBU and Ministry of Finance.