ALBANIA

Highlights

- **Growth accelerated in 2018, but has slowed in 2019.** After 4.1 per cent growth in 2018, the economy grew by just 2.4 per cent year-on-year in the first half of 2019, the slowdown being primarily due to weaker power generation.
- **Despite primary surpluses in recent years, public debt remains high.** Over the past year, the debt excluding arrears has been hovering around 68.0 per cent of GDP, even without taking into account the potentially significant costs of unsolicited public-private partnerships (PPPs).
- **The banking sector has undergone further consolidation.** At the same time, there is an ongoing shift in ownership away from eurozone banks towards domestic and foreign non-EU (European Union) owners. Non-performing loans (NPLs) have halved since 2014 but still remain at double-digit levels.

Key priorities for 2020

- **Legitimate businesses need further government efforts to tackle informality and level the playing field.** Informality remains one of the most important obstacles for doing business, and further measures are needed to tackle the problem. Measures include a simplified tax system and procedures, and strengthened capacities for inspections and the fight against corruption and bribery in public administration.
- **The government should focus on improving standards of fiscal and public governance.** Issues that need urgent attention include improving the conduct of PPPs and strengthening institutions and the rule of law. In addition, energy sources should be diversified by reducing the country’s dependency on hydro generation and continuing reforms to improve governance and transparency in the power sector.
- **Financial sector resilience and intermediation should be enhanced.** The banking sector is stable but faces important challenges, including the relatively low quality and quantity of lending, high exposure to sovereign debt and high euroisation.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.2	3.3	3.8	4.1	2.8
Inflation (average)	1.9	1.3	2.0	2.0	1.7
Government balance/GDP	-4.1	-1.8	-2.0	-1.6	-2.5
Current account balance/GDP	-8.6	-7.6	-7.5	-6.7	-6.5
Net FDI/GDP [neg. sign = inflows]	-8.0	-8.7	-8.6	-8.0	-7.5
External debt/GDP	74.4	73.5	68.7	65.2	n.a.
Gross reserves/GDP	28.1	27.5	25.9	26.4	n.a.
Credit to private sector/GDP	37.2	36.6	35.1	33.0	n.a.

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Macroeconomic performance

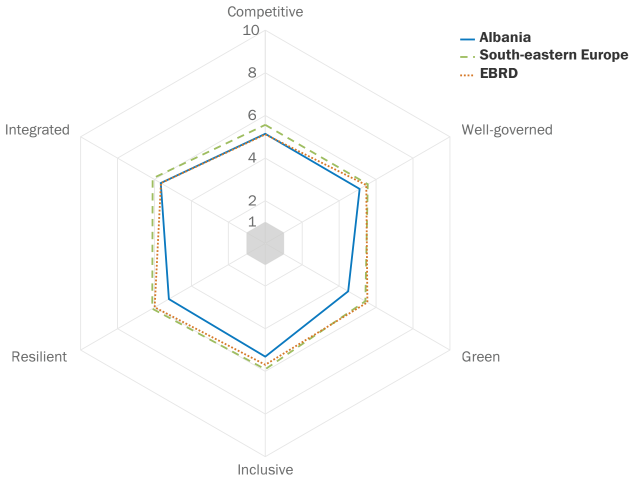
After accelerating in 2018, growth has slowed in 2019. GDP growth increased to 4.1 per cent in 2018, primarily as a result of good hydrological conditions and, consequently, high electricity production. Tourism remained an important contributor to growth too. However, the first half of 2019 saw a significant slowdown in economic growth, to 2.4 per cent year-on-year. It came mainly as a consequence of weaker power generation, combined with the high base effect from last year. Unemployment continued to decline but remains at double-digit levels (12 per cent).

Fiscal deficits are low but public debt is still high. Fiscal policy was slightly tighter in 2018, with the primary surplus increasing to 0.6 per cent of GDP (from 0.1 per cent in 2017). Overall, the budget recorded a deficit of 1.6 per cent of GDP. In the first five months of 2019, the budget (both overall and the primary one) was in surplus, but public debt remains high, at 68 per cent of GDP at the end of March 2019. Government arrears are estimated by the International Monetary Fund at 1.8 per cent of GDP, and contingent liabilities arising from recent PPP contracts, some of which have been inadequately assessed, pose risks for a further increase in public debt.

Monetary policy remains accommodative. At 2.0 per cent in 2018, inflation stayed below the central bank target of 3.0 per cent for the seventh consecutive year. In the first nine months of 2019 it decreased to 1.5 per cent on average, while core inflation, indicative of medium-term inflationary pressures, was even lower, at 0.7 per cent. As a result, the central bank's key policy rate has remained at a record low of 1.0 per cent since June 2018.

Economic catch-up is likely to slow in the short term. The economy is projected to expand at 2.8 per cent in 2019, driven mainly by private consumption, and to accelerate to 3.5 per cent in 2020, helped by the previous year's low base in power generation and under the assumption of further growth of tourism and investment in transport infrastructure. The risks to the forecast are tilted to the downside and relate to the economic slowdown of Italy and the rest of the eurozone, another delay in starting the EU membership talks, and internal risks (associated with both contingent liabilities stemming from unsolicited PPPs and the ongoing political instability).

Assessment of transition qualities (1-10)



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Major structural reform developments

The opening of EU accession negotiations has been delayed. Based on the assessment of the progress in the implementation of the comprehensive EU reform agenda, the Council of the European Union in its Conclusions on the Enlargement adopted in June 2018 set out the path towards opening the accession negotiations with Albania in June 2019. In May 2019, the European Commission issued a strong unconditional recommendation to the Council to launch EU accession negotiations with the country. However, at the European Council meetings in June and October 2019 no consensus was reached on this issue. Consequently, on 18 October 2019 the European Council decided to postpone the decision and to revert to this issue again before the EU-Western Balkans Summit in May 2020.

The business environment remains difficult. Albania was ranked 82nd overall (out of 190 countries) in the World Bank *Doing Business 2020* report, dropping 19 places from the previous year. Albania moved forward in getting electricity by increasing somewhat the reliability of power supply, but made no notable progress in other areas. Getting electricity is still one of the most problematic areas for doing business (107th), together with dealing with construction permits (166th), paying taxes (123rd) and enforcing contracts (120th). In the World Economic Forum 2019 Global Competiveness Index, the country also fell back relative to a year ago, losing five places and ranking 81st out of 141 countries. The country scores poorly in the areas of innovation capability (110th), financial sector development (105th) and infrastructure (98th).

Informality remains one of the most significant obstacles for doing business. The estimates of the size of the informal economy in Albania vary between 25 and 50 per cent of GDP. The causes are numerous and range from poverty to a heavy administrative burden, from complex procedures and frequently changing tax rules (making it altogether difficult and costly to comply), to weak rule of law and lack of trust in public institutions. Formal employment increased significantly since the launch of a campaign against informality in 2015 (with the employment rate rising from 51 per cent in 2014 to 60 per cent in 2018). However, despite contributing to creating a level playing field, a lower VAT registration threshold since April 2018 significantly increases the burden on small businesses, potentially resulting in the under-reporting of revenues.

Further controversial PPPs have been initiated. Large unsolicited PPPs continue to be awarded, particularly in the road sector (for example the Milot-Balldren and Orikum-Llogara sections), without a sufficient level of cost-benefit analysis and competition in the tender process. This increases the potential social cost and exposes the government to implementation risks, also given the general lack of track record and financial standing of the chosen bidders relative to the scale of the projects tendered.

Albania has made the first step towards establishing its first power exchange. Electricity market reforms (that is, liberalisation of the market, unbundling of distribution and supply, establishment of the Albanian Power Exchange and regional integration of the electricity market) are advancing slowly. Following the adoption of the Power Sector Law in 2015, a number of important reforms were made to liberalise the power market, but progress has been limited in the past year. The establishment of the Albanian Power Exchange (APEX), which would support price transparency, was delayed several times from the original deadline (March 2017) mentioned in the Law. Lastly, in May 2019 the government adopted the decision to set up a power exchange, with day-ahead and intraday markets. In order to establish the exchange and make it operational, the relevant implementing legislation remains to be enacted. The country continues to be largely dependent on hydropower generation and exposed to climate change risks. This can be remedied through the diversification of the energy mix, which could be supported by, among other measures, the tendering of solar capacities.

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Consolidation and change of ownership in the banking system is ongoing. Following a strategy to withdraw from the central, eastern and south-eastern European countries and the Western Balkans, several EU-owned banks have left Albania recently. The latest cases were in March 2019, with the acquisition of the Albanian subsidiary of Societe Generale Group by the Hungarian OTP Bank and the sale of Tirana Bank, the Albanian unit of Greece's Piraeus Bank. In July 2019, the acquisition of International Commercial Bank by the local Union Bank was announced. As a result, the number of banks operating in the country went down to 12 in August 2019, from 16 in September 2018.

The banking sector is stable but faces several challenges. Although the banking sector on the whole is well-capitalised, liquid and profitable, high euroisation (around 50 per cent), an NPL ratio of 11 per cent (at the end of August 2019) and high exposure to the sovereign debt (with around one-quarter of assets invested in government securities) remain among the main challenges to the sector's level of resilience. Private sector credit, at 33 per cent of GDP in 2018, is one of the lowest in Europe and acts as a drag on investment. The low level of lending is a consequence of multiple factors, both supply and demand-related: limited investment opportunities, high NPLs, weak demand by the private sector, low financial literacy of small and medium-sized enterprises, and high levels of informality in the economy, including improper accounting practices.

BOSNIA AND HERZEGOVINA

Highlights

- **Growth continued in 2018 amid political uncertainty but has slowed in 2019.** In 2018, GDP increased by 3.6 per cent. However, it eased to 2.7 per cent year-on-year in the first half of 2019.
- **The delay in forming governments has blocked much-needed reforms.** The Federation entity- and state-level government are still not in place after the October 2018 elections, and the IMF programme continues to be stalled.
- **In May 2019, the European Commission adopted the Opinion on Bosnia and Herzegovina's EU membership application.** The Opinion identified 14 key priorities, in the areas of democracy/functionality, rule of law, fundamental rights and public administration reform, which the country needs to fulfil in order to progress with EU approximation.

Key priorities for 2020

- **The business climate needs to improve substantially.** The business environment remains one of the most convoluted in Europe, with different regulations in the two entities and the Brčko district. The private sector would benefit greatly from harmonised regulations and a reduction in "red tape" and para-fiscal charges.
- **Inefficient state-owned enterprises (SOEs) should be tackled.** SOEs impose a significant fiscal burden and have negative effects on other businesses. They should be depoliticised and restructured, followed in some cases by a renewed and credible push for privatisation.
- **Public administration reform should be pursued.** Bosnia and Herzegovina is known for an oversized and inefficient public sector, putting a significant burden on taxpayers and adversely affecting the business environment. The Republika Srpska should also adopt as soon as possible the strategic framework of public administration reform for 2018-22, and the country should embark on developing a professional, de-politicised and merit-based civil service.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.1	3.1	3.2	3.6	3.0
Inflation (average)	-1.0	-1.1	1.2	1.4	1.0
Government balance/GDP	0.7	1.2	2.6	2.3	1.0
Current account balance/GDP	-5.1	-4.7	-4.3	-3.7	-5.0
Net FDI/GDP [neg. sign = inflows]	-1.8	-1.8	-2.1	-2.6	-3.0
External debt/GDP	62.9	63.8	61.1	61.0	n.a.
Gross reserves/GDP	30.1	31.9	33.5	35.3	n.a.
Credit to private sector/GDP	55.0	54.3	55.6	55.2	n.a.

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Macroeconomic performance

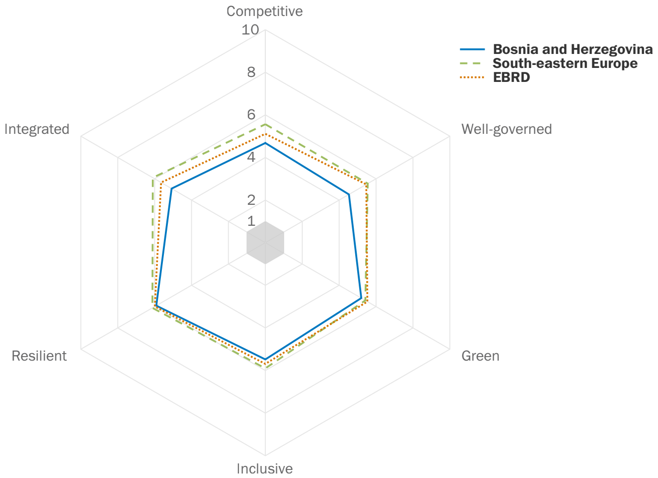
The economy has once again proved to be resilient to a slowdown of reforms and continued political uncertainty. GDP growth in 2018 surprised on the upside, reaching 3.6 per cent, 0.5 percentage points higher than the 2015-17 average. The value-added increased most in the agriculture sector and in electricity production. Unemployment dropped by two percentage points, but at above 18 per cent remains high, especially for young people (close to 40 per cent). In the first half of 2019 growth slowed to 2.7 per cent year-on-year, primarily due to a slowdown in exports and increase in the growth of imports.

Inflation has trended down. After increasing from 0.3 to 1.8 per cent year-on-year in the first half of 2018, on the back of rising fuel prices and excise duties on cigarettes, inflation stabilised around that level for the rest of the year. In 2019, it started to decline, falling back to 0.3 per cent year-on-year in September. The decline was primarily led by the slowdown of transport prices growth.

The consolidated budget stayed in surplus for the fourth year in a row, also due to the under-execution of capital expenditures. In 2018, government revenues were higher than expenditures by 2.2 per cent of GDP. Public debt also fell, reaching 33.6 per cent of GDP as of the end of June 2019. However, the quality of fiscal governance has remained low. The country lacks medium-term fiscal planning and focuses strongly on maintaining current spending patterns, often at the cost of delaying much-needed public investment. Also, accumulated public sector arrears pose significant fiscal challenges. In the Republika Srpska these mostly stem from the health sector, while the majority of arrears in the Federation of Bosnia and Herzegovina (FBIH) have been accumulated by SOEs. Documentation and monitoring of arrears are weak in both entities, too.

Further moderate growth is likely in the short term. GDP is expected to expand by 3.0 per cent annually in both 2019 and 2020. Risks to the projection are tilted to the downside and mainly relate to uncertainty about the reforms (that is, improvements in the business climate and standards of governance, as well as advancement of the country's EU approximation agenda) and slowdown in the main export market, the eurozone.

Assessment of transition qualities (1-10)



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Major structural reform developments

The European Commission has adopted the Opinion on Bosnia and Herzegovina's EU membership application. The country submitted an EU membership application in February 2016. In May 2019 the European Commission issued the Opinion on the application. The Opinion identifies 14 key priorities for the country to fulfil in order to be recommended for the status of EU candidate country. These priorities lie in the areas of democracy and functionality of institutions, rule of law, fundamental rights and public administration reform. The Commission encouraged the authorities to agree and implement socio-economic reform measures, in line with the Economic Reform Programme policy guidance, and to continue engaging in regional cooperation and strengthening bilateral relations with neighbouring countries.

Business environment has remained unchanged over the past year. Bosnia and Herzegovina keeps lagging behind its Western Balkans peers on global competitiveness lists. In 2019, the country was ranked 92nd among 141 economies in World Economic Forum's Global Competitiveness Index, one place lower than in 2018, with several areas with a rank above 100th (institutions, product and labour market, business dynamism and innovation capability). Similarly, Bosnia and Herzegovina ranked 90th among 190 countries in the *World Bank's Doing Business 2020* report, dropping one place from the year before as no major reforms took place. While it ranked relatively well on trading across borders and resolving insolvency (27th and 37th, respectively), the areas in need of major push are starting a business (184th), dealing with construction permits (173rd) and paying taxes (141st).

Public administration reform is stalled. A countrywide strategic framework on public administration reform for 2018-22, developed by inter-institutional working groups appointed by the Council of Ministers of Bosnia and Herzegovina and the entity and Brčko District governments in March 2018, is lacking as Republika Srpska has still not adopted it. The need for reform is urgent as the public administration in Bosnia and Herzegovina is complex and often has overlapping competences, duplications of functions and an unclear division of responsibilities across various levels of governments. The poor quality of the institutional set-up is reflected in the country's lowest ranking (111th) in Europe on institutions in the World Economic Forum's Global Competitiveness Index 2018.

There has been little progress in the past year with privatisation or restructuring of SOEs. The Republika Srpska authorities managed to sell (minority) stakes in three companies out of 14 in the 2018 privatisation plan. The plan also included three strategic enterprises, but one of these went into bankruptcy in February 2019 (a producer of special diesel engines and spare parts for engines Fabrika motora specijalne namjene), while the other two have not been privatised. The entity's railway company started a financial, workforce and organisational restructuring in 2018, planned for completion in 2021. The process is supported by a World Bank loan (€51.3 million) and technical assistance. The FBIH entity sold none of the four enterprises in the 2018 privatisation plan, although they have been planned for sale for a long time. The state footprint in Bosnia and Herzegovina is large, with around 550 SOEs employing 80,000 people, or about 10 per cent of the total workforce. These companies are usually characterised by weak transparency, accountability and performance, and suffer from political influence. Many of them are burdened by excess employment and debts, and are loss makers. As such, they pose risks to macroeconomic performance, fiscal sustainability and competitiveness. One of the recent examples is the indebted aluminium smelter Aluminij, which required government intervention in September 2018. In mid-July 2019, the company was disconnected from the power grid, after strategic partnership talks between the Federation entity's government and a consortium failed. The entity's government gave the company a deadline of the end of 2019 to restructure. Failure to do so could potentially lead to bankruptcy and loss of employment of 900 workers in Aluminij and about 10,000 workers in the supply chain.

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The road network is being improved slowly. The improvements focus mostly on the Corridor Vc motorway, connecting the Port of Ploče in Croatia with Budapest in Hungary. The motorway will represent an important trade route to European markets. In the past year, contracts for few motorway sections in FBIH have been signed, while works on the first section of the corridor in Republika Srpska started in June 2019. In general, the project is lagging behind (it was initially expected to be finished in 2012) and by September 2019 around one-third of the highway (or around 100 kilometres) had been completed. The EBRD supported the project in 2019 with a loan of up to €210 million for a new motorway section that will include a bypass for the town of Doboj. The project is expected to be completed by 2030 and will cost around €4 billion. In addition, the Republika Srpska and China's SDHS-CSI BH signed in December 2018 a 33-year concession agreement on the construction of the 42 kilometre Banja Luka-Prijedor highway.

The banking sector is well-capitalised, but non-performing loans (NPLs) remain elevated. The capital adequacy ratio of the banking sector stood at 17.9 per cent at the end of June 2019, well above the regulatory minimum of 12.0 per cent. Still, some (primarily local) banks have insufficient capital endowments and unfavourable credit portfolios. The NPL ratio of the banking sector stood at 8.0 per cent at the end of June 2019 (down from 9.3 per cent a year ago). The NPLs are concentrated in domestically owned banks and are largely a legacy issue. The new banking laws adopted in 2017 should support the soundness of the banking sector, but banking sector supervision is hampered by fragmented competences. In addition, the country has not yet adopted a law on deposit insurance that would complete the bank resolution framework in line with EU directives.

A controversial coal-fired power station may breach EU commitments and conserve polluting generation capacities. In March 2019, the Energy Community opened an infringement procedure against Bosnia and Herzegovina over state aid to the Tuzla 7 coal power plant. The 450 MW extension of Tuzla thermal power plant is planned to be financed through a loan of €614 million from the Chinese Exim Bank, which received a guarantee by the Federation entity in spring 2019. The new facility (with other planned units) would further increase Bosnia and Herzegovina's reliance on highly polluting lignite-based power generation and would result in expensive stranded assets at a later date.

The entity governments have endorsed a joint package of socio-economic reforms (2019-22). Under this package, which was endorsed in October 2019, the governments will be aiming at improving the business environment and stimulating growth and competitiveness, as well as at depoliticising SOEs, reforming the healthcare system and providing better opportunities for young people, women and other vulnerable groups.

BULGARIA

Highlights

- **Growth has remained solid during 2019.** The economy grew by an estimated 3.1 per cent in 2018, following an average growth rate of 3.8 per cent in 2015-17. The economy grew robustly at 4.2 per cent year-on-year in the first half of 2019.
- **Reforms in the energy sector have continued.** Bulgaria is also developing a number of gas infrastructure projects, with the aim of becoming a major gas hub and transit route in the region.
- **Steps have been taken to advance Bulgaria's integration into the financial architecture of the European Union (EU).** Bulgaria is aiming to join the eurozone and has officially announced its intention to join the European Exchange Rate Mechanism (ERM II) and the EU's banking union simultaneously.

Key priorities for 2020

- **Reforms needed to prepare the country for joining ERM II and the EU's banking union should be stepped up.** While Bulgaria consistently meets the macroeconomic requirements to become part of ERM II, the authorities should remain committed to key structural reforms needed to achieve this goal.
- **Bulgaria should continue working on implementation of the commitments within the framework of the EU's Cooperation and Verification Mechanism (CVM).** According to the latest CVM report, the European Commission considers that the progress made by Bulgaria under the mechanism is sufficient to meet the country's commitments made at the time of its accession to the EU.
- **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. Attention should be turned to reforming the business environment, retaining qualified workers and improving the skills of the existing labour force.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	4.0	3.8	3.5	3.1	3.7
Inflation (average)	-1.1	-1.3	1.2	2.6	2.0
Government balance/GDP	-1.7	0.1	1.1	1.8	0.8
Current account balance/GDP	0.0	2.3	4.4	2.4	1.6
Net FDI/GDP [neg. sign = inflows]	-5.0	-1.3	-3.9	-2.6	-2.4
External debt/GDP	72.6	67.8	68.7	58.2	n.a.
Gross reserves/GDP	44.0	47.3	48.0	43.8	n.a.
Credit to private sector/GDP	54.9	52.1	51.3	51.9	n.a.

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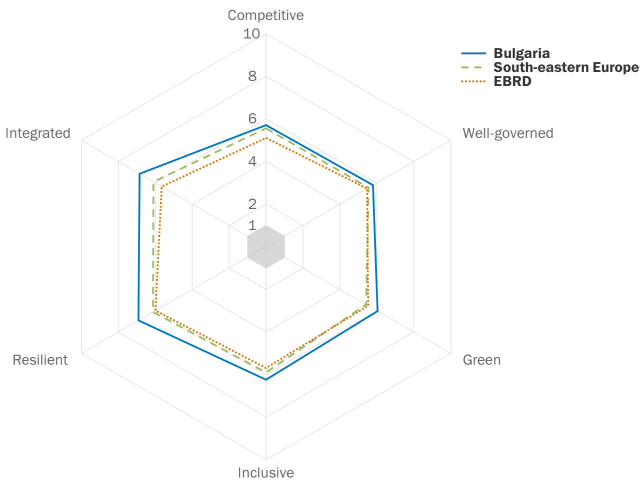
Macroeconomic performance

Economic growth remains solid. The economy grew by an estimated 3.1 per cent in 2018, following an average growth rate of 3.7 per cent in 2015-17. Private consumption has been the main driver of growth, fuelled by increased earnings and a higher employment rate amid the tightening labour market. Unemployment was down to almost 4.0 per cent as of June 2019, while nominal wages kept growing at high single-digit rates. The government raised the monthly minimum wage by 10.0 per cent in January 2019, to €286. Investment has also been strong, with growth of about 6.0 per cent in 2018, helped by the growing disbursement of EU funds. Meanwhile, net exports have weighed on growth in 2018 as strong private consumption has pushed up imports, while exports experienced a small decline, not least because of the downturn in the economy in Turkey, an important trading partner. Real gross domestic product (GDP) expanded by 4.2 per cent year-on-year in the first half of 2019. Household consumption has continued to be the main source of growth. Inflation reached a high of 3.7 per cent in August 2018, averaging 2.6 per cent in 2018, but has since come down to 2.5 per cent as of August 2019.

Fiscal policy has remained tight. A period of fiscal tightening resulted in three consecutive years of budget surpluses in 2016-18, reaching 1.8 per cent of GDP in 2018, which places Bulgaria among the top performers in the EU. Government spending rose in 2019, mainly due to a large one-off army-related expense, and the budget may be in deficit after three consecutive years of budget surpluses. Nevertheless, public debt continues to decline and stands at around 21.0 per cent of GDP, one of the lowest percentages in the EU.

Growth is expected to remain solid. The economy is expected to grow by 3.7 per cent in 2019 and 3.0 per cent in 2020, the latter being broadly in line with the country's current growth potential. Growth is likely to be underpinned by private consumption, which traditionally fuels economic activity. Investment should also contribute positively to growth, as the absorption of EU funds is accelerated towards the end of the 2014-20 funding period. Fiscal policy is expected to remain tight, limiting the contribution of government spending to growth. Key risks to the outlook are: prolonged weakness of major trading partners, particularly that of the eurozone and exacerbation of current labour shortages (due to the declining population, emigration of skilled workers and a skills gap in the workforce). While convergence prospects remain high, with GDP per capita (in purchasing power standards) standing at just half of the EU average, sustaining high growth rates in the long term will require the reinvigoration of structural reforms.

Assessment of transition qualities (1-10)



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Major structural reform developments

Plans for euro adoption are advancing. In November 2018, the parliament adopted legislative changes to strengthen the autonomy of the central bank, as recommended by the European Central Bank (ECB). This was a necessary step for the country's entry into the EU's banking union. Bulgaria is eager to join the eurozone and has stated its firm intention to apply to the ERM II, having met all the nominal criteria for membership, namely, a stable currency (fixed peg to the euro), low inflation and healthy public finances. The ECB has undertaken a comprehensive analysis of six Bulgarian banks as part of the procedure for the country's parallel entry into the banking union. The analysis, published in July 2019, identified a capital shortfall in two domestically owned banks. Additional commitments relate to other financial-sector issues and institutional quality and governance.

There was further progress in implementing the Cooperation and Verification Mechanism (CVM). According to the latest CVM report, published in October 2019 by the European Commission, Bulgaria's progress has been assessed as sufficient to meet the country's commitments at the time of its EU accession.

The business environment remains problematic in some areas. According to the latest World Bank *Doing Business 2020* report, published in October 2019, Bulgaria ranked 61st out of 190 countries in ease of doing business, dropping two places compared with the previous year. This is among the lowest rankings in the EU. Procedures for starting a business, paying taxes and getting electricity remain burdensome, although, similar to most EU members, Bulgaria performs well in trading across borders.

Energy infrastructure improvements have continued. Construction of the Turkish gas stream, aimed at bringing Russian gas to central Europe through Bulgaria, Serbia and Turkey, is progressing. In June 2019 the Competition Protection Commission restored a Saudi Arabian-Italian consortium (Arkad) as the tender winner for the construction of the Turkish stream extension in Bulgaria. Subsequently, in September 2019 the Bulgarian natural gas transmission system operator Bulgartransgaz and Arkad signed a contract for the delivery of materials, investment project design and the development and commissioning of the gas pipeline. Also, construction of the long-delayed €220 million Bulgaria-Greece gas interconnector was launched in May 2019, a week after Greece's J&P AVAX was selected to execute the project. The interconnector will help diversify natural gas sources for Bulgaria, which, at present, mainly depends on Russian gas. Meanwhile, in December 2018, the European Commission's anti-trust body fined the state-owned energy firm Bulgarian Energy Holding and its gas infrastructure subsidiary Bulgartransgaz €77 million for blocking access to natural gas infrastructure in Bulgaria during 2010-15, thus not allowing potential competitors to enter wholesale gas supply markets in Bulgaria. Also, the Czech energy company ČEZ Group has decided to withdraw from Bulgaria over longstanding disputes with the Bulgarian authorities. In June 2019, Bulgarian financial and insurance group Eurohold signed a deal with ČEZ to buy its local assets for €335 million, including an electricity distribution business with two million customers and two renewable plants. However, in October 2019, Bulgaria's competition regulator blocked the acquisition, saying that the deal could hinder competition.

Transport infrastructure is being developed. In April 2019, the government launched the construction of a 56-kilometre section of the Hemus motorway heading eastwards from the junction with the Veliko Tarnovo-Ruse road to the city of Targovishte. The Hemus motorway links Sofia to the Black Sea port of Varna through the northern part of the country. In December 2018, the government decided to allocate €690 million for the construction of a 134-kilometre stretch of the Hemus motorway, to be built by the state-owned civil engineering company Avtomagistrali, which was given the contract without a public procurement procedure. Meanwhile, the EU has allocated €293 million to fund the modernisation of the railway between two of Bulgaria's biggest cities, Plovdiv and Burgas, which would reduce travel time significantly. In July 2019, the government picked SofConnect – a consortium between French-registered Meridiam Eastern European Investments, the Austrian construction company Strabag and the Munich Airport operator – as the 35-year concessionaire for Sofia Airport. The decision, however, was appealed in front of Bulgaria's Commission for the Protection of Competition by the other four bidders.

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Consolidation and change of ownership in the banking system are ongoing. In June 2019, the Eurobank-owned Post Bank acquired the Bulgarian subsidiary of Piraeus Bank. Following the acquisition, Post Bank will become one of the largest banks in Bulgaria, with a market share of around 10 per cent. The operational integration should be completed by the end of the year. In January 2019, DSK Bank, owned by OTP Bank, closed the acquisition of Société Générale's Bulgarian unit, Expressbank, which has a market share of 6 per cent. This will further strengthen OTP Bank's market position in Bulgaria and boost its market share to almost 20 per cent after the acquisition. Profits in the banking sector, as a whole, increased by 43 per cent in 2018 to €860 million.

CYPRUS

Highlights

- **The strong post-crisis economic recovery continues.** Gross domestic product (GDP) growth remained solid in 2018 at 3.9 per cent, driven by rising investment and private consumption, and unemployment rates continue to fall.
- **Non-performing exposures (NPEs) have dropped significantly.** Current levels (as of the middle of 2019) of NPEs are still elevated by European standards at 20 per cent of all loans, but this constitutes a major reduction relative to the 43 per cent recorded at the end of 2017. Legislative changes and sales of bad loans have both contributed to this major reduction in NPEs.
- **Energy sector liberalisation has been delayed.** Progress is being made towards full opening up of the energy market but plans are behind schedule and are meeting some resistance.

Key priorities for 2020

- **Further efforts are needed to reduce non-performing exposures.** The major reduction in NPEs in the past year is welcome, but the share of NPEs in total remains high and should be cut to single digits. This means the government should avoid any steps that would unnecessarily impede the resolution of NPEs.
- **Business environment reforms should be accelerated**. The authorities should focus on areas such as public administration and the judiciary, as well as anti-money laundering, where Cyprus continues to lag behind best practice in other EU countries.
- **Energy sector reform should advance.** Increasing the efficiency and competitiveness of the state-owned power company is crucial for the strength and development of the economy.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	2.0	4.8	4.2	3.9	3.2
Inflation (average)	-1.5	-1.2	0.7	0.8	0.5
Government balance/GDP	-0.3	0.3	1.8	-4.8	3.3
Current account balance/GDP	-1.5	-5.1	-8.4	-7.0	-7.3
Net FDI/GDP [neg. sign = inflows]	47.4	-9.8	-23.1	-22.6	-8.9
External debt/GDP	572.6	576.5	552.3	494.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	246	222.8	198.2	142.3	n.a.

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Macroeconomic performance

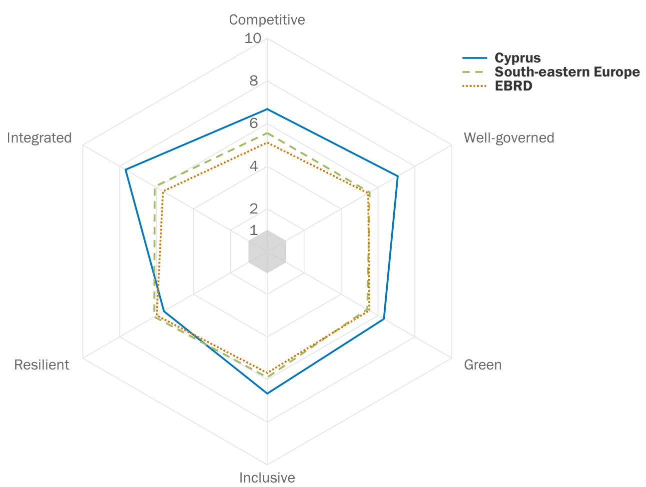
Robust growth is continuing. Economic activity continued at a strong rate in 2018 with GDP growth of 3.9 per cent. Investment was one of the main drivers, as the construction sector continued to grow strongly. The increase in private consumption was another significant factor and is expected to remain resilient, thanks to improving labour market conditions, wage increases and buoyant economic sentiment. Unemployment has continued on a downward trend, reaching 6.6 per cent (seasonally adjusted) in September 2019, its lowest level in eight years and more than eight percentage points below the peak in 2014. In the first quarter of 2019, GDP growth moderated slightly to 3.4 per cent year-on-year, followed by 3.2 per cent year-on-year in the second quarter. On the demand side, private consumption has remained robust, while gross fixed capital formation grew strongly, especially in residential investment. Cyprus enjoyed a particularly good tourism season in 2018, but the sector has levelled off so far in 2019, with tourist arrivals down by 1.1 per cent over the first five months of 2019 compared with the same period in 2018.

Fiscal performance remains strong. Due to the sale and winding down of the Cyprus Cooperative Bank (CCB), the second-largest bank in the country, the public debt burden remains large at around 102.5 per cent of GDP and the primary fiscal balance was negative at -2.3 per cent of GDP in 2018. However, strong GDP growth and primary surpluses (expected to be at 5.7 per cent of GDP in 2019) should allow the debt-to-GDP ratio to resume its downward path from this year onwards. Moreover, the resolution of CCB has reduced systemic risks in the banking sector significantly.

Cyprus is rated investment grade by some credit rating agencies. Both Standard & Poor's (S&P) and Fitch rate Cyprus at investment grade BBB-, with S&P raising the sovereign rating to that level in September 2018 and Fitch in October 2018. In October 2019, Fitch also revised the outlook on its BBB- rating for Cyprus from stable to positive. The other major rating agency, Moody's, still has Cyprus below investment grade at Ba2, but in September 2019, it raised the outlook from stable to positive. Yield spreads over German sovereign bonds have dropped to historically low levels, helping the government to issue a €1 billion 15-year Eurobond and a €750 million 30-year Eurobond in 2019, the longest maturity Eurobonds to date, at an average yield of 2.75 and 2.88 per cent, respectively. Moreover, given the current low market rates of Republic of Cyprus bonds, the government announced in October 2019 that it intends to repay early the remaining amount of the debt to the International Monetary Fund, which stands at 570 million Special Drawing Rights (approximately €700 million).

Robust growth is likely to continue in the short term. Taking into account all the relevant factors, we expect growth to slow down moderately in 2019 and 2020 to 3.2 per cent and 2.8 per cent, respectively. Key downside risks include the slowing European economy and internal risks associated with high levels of personal and corporate debt, as well as an economy that remains dependent on a few key sectors.

Assessment of transition qualities (1-10)



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Major structural reform developments

The banking sector continues to strengthen. In 2018, the sector reported the first net profit in eight years. NPEs had been exceptionally high, accounting at one point for more than half of all loans, but the rate has come down dramatically in the past two years, from 43.0 per cent as of the end of 2017 to 30.5 per cent at the end of 2018. The process was helped by two one-off transactions in 2018: the transfer of the non-performing Cyprus Cooperative Bank (CCB) assets to the state-owned management company KEDIPES, and the sale of a large NPE portfolio by the Bank of Cyprus. These two operations strengthened the balance sheets of these two banks, which are the largest in the country. Legal changes in recent years to encourage the sale of NPEs are also having an important effect.

Anti-money laundering (AML) legislation and supervision of insurance and pension funds are being improved. According to the fifth AML Law, the transposition of the fifth EU AML Directive into Cyprus law should take place in 2019. Full functionality of the Ultimate Beneficial Owner registries is expected to be in place from March 2020. Meanwhile, in order to integrate and strengthen the supervision of insurance companies and occupational pension funds, a draft bill on the creation of a single independent supervisory authority for the supervision of insurance companies and occupational pension funds has been prepared, based on an independent report commissioned with the support of the European Insurance and Occupational Pensions Authority. It aims at a more efficient and effective supervision of the two sectors, thus better managing risks and guarding the interests of stakeholders. The future organisational structure of the new supervisory entity is currently under consultation, following which the final draft Bill will undergo legal vetting, with the aim of adopting the bill by December 2019.

Energy-sector liberalisation has been delayed. The authorities originally committed to liberalising electricity and gas markets by 2019, but progress to date has been slow. The Cyprus Energy Regulatory Authority (CERA) is now working towards the full opening up of the energy market and granting consumers the right to choose their own supplier – with expectations of full liberalisation in 2020-21. CERA's proposition is a "net pool" model, where the operations of the state power company, EAC, are unbundled and the production and supply operations separated. EAC production would then enter into bilateral agreements with suppliers for the sale of energy at regulated prices. However, these plans have experienced some resistance from unions, as they are seen as moves that could increase pressure to privatise EAC.

The business environment still has serious deficiencies in several areas. Cyprus continues to receive a poor overall ranking (54th out of 190 countries) in the World Bank's *Doing Business 2020* report, although it has risen by three places relative to the previous year. The reform of the judicial system and, in particular, the ongoing reforms to increase the efficiency of the courts and accelerate enforcement of commercial claims remain key challenges for achieving a better business environment. Other issues to be tackled include the reform of public administration and the establishment of an e-justice system.

GREECE

Highlights

- **Economic indicators continue to improve.** The economic recovery, which began in 2017, continued into 2018 and the first half of 2019, but at a relatively modest rate. Economic sentiment has risen sharply since May 2019, reaching a 12-year high, and unemployment has dropped below 17 per cent.
- **Important reforms have advanced.** The previous government made sufficient progress on achieving specific reform commitments by the end of 2018 to enable creditors to grant €970 million debt relief measures, while the new government has already brought forward important fiscal, labour market and governance reforms.
- **Capital controls have been fully lifted.** Effective since September 2019, this measure brings to an end more than four years of restrictions on the free flow of capital.

Key priorities for 2020

- **Further progress is needed in reducing non-performing exposures (NPEs).** New levers are now in place or in preparation, including an asset protection scheme, and should be used vigorously to help banks bring down the level of NPEs from current excessive levels.
- **Flagship privatisations should be carried out in a timely way.** The key short-term project is Hellenikon (the former Athens airport), which has the potential to be transformative for the economy, but other important assets should also be commercialised and prepared for sale in a timely way.
- **Reforms to governance are urgently needed.** Greece's ranking on global governance measures is poor, reflecting many years of weak public administration, problems in the judiciary and inadequate corporate governance standards. The new government should follow up promptly on its plans for reforms in these areas.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	-0.4	-0.2	1.5	1.9	2.0
Inflation (average)	-1.1	0.0	1.1	0.8	1.1
Government balance/GDP	-5.7	0.6	1.0	0.4	-0.2
Current account balance/GDP	-0.2	-1.7	-2.4	-3.4	-2.7
Net FDI/GDP [neg. sign = inflows]	0.2	-2.4	-1.5	-1.6	-1.8
External debt/GDP	245.5	236.1	224.0	217.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	112.2	107.3	99.0	89.1	n.a.

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Macroeconomic performance

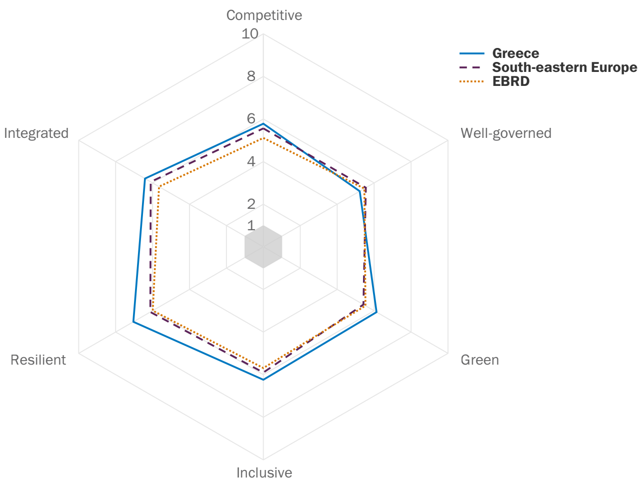
Modest economic growth has continued. GDP grew by 1.9 per cent in 2018. Private consumption continued to have a positive impact on growth and labour market developments have been encouraging, with unemployment falling to 16.9 per cent (seasonally adjusted) in July 2019 – still very high relative to peers but the lowest rate since 2011. The economic recovery is broad-based, with services being the main driver. In the first half of 2019, GDP increased by 1.5 per cent year-on-year, as exports of goods and services (including tourism) and public consumption all moved in a positive direction. Investment remains a weak spot, with gross fixed capital formation falling at double-digit levels in 2018, and net investment (gross investment minus depreciation) still strongly negative. However, all main components of investment apart from transport equipment and weapons investments are increasing and are expected to pick up further in the short term. Foreign direct investment (FDI) has been on an upward trend since 2015, reaching €3.7 billion in 2018, versus less than €1.2 billion in 2015, with further strong inflows (€2.5 billion) in the first seven months of 2019.

Fiscal and external balances remain encouraging. The primary fiscal surplus reached 4.3 per cent of GDP in 2018, outperforming significantly the target of 3.5 per cent of GDP. An expansionary fiscal package was adopted by the previous government in May 2019 but the recovering economy and boosted revenue collection should help ensure that the target is again achieved in 2019. Meanwhile the current account deficit rose from -0.8 per cent of GDP in 2017 to -3.4 per cent of GDP in 2018, despite the continued upward trend in exports of goods and services, but is countered by the positive developments in FDI noted above.

Capital market access has improved amid boosts to the country's sovereign credit rating. The government has issued several bonds in 2019, including a seven-year €2.5 billion bond in July 2019, with a yield of just 1.9 per cent (below US Treasuries' yields). The low yield reflects not only global financing conditions but also Greece's improved standing among creditors in recent years. In March 2019, Moody's raised Greece's sovereign rating by two levels to B1 and in October 2019, Standard & Poor's upgraded Greece's sovereign credit rating from B+ to BB-, given the reduced fiscal risks and lifting of capital controls. However, all major credit ratings agencies still have Greece several notches below investment grade.

Short-term GDP growth is likely to rise somewhat. Our current projection is that the economy will grow by 2.0 per cent in 2019 and 2.4 per cent in 2020. The main drivers of growth are likely to be exports and a stronger impact of private consumption as a result of the sharp increase in economic sentiment and falling unemployment rates. However, risks associated with a possible deterioration in the global economy remain significant. Internally, the new government has committed to an ambitious reform agenda, and investors will be looking to see if they can deliver on their promises and make major improvements to the business environment. If that happens, prospects for higher growth rates in the medium term will be significantly enhanced.

Assessment of transition qualities (1-10)



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Major structural reform developments

Important reforms have advanced. Following the completion of the Third Economic Adjustment Programme in August 2018, Greece is now in a post-programme enhanced surveillance framework. As of September 2019, there have been three enhanced surveillance reports, prepared by the European Commission in partnership with other institutions. The third report, published in June 2019, presented a mixed picture. It noted progress in areas such as public sector reform, corporate governance in state-owned enterprises (SOEs) and land reform, but it revealed that the pace of reform had slowed in 2019, with reversals in certain areas. Meanwhile, the new government, which took office in July 2019, has placed economic reform and governance improvements at the heart of its programme. An omnibus bill with a number of growth-enhancing reforms was submitted to parliament in September 2019.

Privatisation is advancing, albeit with some delays. The privatisation strategy and the governance reform of SOEs is being implemented by the Privatisation and Investment Fund (the Hellenic Corporation of Assets and Participations). Important deals in the past year include the sale of 66 per cent of the gas transmission systems operator, DESFA, which was closed at the end of 2018; and a 20-year extension of the concession agreement for Athens International Airport, completed in February 2019. Other major projects in preparation and at an advanced stage include the development of Hellenikon (site of the former Athens airport) and Egnatia motorway. With regard to the former project, final submissions under a tender for a casino licence were submitted on 4 October 2019, and construction should begin on site in early 2020. However, other privatisations have encountered delays, and the proposed sale of a majority stake in Hellenic Petroleum failed to attract any bids.

Capital controls have been fully removed. As of 1 September 2019, all remaining restrictions on the transfer of capital abroad were removed. Capital controls were introduced at the height of the crisis in June 2015 but had been relaxed gradually in stages since then.

The financial sector is still recovering and NPEs are being reduced. The banking sector as a whole is profitable, but banks continue to be burdened by exceptionally high levels of NPEs, which stood at €75.4 billion, or 43.6 per cent of total loans as of June 2019. The four systemic banks are addressing the problem using a variety of tools and according to targets agreed with the Bank of Greece. The new government has developed an asset protection scheme, which was approved by the European Commission (DG Comp) in October 2019. It is expected to be operational in the coming months. Under this scheme, special purpose vehicles would be set up to issue government-guaranteed bonds, allowing banks to take some of their NPEs off their balance sheets.

Further improvements have been made to the business environment. Important steps over the past year include efforts to streamline licensing and customs procedures, the introduction of one-stop shops, and progress on land and cadastral reform. Further business-friendly measures are in the pipeline of the new government's programme. At the same time, Greece's ranking on the World Bank's ease of doing business assessment remains low by EU and OECD standards, reaching 79th position (out of 190 countries) in the 2020 report (down seven places from the previous year), with persistent problems in getting credit, registering property, enforcing contracts and resolving insolvency.

Governance reforms are being introduced. A key pillar of the post-programme enhanced surveillance framework is 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. The new government has also signalled that governance reform will be at the heart of its programme, and has already taken steps to unify all entities that audit and oversee the activities of the government.

KOSOVO

Highlights

- **Relatively strong growth continues.** Gross domestic product (GDP) grew by 3.8 per cent in 2018 and 4.2 per cent year-on-year in the first half of 2019, driven by robust domestic demand.
- **Inflation has accelerated.** Average inflation has increased from below 1.0 per cent in the period of January to October 2018 to above 3.0 per cent thereafter, driven primarily by rising food prices.
- **The country has stepped up the fight against informality.** In May 2019, Kosovo adopted a revised strategy and action plan for fighting informality for the period 2019 to 2023.

Key priorities for 2020

- **Business climate reforms are needed to accelerate the growth of the private sector.** The Kosovo authorities should step up the fight against informality and tax evasion, as well as facilitate access to finance for small and medium-sized enterprises (SMEs) by addressing the underlying legal and institutional constraints that discourage formal activities. The competitiveness of SMEs should be supported as well since businesses often lack skills and expertise.
- **Problems in state-owned enterprises (SOEs) should be addressed.** Financial oversight, corporate governance, accountability and efficiency of SOEs are areas that need improvement. In addition, the privatisation of non-strategic SOEs should be stepped up.
- **Diversification away from coal is warranted.** The country should urgently take measures to decrease its (almost exclusive) reliance on lignite as a source of electricity and increase the share of renewables in power generation. Also, a broader green agenda is needed, including steps to improve energy efficiency at the residential, private sector and municipal level, and the construction of new wastewater treatment plants.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	4.1	4.1	4.2	3.8	4.0
Inflation (average)	-0.5	0.3	1.5	1.1	3.0
Government balance/GDP	-1.9	-1.5	-1.4	-2.9	-3.5
Current account balance/GDP	-8.6	-7.9	-6.0	-8.0	-7.5
Net FDI/GDP [neg. sign = inflows]	-4.7	-2.9	-3.3	-2.5	-3.0
External debt/GDP	33.3	33.2	33.2	30.3	n.a.
Gross reserves/GDP	12.2	10.0	10.7	11.4	n.a.
Credit to private sector/GDP	34.5	36.5	38.6	40.8	n.a.

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Macroeconomic performance

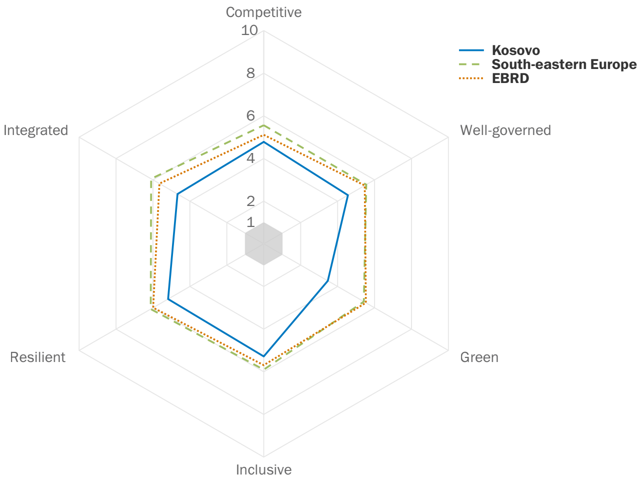
Relatively strong economic growth has continued for the fifth year in a row. After 4.2 per cent growth in 2017, GDP grew by 3.8 per cent in 2018, driven by investment and consumption. However, greater domestic demand contributed to an increase in imports and a widening of the current account deficit to over 8.0 per cent of GDP. Higher growth has not yet translated into more jobs, as the employment rate fell in 2018 by one percentage point, to 28.8 per cent. Similarly, the unemployment rate fell only slightly, staying close to 30.0 per cent, and at 55.4 per cent for young people. Despite high unemployment, businesses often struggle to find a skilled labour force. A salient feature of Kosovo's labour market is the very limited presence of women, with the female employment rate at only 12.3 per cent in 2018. Strong, domestic demand-driven growth continued in the first half of 2019, at 4.2 per cent year-on-year. Nevertheless, growth has been hindered by political instability and is still low for a meaningful catch-up.

Inflation has picked up. Inflation in 2018 remained subdued for the year as a whole, at around 1.0 per cent, but it has risen since the second half of the year, averaging 3.0 per cent year-on-year in the first nine months of 2019. The surge in inflation has been mainly driven by food prices (increasing on average 6.9 per cent year-on-year in the first nine months of 2019) and possibly also related to the imposition in November 2018 of 100.0 per cent taxes on goods imported from Serbia and Bosnia and Herzegovina.

Public debt remains low, but the government expenditure structure is unfavourable. While the budget deficit as defined by the fiscal rule (that is, the deficit excluding investments financed by international financial institutions, donors and privatisation proceeds) stayed well within the fiscal rule ceiling of 2.0 per cent, the overall deficit increased to 2.9 per cent of GDP in 2018 (from 1.4 per cent in 2017). Still, the public debt remains exceptionally low by regional standards. At the end of June 2019, it reached 16.5 per cent of GDP. However, transfers and subsidies have risen rapidly in recent years, accounting for a significant share of government current expenditures (around 40.0 per cent). The reform of the war veteran pension schemes, which would reduce pension costs, has still not been implemented. High social spending is not only adversely affecting the fiscal balance but is also having a negative impact on labour market participation. A government plan to build a new lignite-based power station and renovate an old one would not only conserve a highly polluting power generation structure with excessive carbon emissions, but also create additional fiscal risks, potentially leading to a breach of the fiscal rule.

Further catch-up is likely in the short term. GDP growth in 2019 and 2020 is expected to be 4.0 per cent annually, with domestic demand continuing to be the main growth driver. The risks to the projection are balanced. While upside risks relate to the possible start of the construction of a major new power plant and faster reform progress, weaknesses in public investment management, the economic slowdown in the European Union (EU), domestic political uncertainty and deteriorating relations with neighbours represent the main downside risks.

Assessment of transition qualities (1-10)



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Major structural reform developments

There has been little progress in EU approximation over the past year. Kosovo signed the Stabilisation and Association Agreement (SAA) with the EU in October 2015. It formally entered into force on 1 April 2016. While the European Commission has repeatedly stressed that Kosovo shares the European perspective of the Western Balkans, the question of its integration into the EU remains contentious due to the fact that five Member States do not recognise Kosovo bilaterally. The decision by the Kosovo government, on 20 November 2018, to impose 100 per cent tariffs on goods from Serbia has further complicated relations with the EU as it has been perceived by Brussels as a violation of the SAA and Central European Free Trade Agreement (CEFTA).

The business environment remains problematic. Widespread informality and corruption, an inefficient judiciary and weak rule of law and institutions are the key obstacles to doing business. Although business registration is simple and fast, with "one-stop shops" in place, businesses are burdened with a large number of licences and permits, cumbersome administrative procedures and frequent, uncoordinated and costly inspections. A general inspections reform is ongoing, with a plan to decrease the number of (overlapping and parallel) inspections from 36 to 15. However, the new Law on Inspections has not been adopted yet. According to the World Bank, Kosovo ranked 57th out of 190 in the *Doing Business 2020* report, dropping 13 places from the year before. Despite some improvements over the past year, the most problematic areas remain the same – dealing with construction permits (160th), protecting minority investors (128th) and getting electricity (90th).

A strategy against informality has been adopted. The informal economy, estimated by international institutions at close to one-third of GDP, is one of the main barriers for doing business in Kosovo. In May 2019, Kosovo adopted a revised strategy and action plan for fighting informality for the period 2019 to 2023. The measures include improving information exchange between relevant government institutions, reducing the cost of transactions for electronic payments in order to reduce cash payments and provision of bank loans based on financial statements submitted to the Tax Administration. The strategy also includes qualitative and quantitative indicators to enhance the monitoring process.

Public administration reform has advanced somewhat. A process of rationalisation of agencies has started, based on an action plan adopted in June 2018. In February 2019, the Law on Public Officials, defining different categories of public officials, and the Law on Salaries were adopted. The latter sets up a coherent and transparent salary system, although it risks having an adverse medium-term impact on the budget. A large increase in wages as part of the public administration reform, combined with an increase in employment, might entail a large fiscal cost and put the fiscal rule at risk. Also, political influence on senior appointments is still present and a comprehensive monitoring system of the public administration reform has not yet been established. The reform monitoring reports are neither actively discussed nor followed up at the political level. In addition, the reform relies predominantly on external donors, whose support often has not been secured, while annual budgetary expenditures are usually lower than planned. This raises concerns about the financial sustainability of the reform.

Resolution of state-owned enterprises (SOEs) is progressing slowly. According to the IMF, there are 16 non-financial central level and 44 local level publicly owned companies in the sectors of energy, telecommunications, railway and bus transport, water supply, sewerage and waste. The financial oversight, accountability and efficiency of SOEs are often inadequate. The privatisation process has lagged behind after the authorities' decision in November 2017 to freeze privatisation of socially owned land. In the second half of 2018, there were just six asset sales by the Privatization Agency from a total of 400 in the tender process. In January 2019, the government decided to re-launch the procedure for the privatisation of Kosovo Telecom (the third attempt since 2011), with the assistance of the EBRD. The company is overstaffed and has been a loss-maker since 2015. In March 2019, the socially owned Trepça mining complex, which holds Europe's largest lead-zinc and silver ore mine, was officially transformed into a joint stock company. The government has kept control of 80 per cent of the shares, while the remaining 20 per cent is owned by the employees. However, the ownership of the company has been disputed by Serbia.

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Modernisation of the country's transport infrastructure has progressed. Infrastructure development is key to the country's continued integration with the region. In May 2019, a second motorway was completed – the 60-kilometre highway linking the capital Pristina to the border with North Macedonia – but the project was criticised for its lack of transparency. In July 2019, the country started to upgrade its only operational international rail link, the 148-kilometre line connecting the Serbian border and Pristina with the capital of North Macedonia, Skopje. The project should improve the connection between Kosovo's railway network and the wider European network through European transport Corridor VIII and Corridor X.

Progress has been made to unlock investments in renewables. Kosovo is characterised by high energy intensity and over-reliance on coal, with less than 5 per cent of electricity produced from renewable sources in 2017. Following extensive policy dialogue, improvements to the power offtake structure were adopted in June 2019 and the EBRD financed the country's first major investment in wind power later that month. In line with the country's obligations as a member of the Energy Community, the next step is to establish an open and transparent auction system for further renewable energy projects. Limited progress has also been made to improve energy efficiency in the residential, public and private sectors, and adjustment of energy tariffs and incentives are required.

MONTENEGRO

Highlights

- **Growth surprised on the upside in 2018, but has slowed in 2019.** GDP growth rose to 5.1 per cent in 2018 on the back of strong domestic demand. However, it slowed to 3.1 per cent year-on-year in the first half of 2019 as a consequence of the slowdown in investments.
- **Public debt has increased further from already elevated levels.** At the end of 2018, public debt, including guarantees, reached almost 75.0 per cent of GDP. This is mainly due to the large highway project, which is financed by a Chinese loan.
- **Two non-systemic banks went bankrupt over the past year.** The banking sector, however, remained stable, while the non-performing loan (NPL) ratio has dropped to 5.3 per cent.

Key priorities for 2020

- **Public debt sustainability should be further reinforced.** Achieving this will require, among other things, the maintenance of a primary surplus over the medium term, sustained efforts to strengthen budgeting procedures and public investment management and improved public and tax administration. Once the first phase of the highway project is completed, any further construction should be preceded by a careful cost-benefit analysis.
- **The private sector would benefit from less informality.** More comprehensive measures, focusing on underlying causes such as the regulatory burden, weak enforcement capacity and corruption, should be put in place in order to reduce unfair competition from the informal sector, which weighs primarily on local micro, small and medium-sized enterprises.
- **The financial system needs strengthening.** A bank asset quality review and stronger banking supervision would be welcome. In addition, the central bank should closely monitor the rapid growth of cash loans with long maturities in order to limit potentially negative systemic effects.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.4	2.9	4.7	5.1	2.8
Inflation (average)	1.5	-0.3	2.4	2.6	0.5
Government balance/GDP	-8.0	-3.4	-5.5	-3.5	-3.3
Current account balance/GDP	-11.0	-16.2	-16.1	-17.2	-17.0
Net FDI/GDP [neg. sign = inflows]	-16.9	-9.4	-11.3	-7.0	-9.0
External debt/GDP	166.2	160.9	159.2	167.5	n.a.
Gross reserves/GDP*	16.8	18.1	20.8	22.1	n.a.
Credit to private sector/GDP	49.7	48.7	48.6	49.5	n.a.

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Macroeconomic performance

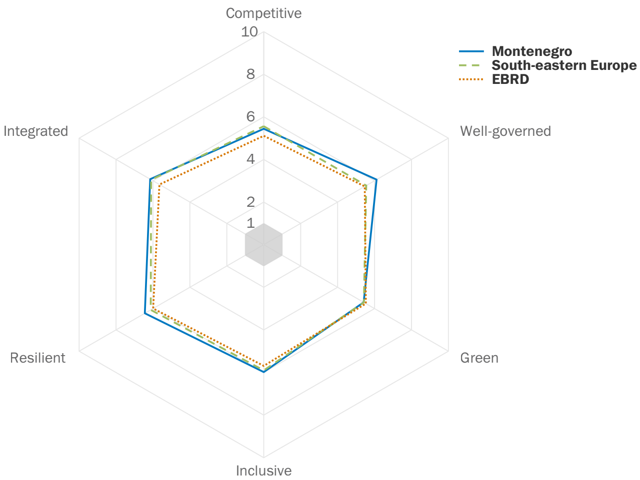
Growth stepped up to 5.1 per cent in 2018. The economy expanded strongly on the back of the highway construction, some coastal flagship real estate projects, an exceptionally strong tourism season and a further rise in private consumption. However, strong domestic demand and consequently higher imports caused the current account deficit to widen further, to over 17.0 per cent of GDP. In the first half of 2019 GDP growth slowed to 3.1 per cent year-on-year, primarily due to large investment projects (the Bar-Boljare highway and the power link to Italy) approaching completion. The first half of 2019 was also marked by poor industrial performance, due to declines in electricity production and manufacturing sector output. On the other hand, the tourism sector has continued to perform well.

Inflation has trended down. Price growth has slowed since the second half of 2018, primarily on the back of falling tobacco, clothing and footwear prices, but also due to decreasing transport prices, which is related to oil prices. As a consequence, the average inflation rate decreased from 2.6 per cent in 2018 to 0.3 per cent in the first nine months of 2019. The period from June to September 2019 has been marked by deflation (-0.2 per cent monthly on average).

Gradual fiscal consolidation has started to yield results. The budget deficit narrowed to 3.5 per cent of GDP in 2018 (from 5.5 per cent in 2017), but was above the target of 1.6 per cent in the original budget (2.2 per cent in the revised budget), and the public debt, including guarantees, reached close to 75.0 per cent of GDP by the end of 2018. The debt, which is expected to start declining in 2020, is also helped by phasing out highway-related spending. However, contingent liabilities and spending overruns may threaten the results. Further necessary fiscal reforms are planned, such as optimising public administration, introducing medium-term budgeting, improving tax administration and conducting the pension reform.

Growth is likely to slow down in the short term. With the completion of large investment projects, growth is projected to moderate significantly, to 2.8 per cent in 2019 and 2.6 per cent in 2020. Still, private investment in tourism and energy is expected to stay high. The risks to the projections mainly relate to weaker growth in the European Union. Besides improving public finance management, growth risks could be mitigated by reforming the labour market and public administration, as well as by strengthening economic institutions.

Assessment of transition qualities (1-10)



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Major structural reform developments

Montenegro continues to advance in EU approximation. Over the past year, the country has opened one new chapter, bringing the number of opened chapters to 32 in total (out of 33 chapters) since the opening of accession negotiations in June 2012. Three chapters have been provisionally closed. According to the 2019 European Commission's country report, further progress in negotiations will primarily depend on meeting the interim benchmarks set in the rule-of-law chapters (23 and 24).

Business conditions have improved somewhat. An action plan for the implementation of the 2018-22 strategy for the development of micro, small and medium-sized enterprises, envisaging over 200 activities, was adopted in December 2018. Furthermore, in 2019 three important laws were approved: the law on administrative fees, eliminating or reducing 18 per cent of existing taxes; the law on fiscalisation, allowing a real-time transfer of data from the taxpayers' POS terminals to the Tax Administration and supporting the fight against the informal economy; and the law on domestic trade, making Sunday a mandatory non-working day for the majority of businesses. An e-cadastre is being developed, with notaries and public bailiffs being the first to get access in July 2019. However, there is still room for improvement, especially in the area of getting electricity (as suggested by World Bank's *Doing Business 2020* report, where the country ranks 134th among 190 countries) and with regard to infrastructure (as suggested by the World Economic Forum's 2019 Global Competitiveness Index, where Montenegro ranks 83rd out of 141 countries).

Public administration reform is advancing slowly and with some setbacks. The public service in Montenegro is relatively large and often politicised. In November 2018, a new Law on State Administration was adopted, rationalising its organisation and addressing the main issues related to accountability lines between institutions. However, it was followed by a very rapid reorganisation of many bodies, without sufficient transition or enough time for stakeholders to adequately prepare for changes. Also, before the optimisation plan 2018-20 was adopted in July 2018, additional staff were hired, which partly undermined the reform results.

Important infrastructure concessions have been granted, while further legal changes are envisaged. In November 2018, a 30-year concession for the bankrupt shipyard, Bijela Adriatic, was approved. Also, in July 2019, following a delay, the government adopted a plan to award 30-year concessions for the country's two main airports (in Podgorica and Tivat). Besides these, work is ongoing for concessions on a ski resort, public forests and agricultural land. However, in order to align the legislation with EU rules and comply with principles of transparency, competition, equal treatment and non-discrimination, amendments to the law on public procurement and a new public-private partnership law are under consideration. Their adoption was envisaged by mid-2019 but faces delays. On the privatisation side, there has been some progress in 2019. Negotiations to sell the health institute in Igalo have started, and the asset restructuring (prior to the sale) of the hotel group Budvanska Rivijera has been completed. In addition, calls for privatisation have been published for another two companies from the 2019 privatisation plan. Conversely, the government proceeded with the buy-back of shares of the power utility (EPCG) from the minority Italian shareholder (A2A), raising its stake to close to 77 per cent in July 2019. The national flag carrier (Montenegro Airlines) and the national railway operator (ZPCG) continue to face financial issues due to accumulated debt.

Works on the transport and energy infrastructure continue, albeit sometimes with delays. The two big investments in recent years have been the construction of the Bar-Boljare highway, and the power link to Italy. The third large investment planned (the construction of the second unit of the Pljevlja thermal power plant) was cancelled in September 2019 due to environmental concerns. While the power link (a largely undersea cable that measures 455 kilometres) is in a testing phase and expected to be fully operational by the end of 2019, the construction of the 170-kilometre long highway, financed by a Chinese loan, has suffered delays and cost overruns. The first section of the highway, which was supposed to have been completed by the end of May 2019, is now planned for completion in September 2020 and will cost 10 per cent more than initially planned. The latter is also due to the unfavourable US dollar-euro exchange rate developments, as the loan is US dollar-

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denominated. In July 2019, the power utility EPCG issued a tender for an ecological revamp of the existing unit at the Pljevlja thermal power plant. The government and the EPCG have committed to increasing the share of renewables in the energy portfolio, as indicated by the recent approval of several large-scale solar and wind projects.

The banking sector remains stable despite two banks going bankrupt. In 2018, three out of 15 banks had operational problems, two of which closed due to bankruptcy, while the third has been recovering. Despite the freeze on deposit withdrawals from the two bankrupt banks, there was no negative spillover to the banking sector as a whole. The majority of the guaranteed deposits from the bankrupted banks have returned to the system. The sector remains liquid and well capitalised, with the capital adequacy ratio in June 2019 at 19.5 per cent. NPLs kept trending down to 5.3 per cent in June 2019. In July 2019, Montenegrin Commercial Bank (CKB), owned by Hungarian OTP Bank, completed the purchase of 90.6 per cent of the local unit of Société Générale, and the Azerbaijani-backed Nova Banka was sold.

NORTH MACEDONIA

Highlights

- **An historic agreement with Greece on the country's new name has been reached.** Although this can help facilitate North Macedonia's European Union (EU) approximation and NATO membership, the opening of EU accession negotiations has been delayed.
- **The economy has been recovering after the resolution of the political crisis.** GDP expanded by 2.7 per cent in 2018 and a further 3.6 per cent year-on-year in the first half of 2019.
- **The NPL ratio is on the rise.** Liquidity is ample and capital adequacy is relatively high, but the share of non-performing loans (NPLs) increased somewhat in the first half of 2019.

Key priorities for 2020

- **Further measures are needed to improve the business climate.** The focus should be on implementing measures to reduce the informal economy, in accordance with the government's 2018-22 strategy and 2018-20 action plan, but also on balancing formal enforcement with measures targeting underlying incentives for informality, such as simplifying the rules for the establishment and operation of businesses (especially in the case of entrepreneurs and micro enterprises).
- **The labour market needs to become more competitive.** Addressing skills shortages and aligning better vocational training with business needs are necessary in order to enhance the country's competitiveness.
- **To ensure the sustainability of public finances, more ambitious fiscal consolidation measures are needed.** The public debt is relatively high and the structure of government spending worsened further in the past year, shifting from capital to current expenditures. The government should further improve revenue collection, reduce tax exemptions, rationalise subsidies and ensure long-term pension sustainability. The introduction of fiscal rules is also needed; North Macedonia is the only Western Balkans country lacking such rules.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.9	2.8	0.2	2.7	3.2
Inflation (average)	-0.3	-0.2	1.4	1.5	1.2
Government balance/GDP	-3.5	-2.6	-2.7	-1.8	-2.5
Current account balance/GDP	-2.0	-2.9	-1.1	-0.1	-1.0
Net FDI/GDP [neg. sign = inflows]	-2.2	-3.3	-1.8	-5.6	-2.5
External debt/GDP	69.3	74.7	73.6	73.1	n.a.
Gross reserves/GDP	24.9	27.1	23.4	26.7	n.a.
Credit to private sector/GDP	50.9	47.9	48.6	48.8	n.a.

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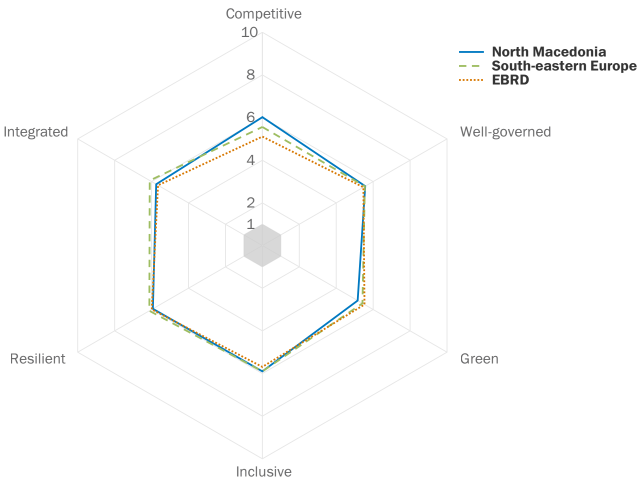
Macroeconomic performance

The economy has been recovering after the resolution of the political crisis. Growth recovered to 2.7 per cent in 2018 after just 0.2 per cent in 2017, driven mainly by strong exports but also private consumption. Robust export performance came as a result of stronger activity of both foreign direct investment-related and traditional industries (machinery and transport equipment, chemicals, iron and steel, furniture), helping to reduce the current account deficit to 0.4 per cent of GDP. However, total investments declined due to the postponement of large infrastructure projects and stagnating construction. The growth rate accelerated in the first half of 2019, to 3.6 per cent year-on-year, driven primarily by investment recovery. Despite declining, unemployment stayed high over the past year, at close to 20.0 per cent, and especially for young people for whom the unemployment rate is about 40.0 per cent. Inflation remained subdued at 1.5 per cent in 2018 and 1.0 per cent in the first nine months of 2019.

Public debt increased slightly in 2018. The general government deficit decreased to 1.8 per cent of GDP in 2018, after 2.7 per cent in 2017. Lower spending on public investment, instead of restraint on current expenditures, and higher tax revenues have been major drivers of the adjustment. Government arrears, including in VAT refunds, have continued to decline and measures were taken to prevent their build-up in the future. Public debt increased in 2018 by 0.7 percentage points, to 48.5 per cent of GDP. Financing of public enterprises and large infrastructure projects is often non-transparent, adding to medium-term fiscal risks.

Growth is projected to pick up to 3.2 per cent in 2019 and 2020. It will be supported primarily by a rebound in investment. The resolution of the name issue with Greece was expected to speed up EU accession progress, thus strengthening investor confidence and growth, as confirmed by Fitch's upgrade in June 2019 of the country's sovereign rating to BB+. However, current risks to the projection are more on the downside. These are mainly related to the delayed start of EU accession talks, which may weaken the reform momentum within the country, and the economic slowdown of the European Union.

Assessment of transition qualities (1-10)



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Major structural reform developments

The opening of EU accession negotiations has been delayed. Based on assessment of the progress in the implementation of the comprehensive EU reform agenda, the Council of the European Union in its Conclusions on the Enlargement adopted in June 2018 set out the path towards opening the accession negotiations with North Macedonia in June 2019. In May 2019, the European Commission issued a strong unconditional recommendation to the Council to launch EU accession negotiations with North Macedonia. The latter was based both on its assessment of the progress in reforms and on the country's achievements in normalisation of relations with regional neighbours, including the historic agreement on the resolution of the name issue and establishment of a strategic partnership with Greece. However, at the European Council meetings in June and October 2019 no consensus had been reached on this issue. Consequently, on 18 October 2019 the European Council decided to postpone the decision and to revert to this issue again before the EU-Western Balkans Summit in May 2020. The decisions of the Council triggered early general elections in North Macedonia, expected in April 2020.

Despite a high Doing Business ranking, the business environment needs to improve further. For many years, North Macedonia has ranked near the top of the annual World Bank *Doing Business* rankings, above many of the world's richest and most advanced economies. In the 2020 report the country dropped six places from the year before and ranked 17th out of 190 economies. The areas with the most room for improvement were starting a business (78th) and getting electricity (68th). In the World Economic Forum's 2019 Global Competitiveness Index (GCI), however, the country is relatively low-ranking, at 82nd out of 141 countries. While North Macedonia has advanced a lot in its business legislation and processes, in other institutional elements the country still has a lot of gaps to fill, including in improving the quality of the transport infrastructure and education, levelling the playing field for businesses, removing distortive taxes and subsidies and strengthening innovation. Political connections are also perceived to be important for success in life, according to the EBRD/World Bank Life in Transition Survey III.

The government is working on measures to reduce the informal economy. A government strategy and action plan to reduce informal employment, adopted in 2018, focuses on the formalisation of jobs and on mitigating incentives to do business informally. Competition from the informal sector and access to finance (more than in other Western Balkans economies) are significant obstacles to doing business and weigh on competitiveness of the formal private sector, according to the latest round of the EBRD-European Investment Bank-World Bank Group Enterprise Survey. The size of the informal economy is estimated to range between 20 and 40 per cent of total output, depending on the method applied.

Work is ongoing on improving energy security and efficiency. The government plans to adopt an energy sector strategy up to 2040, based on the principles of the EU Energy Union. A new draft law on energy efficiency has also been prepared. The energy law, adopted in May 2018, allows small and medium-sized enterprise and households to install photovoltaic electricity generation facilities for their own consumption, transferring the surplus to the network. ELEM, the state-owned electricity company is also investing in its first 10 MW photovoltaic power plant. Construction of a national gas distribution system and connection to regional gas pipeline systems are among the government's priorities. The first ever auction for a feed-in premium for 35 MW photovoltaic plants on state-owned land was successfully published in June 2019, with the EBRD's support.

The banking sector is liquid and well-capitalised but the share of NPLs is increasing. Liquid assets make up more than 30 per cent of total assets, while capital adequacy was at 17.4 per cent at the end of June 2019, exceeding the regulatory minimum. Lending growth picked up on the back of corporate lending to 8.4 per cent year-on-year in the first half of 2019 (from 6.7 per cent in 2018). NPLs had declined from 6.1 per cent at the end of 2017 to 4.9 per cent in September 2018, mainly due to the collection of corporate claims, but have increased thereafter. In June 2019, the NPL ratio stood at 5.4 per cent. Foreign currency (euro) lending declined substantially since 2012 (from around 60 per cent of total loans), but at close to 40 per cent in mid-2019 remains high.

ROMANIA

Highlights

- **Growth remains strong.** The economy grew by 4 per cent in 2018 but fiscal and current account deficits have increased as a result of the government's pro-cyclical stimulus measures.
- **Progress under the Cooperation and Verification Mechanism (CVM) continues to be uneven.** The latest CVM report noted reversals on Romania's progress in the areas of the rule of law and the fight against corruption.
- **Investor sentiment was hurt by a package of measures taken in late December 2018 (Emergency Ordinance 114/2018).** The proposals would have had a potentially significant negative impact on specific sectors, including banking, pension funds, energy, and telecommunications, but following pressure from various stakeholders, the government has softened the measures.

Key priorities for 2020

- **Further reforms to strengthen good governance 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. Initial public offerings (IPOs) and secondary public offerings (SPOs) of SOEs already listed would attract investors and increase market capitalisation.
- **Business environment reforms should be prioritised.** Efforts to address the difficulties in accessing skilled labour, inadequate transport infrastructure and inefficient government bureaucracy constitute the highest reform priorities.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.9	4.8	7.1	4.0	4.0
Inflation (average)	-0.4	-1.1	1.1	4.1	3.6
Government balance/GDP	-0.6	-2.6	-2.6	-3.0	-3.5
Current account balance/GDP	-1.2	-2.1	-3.4	-3.5	-3.4
Net FDI/GDP [neg. sign = inflows]	-1.8	-2.6	-2.6	-2.5	-2.5
External debt/GDP	56.3	52.0	52.3	46.4	n.a.
Gross reserves/GDP	21.7	21.2	20.8	17.5	n.a.
Credit to private sector/GDP	29.9	28.0	26.3	25.9	n.a.

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Macroeconomic performance

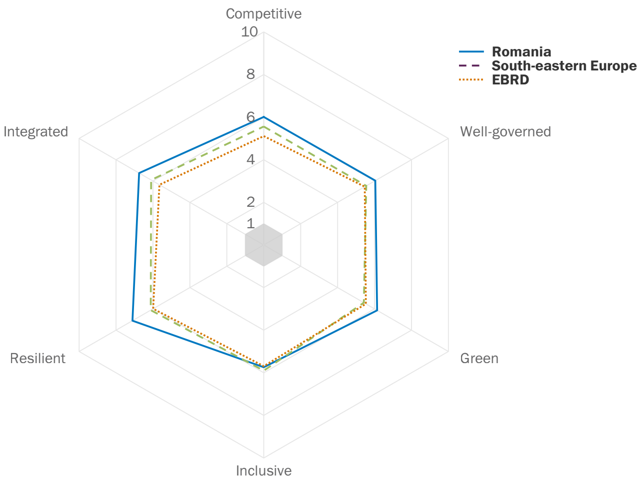
Growth has moderated but remains strong. Following a growth peak of 7.1 per cent in 2017, the economy slowed to an estimated 4.0 per cent growth in 2018. Private consumption has been the main driver of the economy over the past two years (although at a slower pace in 2018), supported by a pro-cyclical fiscal policy, including public-sector salary hikes. Fuelled by increased absorption of EU funds, the contribution of investment to growth was also positive. Despite growing exports, the trade deficit has been widening since 2015, as rising domestic demand has driven up imports even more, thus negatively contributing to growth. The unemployment rate, at about 4.0 per cent as of the end of 2018, is the lowest in a decade, making recruitment difficult and driving wage growth. The average net monthly wage in December 2018 was €635, an increase of about 10.0 per cent year-on-year in real terms. The economy grew by 4.6 per cent year-on-year in the first half of 2019, which was better than expected by most analysts.

Inflation has accelerated. Driven by the tightening labour market and rising household consumption, inflation peaked at a five-year high of 5.4 per cent in June 2018, well above the central bank's upper target of 2.5 per cent +/-1pp. Consequently, the central bank tightened its monetary policy, raising its main policy rate three times in 2018 from 1.75 to 2.50 per cent. Although inflation gradually receded to 3.3 per cent in December 2018, it has risen to an average of 3.9 per cent in the first half of 2019, again above the central bank's upper target.

Twin deficits have increased in the wake of government pro-cyclical stimulus measures. The current account deficit is estimated to have widened to 3.5 per cent of gross domestic product (GDP) in 2018 (from about 1.0 per cent in 2015), driven by rising imports and dividends outflows from the accumulated foreign direct investment stock. Meanwhile, the budget deficit is estimated to have reached 3.0 per cent of GDP in 2018 (second highest in the European Union (EU)) on the back of continued loose fiscal policies as well as weak revenues. The International Monetary Fund and the European Commission (EC) have expressed concerns about plans for pension and public-sector wage increases. In June 2019, the lower house of the parliament passed the new pension law, which provides for an accelerated increase in public pensions over the next two years until they reach a level 70.0 per cent higher than the current one by September 2021. On the positive side, general government debt is low by regional standards, at around 35.0 per cent of GDP, and has been stable for some time thanks to high nominal growth.

GDP growth is likely to moderate further in the short term. Growth is expected at 4.0 per cent in 2019, moderating to 3.2 per cent in 2020, reflecting weakness in major trading partners, not least the euro area, and higher perceived investment risks. In the longer term, the diversified economy, large market size and scope for convergence within the EU (GDP per capita in power purchasing standards is 64.0 per cent of the EU average) should allow growth rates of around 4.0 per cent to be sustained, provided structural reforms remain on track.

Assessment of transition qualities (1-10)



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Major structural reform developments

Controversial economic policy measures have been softened. A set of measures announced in December 2018 (Emergency Ordinance 114/2018) and affecting the banking, pension, telecommunications (telecoms) and energy sectors caused significant concern among investors because of their potentially damaging impact on investment and business confidence. Steps have been taken since to soften some of the measures. The bank asset tax was eventually set at 0.4 per cent (which may be further adjusted downwards depending on the credit growth and the loan-deposit (net) interest margin), with the taxable amount excluding government loans and securities. Capital requirements for private pension funds have been raised (although lowered relative to the original ordinance), while a cap was introduced on administration fees charged by private fund managers. In the telecoms sector, the 3 per cent turnover tax levied on all telecoms operators as of January 2019 remains in place, as originally proposed. Similarly, the gas price caps, at RON 68 (around €14) per MWh for the next three years, will be maintained for household consumers and producers supplying household heating centres, but will be removed for industrial consumers. The latter measures are still at odds with EU legal requirements, and the EC has already launched an infringement procedure against Romania, claiming that the provision breaches the EU Gas Directive. Nevertheless, the measures left significant doubts about the predictability of the business environment and the quality of the legislative process.

Some business environment reforms have advanced. Over the past year, Romania made starting a business easier by allowing voluntary value added tax registration and making paying taxes less costly by eliminating a number of employer-paid taxes and contributions. However, the country's ranking fell three places to 55th (out of 190 economies) in the World Bank's *Doing Business 2020* report. In a positive development, in September 2019 FTSE Russell announced that Romania will be assigned Secondary Emerging market status, effective in September 2020.

Progress under the European Commission's Cooperation and Verification Mechanism (CVM) continues to be uneven. The latest CVM report, published in October 2019, noted reversals on Romania's progress in the areas of the rule of law and the fight against corruption. However, the authorities have recently confirmed their commitment to close the relevant benchmarks.
The government has endorsed a plan for euro adoption. A memorandum with this aim was published in February 2019, including the plan for the adoption of the euro by 2024. Romania meets only one of the nominal criteria for joining the eurozone, namely, the criterion that the government deficit should be below 3 per cent of GDP (although with a negative trend). The country does not fulfil the criteria on price stability and on the convergence of long-term interest rates.

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The government has revived plans for establishing an investment and development sovereign fund. According to a revised draft bill from March 2019, the fund's portfolio would include controlling or minority stakes in 28 companies in the transport, pharmaceutical and energy sectors and cash of €2 billion to be disbursed in stages, which is supposed to come from privatisation revenues held in a reserve account of the government. Also, according to the legislation, the fund will be able to privatise the companies it holds at discretion and without complying with a high degree of transparency. The most valuable companies that will be part of the fund, besides the state-owned minority stakes in OMV Petrom, Telekom Romania, and Engie, Eon subsidiaries, are Hidroelectrica, Romgaz, Nuclearelectrica, Constanta Port, Conpet, Romanian Lottery, Cuprumin, Unifarm and Antibiotice Iasi.

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Offshore gas development in the Black Sea is progressing slowly. The Black Sea Oil & Gas company has launched its investment in developing the offshore gas reserves in the Black Sea, following government approval in April 2019. This is the first new offshore gas development project in Romania's Black Sea to be built after 1989. At the same time, in late 2018 OMV Petrom deferred a decision to go ahead with investments in its offshore gas fields, due to changes in both the offshore law (including the mandatory sale of 50 per cent of the output on the local market at regulated price) and the introduction of a supplementary 2 per cent turnover tax on energy companies, enacted by the government suddenly in late 2018. OMV Petrom runs the project in a 50-50 joint-venture with American group ExxonMobil. Meanwhile, in December 2018 Romania's gas transport grid operator Transgaz launched the tender for a major pipeline, aimed at bringing the natural gas produced by OMV Petrom and ExxonMobil at the Black Sea to the Bulgaria-Romania-Hungary-Austria gas pipeline. The new connection is the latest of a long series of pipelines Transgaz is currently developing or planning to build quickly. Under another project, Transgaz will make its gas route from Moldova reversible in order to allow exports to Moldova (and Ukraine, in principle) as well.

Romanian banks continue to clean up their balance sheets amid increasing profits. The non-performing loan (NPL) ratio in the country's banking system, calculated under European Banking Association methodology, dropped to less than 5 per cent as of the end of 2018, from a peak of more than 20 per cent in 2014. Romania's banks reported aggregated net profits of €1.5 billion in 2018, the highest annual profit for the past decade (2009-18). However, the introduction of the tax on bank assets may put pressure on the banks' profitability. Meanwhile, in June 2019 Romania's state-owned Eximbank, which specialises in corporate banking, reached an agreement to take over Banca Romaneasca, the local subsidiary of the Greek bank NBG. Also, in March 2019 Romania's Constitutional Court invalidated three controversial banking laws (which had been passed in December 2018) following objections raised by the opposition parties. The first law capped interest rates on retail loans (mortgage and consumer); a second law regulated the regime for NPLs, allowing the buyers of such loans to recover from debtors at almost twice the price they paid to buy them from the original creditors; and the third law reduced the power of creditors, obliging them to ask for court orders to enforce their claims.

SERBIA

Highlights

- **After a robust performance in 2018, economic growth is moderating in 2019.** Lower growth primarily reflects stagnation in the agricultural sector and a fall in industrial production.
- **Foreign direct investment (FDI) inflows have been strong in the past few years, especially in 2018, more than covering the growing current account deficit.** Nevertheless, the structure of FDI has changed to more labour-intensive projects, requiring low-skilled labour and supported by high subsidies.
- **Non-performing loans (NPLs) in the banking sector have continued to decline, but the financial sector remains highly euroised.** The NPL ratio fell to 4.9 per cent in August 2019, mainly due to mandatory write-offs. Euroisation of loans and deposits remains at close to 70.0 per cent.

Key priorities for 2020

- **Serbia has to systematically address the institutional causes of chronically weak growth.** Average growth between 2010 and 2018 was just 1.7 per cent, significantly below that of regional peers. The focus should be on strengthening the rule of law, fighting corruption and increasing domestic private and public investment.
- **The governance of state-owned enterprises (SOEs) and public projects needs to be improved.** The government should focus on improving the efficiency of large SOEs, also through necessary legal changes and/or stronger implementation of existing legislation. A single pipeline for all public projects should be developed, enabling proper cost-benefit assessment and monitoring while project implementation should be strengthened further.
- **Public administration reform should be high on the agenda.** Planned reform measures, including the introduction of a new public-sector pay grade system, as well as professionalisation and de-politicisation of public administration, have been postponed several times and should be implemented without further delay.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	1.8	3.3	2.0	4.4	3.2
Inflation (average)	1.9	1.2	3.0	2.0	2.0
Government balance/GDP	-3.5	-1.2	1.1	0.6	-0.5
Current account balance/GDP	-3.5	-2.9	-5.2	-5.2	-5.5
Net FDI/GDP [neg. sign = inflows]	-5.1	-5.2	-6.2	-7.5	-6.1
External debt/GDP	73.5	72.1	65.3	62.7	n.a.
Gross reserves/GDP	29.1	27.8	25.4	26.3	n.a.
Credit to private sector/GDP	40.7	41.0	40.3	41.5	n.a.

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Macroeconomic performance

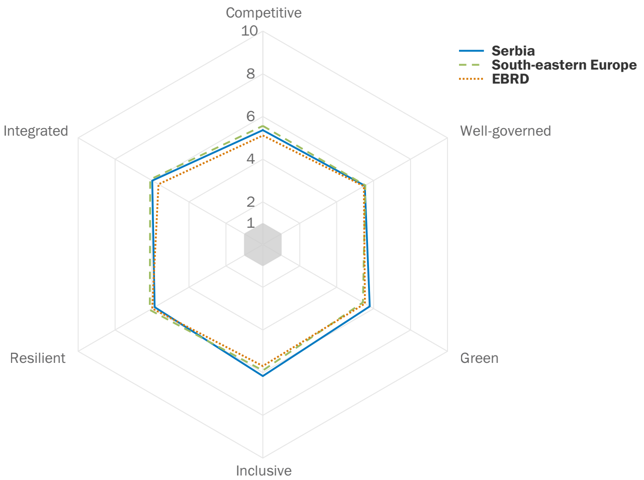
Growth was strong in 2018, but has subsided during 2019. GDP expanded by 4.4 per cent in 2018, driven by private consumption and investments and supported by a strong agricultural season. On the other hand, a negative contribution by net exports acted as a drag on growth for the second year running. In addition, mining and utilities output started to fall again in the second half of 2018, indicating governance problems at the state-owned electricity company EPS. Unfavourable trends in industrial production continued in the first half of 2019, with industrial output declining by 2.0 per cent year-on-year on the back of falling mining and manufacturing, while utilities output stagnated. In addition, agricultural output stagnated. As a consequence, the overall growth rate slowed to 2.8 per cent year-on-year in the first half of 2019.

The general government budget remained in surplus for the second year in a row. The 2018 budget recorded a surplus of 0.6 per cent of GDP, versus an initially planned deficit of 0.7 per cent. Although prudent fiscal policy is desirable, persistent significant over-performance of the planned budget targets indicates a need for better budget planning. In addition, the composition of expenditures is heavily weighted towards consumption, while public investments, despite the increase in 2018 and 2019, remain low. Public debt continued to decline, reaching 54.5 per cent of GDP at the end of 2018, but remained broadly at the same level in the first half of 2019. In September 2019, the Fitch agency upgraded Serbia's credit rating from "BB" to "BB+" (with a stable outlook), citing among other factors the maintained fiscal discipline and decreasing public debt. In October, the 2019 budget was revised to account for additional capital spending, a one-off payment to pensioners and public-sector wage increases. That moved the budget from a small surplus in the first eight months of the year to a deficit of 0.5 per cent of GDP expected for the year as a whole.

Inflationary pressures have been low, also thanks to the strong exchange rate. Inflation fell to 2.0 per cent in 2018, coming closer to the lower bound of the central bank's target band (3 ± 1.5 per cent). In 2019, it initially picked up, reaching 3.0 per cent year-on-year in April, but then fell back to 1.1 per cent in September. After keeping the policy rate unchanged at 3.0 per cent for more than a year, the central bank cut the rate again in the third quarter of 2019. In October 2019, the rate stood at 2.5 per cent. The central bank also continues to actively intervene in the foreign exchange market, on both the purchase and sale sides, but has remained a net buyer of foreign exchange.

Growth is expected to moderate in the short term. GDP is expected to expand by 3.2 per cent in 2019 and 3.5 per cent in 2020. Domestic demand should remain the main growth driver, while net exports will most likely keep contributing negatively. On the other hand, the economic slowdown of the main trading partner, the European Union (EU), and the slow pace of reforms within the country might act as a drag on growth in the near term and make it more volatile. While the introduction of a 100.0 per cent tariff on Serbian products by Kosovo may have a negative effect on exports of up to €400 million a year, reliable assessments of the effects are not yet available.

Assessment of transition qualities (1-10)



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Major structural reform developments

EU accession negotiations are advancing, albeit slowly. Over the past year, three new chapters have been opened, making 17 in total (out of 35) since the opening of negotiations in January 2014. Two chapters were provisionally closed earlier. According to the 2019 European Commission's country report, the future speed of negotiations will primarily depend on the pace of reforms to the rule of law as well as on progress in the normalisation of relations with Kosovo. In October 2019, the country signed a free trade agreement with the Eurasian Economic Union, from which it has pledged to withdraw on the day of EU accession.

The business environment remained broadly unchanged. In the World Bank's *Doing Business 2020* report Serbia ranked 44th out of 190 economies. While the country made starting a business more complicated by requiring that entrepreneurs obtain an electronic certificate and register the ultimate beneficial owners separately after incorporation, the business environment improved in several other areas, resulting in an increase of four positions from last year's report. Enforcing contracts, getting credit and resolving insolvency are the areas where Serbia lags behind the frontier most. In the World Economic Forum's 2019 Global Competitiveness Report, Serbia's weakest areas are its financial system, adoption of information and communications technology (ICT) and its institutions. The country has worsened its overall standing in the report, ranking 72nd out of 141 countries (down seven places from the previous report). Over the past year there was no progress in establishing the legal framework for microfinance institutions.

The state's footprint in the economy remains large. Serbia has the third-largest share of SOE employment among the 21 central, eastern and south-eastern European countries, according to recent estimates by the International Monetary Fund (IMF). The financial performance of SOEs is also weak compared with the private sector. Recurring problems in mining and electricity generation at the electricity company EPS in the past couple of years, due to weak management, have decreased economic growth visibly. Improved resource allocation at SOEs could result in sizeable growth benefits, raising GDP by 2 per cent permanently, according to IMF estimates. Under the IMF programme, the government has committed to new reform targets related to SOEs, namely, publishing the full list of SOEs by the end of October 2019 and adopting the state ownership policy by the end of February 2020. However, recent examples of growing state ownership in certain sectors (for example, cable television) have raised concerns about increasing political influence. The resolution of SOEs that are not bankrupt or in the process of being privatised has been advancing cautiously.

Public administration reform is progressing slowly. Implementation of legislation related to much-needed public administration reform has been partial or delayed. Amendments to the Law on Civil Servants from December 2018 and new secondary legislation from January 2019 introduced criteria for the organisation of recruitment selection tests and a new performance assessment system. However, heads of institutions still have much discretion, for example, in setting up selection committees. In addition, the amendments to the law did not address the frequent misuse of provision on "acting" positions. Namely, the majority of senior staff are in such positions, making them more susceptible to political influence and limiting proper professional conduct. The introduction of the pay grade system, introducing "equal pay for equal work" for all public-sector employees, based on a law from 2016, has been postponed again to mid-2020. Tax administration reform is also progressing slowly.

Efforts are under way to fight informality. Amendments to the Law on Inspection Supervision, adopted in December 2018, give more remit to supervise unregistered activities. The coordination of inspections and risk-based approaches has advanced as well, including through the introduction of a unified inspection information platform. However, the law may need to be amended further in order to comply with the International Labour Organization's Labour Inspection Convention. Namely, contrary to the convention, which states that inspectors enter a company without previous notice, the current law requires written notice at least three days in advance, which opens the space for misconduct.

CONTINUES

NPL resolution has progressed further, but euroisation remains high. Over the past year, NPLs declined by 2.6 percentage points, to 4.9 per cent in August 2019, mostly due to mandatory write-offs. To address remaining issues, a new NPL resolution programme (2018-20) was adopted in December 2018. Despite regulatory efforts to discourage foreign currency lending and depositing, euroisation has remained high at close to 70.0 per cent, potentially posing financial stability risks if the dinar were to depreciate significantly. Foreign currency lending for households has declined, but mainly due to the increase in (often) long-term dinar-denominated cash loans that could pose risks to financial stability during a downturn. In response, in December 2018 the National Bank of Serbia limited the tenor of these loans to eight years from 2019, reducing it to six years from 2021. The privatisation of the third largest bank, Komercijalna banka is finally advancing and a tender was announced in May 2019. Four non-binding offers have been submitted and the submission of binding bids is expected by early December 2019.

A law on the conversion of Swiss franc mortgage loans was adopted. The new law, adopted in April 2019, envisages the conversion of mortgage loans denominated in Swiss francs to euros by July 2019, with a 38 per cent haircut and capped interest rates, and with the state covering 15 per cent of banks' related losses. The selected solution, relieving borrowers and banks of some of the financial consequences of their decisions, has budgetary costs of up to 0.2 per cent of GDP and may create moral hazard risks. Around 90 per cent of Swiss franc loans have been converted to euros.