CROATIA

Highlights

- **The economy is recovering well after a deep shock in 2020.** After recording an 8.1 per cent decline in gross domestic product (GDP) in 2020, the economy expanded by 7.8 per cent year-on-year in the first half of 2021, followed by a better-than-expected tourist season in July and August.
- **The Recovery and Resilience Facility (RRF) plan has been approved.** Croatia was among the front runners, as the European Commission approved the plan relatively early, with the first tranche of €818 million already disbursed in September 2021.
- **Renewables deployment has advanced.** Following the fully aligned premium model for renewables and new quotas, investor appetite for capitalising on Croatia's high potential in this area is rising.

Key priorities for 2022

- **The reforms outlined in the RRF plan need to be implemented in a timely manner.** The RRF plan has multiple reform components tied to investments, ranging from business environment measures to education reforms, which will require additional efforts from the authorities. In light of the significant total allocation up to 2027 (38 per cent of 2020 GDP), European Union (EU) funds absorption capacity in general will need to improve.
- **Improvements to the corporate governance of state-owned enterprises (SOEs) should continue.** A recent Organisation for Economic Co-operation and Development (OECD) review of the existing corporate governance framework pointed to weaknesses in ownership policy, disclosure practices and board independence. Upcoming reforms to tackle these problems are part of the post-exchange rate mechanism (ERM) II accession commitments.
- **A more structured approach to reconstruction efforts in earthquake-affected areas should be developed.** Amending legal frameworks and improving institutional coordination will be major preconditions to removing the legal and financial barriers to the full implementation of post-earthquake reconstruction activities in Croatia.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.4	2.9	3.5	-8.1	8.0
Inflation (average)	1.1	1.5	0.8	0.1	2.0
Government balance/GDP	0.8	0.2	0.3	-7.4	-4.1
Current account balance/GDP	3.4	1.8	2.7	-0.8	-0.1
Net FDI/GDP [neg. sign = inflows]	-2.2	-1.6	-1.9	-1.9	-2.0
External debt/GDP	87.3	80.8	72.5	79.9	n.a.
Gross reserves/GDP	31.5	33.1	33.4	37.7	n.a.
Credit to private sector/GDP	54.4	53.0	52.2	58.8	n.a.

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Covid-19: macroeconomic implications

The economy is bouncing back strongly after a deep recession in 2020. In 2020 GDP fell by 8.1 per cent, one of the biggest drops in output in the EU. The tourism sector was the main channel of disruption, as arrivals decreased by 64 per cent versus 2019. However, in the first half of 2021 growth was broad-based and reached 7.8 per cent year-on-year. The recovery is also reflected in the labour market, as the registered unemployment rate reached 7.3 per cent in August 2021, down from a peak of 9.8 per cent in January 2021 and already below the value recorded at the end of 2019.

Tourism and goods exports have recorded significant growth rates. Preliminary data are exceeding the authorities' initial expectations in 2021. By the end of August 2021 tourist overnight stays were 74 per cent of the record 2019 levels for the same period, with a longer season expected this year than in 2020. Moreover, in the first three weeks of August, overnight stays were around 90 per cent of the corresponding period in 2019, while total receipts from July to mid-August were 9 per cent higher than in 2019. Goods exports have also grown strongly in the first half of 2021, with volumes in this period being 21 per cent higher than in 2019. These two important components of the economy are supporting the accelerated recovery.

Public finances also improved in 2021. In the first half of 2021 the fiscal deficit inched down towards 2.6 per cent of GDP, with a target for the year as a whole of 4.5 per cent of GDP. The increase in revenues has been broad-based, while the spending increase has been milder. Public debt is projected to decrease to 83 per cent of GDP in 2021, after a significant increase from 73 per cent at the end of 2019 to 89 per cent at the end of 2020. The euro adoption plan could serve as an anchor to fiscal consolidation in the medium term, even if the final shape of the EU fiscal rules post-Covid-19 remains uncertain.

The economic outlook continues to be positive but significant risks remain. We forecast the economy to recover by 8.0 per cent in 2021, followed by a normalisation of growth towards 4.2 per cent in 2022. Considering the good performance of the tourism sector in the third quarter as well as the overall performance in the first half of the year, risks to the current forecast are oriented towards the upside. The main downside risk is the evolution of the Covid-19 pandemic, especially in light of the slow vaccination rate, although strict containment measures are unlikely to be reintroduced. In the medium term, EU fund absorption and associated reforms will define the extent to which growth increases above relatively low historical values.

Policy response to Covid-19

The authorities have continued the key job retention mechanism in 2021. After devising a fiscal support package of about 3.8 per cent of GDP in 2020, the authorities have partially wound down assistance in 2021, estimated by the International Monetary Fund (IMF) at 2.5 per cent of GDP. The main scheme operational in both 2020 and 2021 is the job retention mechanism, which covered HRK 4,000 (€530) per retained worker in affected firms and sectors. In July 2021 the European Commission transferred €530 million from the Recovery Assistance for Cohesion and the Territories of Europe (REACT-EU) package to support the scheme. Other support measures include grants to firms in affected sectors, including a dedicated scheme to support the tourism sector.

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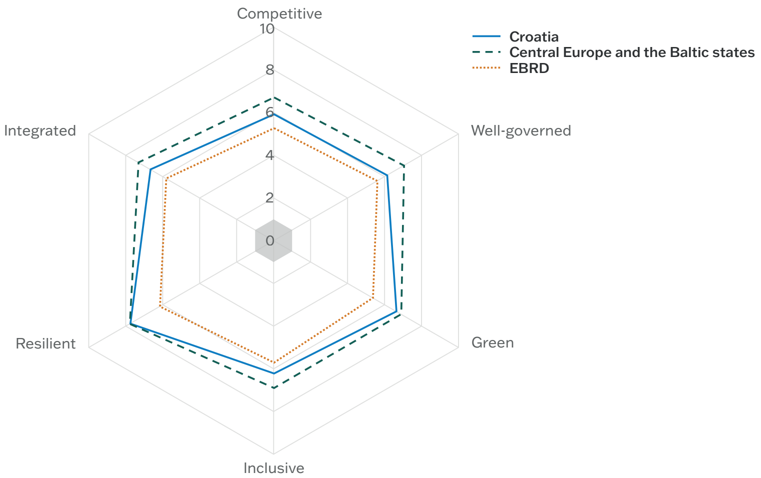
Assessment of transition qualities (1-10)



Structural reform developments

The RRF plan includes key structural reforms. The €6.3 billion in grants will be targeted towards raising the productivity of the economy, primarily by enhancing the green and digital transition. On top of these two priorities, the plan outlines structural reforms in public administration, the judiciary, education, the labour market and social policy.

The government adopted the National Development Strategy. The strategic long-term development document was adopted in February 2021 and provides a framework for long-term budget planning, the use of EU funds and key reforms up to 2030. The development goal for 2030 is to increase GDP per capita in purchasing power standards (PPS) from the current 63 per cent to 75 per cent of the EU average, as well as to increase the share of exports of goods and services to 70 per cent of GDP.

The government adopted a proposed anti-corruption strategy for the period 2021 to 2030. The new strategy sets five priorities in the area of public policy, with most of the measures related to strengthening the institutional and normative framework, as well as the transparency and openness of public authorities' work. In the 2020 Eurobarometer survey on corruption, 97 per cent of respondents said they believed that corruption was widespread, compared with an EU average of 71 per cent.

The European Competition Network Plus (ECN+) Directive regulating competition policy entered into force. Parliament transposed the EU Directive in April 2021 and amended other parts of the Competition Act to fully align it with EU standards. ECN+ aims to ensure a common framework for all member states by establishing minimum common investigative powers and decision-making procedures. The transposition is expected to give more autonomy and instruments to the Competition Authority, thus enabling a fairer and more competitive business environment.

Legislation to promote renewable energy has advanced. All relevant legislation has been adopted so that the premium model for renewables can be put into practice. This model was formally adopted in 2016, replacing the feed-in tariff scheme. However, to date, the project pipeline has not been very strong due to administrative, financial and legislative barriers. By the end of 2020 all relevant acts were aligned with each other, with the main change being the definition of quotas for premiums in May 2020. The authorities expect a significant increase in renewable projects in the coming years. The planned capacity of renewable projects to be tendered amounts to 2.3 GW, a significant amount compared with the 4.8 GW of installed capacity at the end of 2019.

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The New Foreigners Act includes a number of changes to employment regulation. Under the Act, which came into effect in January 2021, the government will no longer determine the annual quota of employment permits for foreigners. Employers will have to request the relevant labour market standard from the Croatian Employment Service before applying for residency and a work permit for foreigners. This aims to ease labour shortages, which are expected to increase once the economy fully recovers from the Covid-19 crisis. Croatia also introduced a scheme to attract so-called "digital nomads".

Further tax cuts have come into force in 2021. Given the plan in place to ease the tax burden since 2016, which resulted in four rounds of tax adjustments, this year the income tax rate has been lowered from 24 per cent to 20 per cent and from 36 per cent to 30 per cent for the higher bracket. The tax rate for small and medium-sized enterprises has been lowered from 12 to 10 per cent. These tax cuts are expected to support the recovery of private consumption in the short term.

Construction of the Krk LNG terminal is complete. The floating terminal started operations in January 2021, with the entire capacity of 2.6 billion cubic meters fully booked for the next three years. The facility is poised to balance the energy needs of Croatia and its neighbours in light of the accelerated green transition, with gas being viewed as a transition fuel from coal.

CZECH REPUBLIC

Highlights

- **The economy has bounced back strongly after a significant decline in 2020.** Export-oriented industries and a rise in demand contributed to a robust recovery in the first half of 2021, while employment has remained stable.
- **The European Union (EU)'s Recovery and Resilience Facility (RRF) plan includes major infrastructure projects but also emphasises the need for reform.** Under the national plan, 42 per cent of the €7 billion plan will be invested into green transition and 22 per cent into digital transformation.
- **Progressive income taxation was reintroduced.** The government abandoned the concept of "super-gross salary" and a flat tax rate. It has shifted to a more employee-friendly system of taxing gross income with two tax rates of 15 and 23 per cent, while the annual personal tax deduction was increased.

Key priorities for 2022

- **The green transition requires concrete steps in the direction of renewable energy.** Reducing the share of the coal industry presents a challenge for certain industrialised regions. Concrete actions are needed to further increase energy use from renewable sources, especially solar, by using Modernisation and Just Transition Funds.
- **Productivity and innovation capacities of the small and medium-sized enterprise (SME) sector should be addressed.** The government's post-crisis response should further focus on supporting productivity in the SME sector through upskilling and promoting digitalisation. A focus should be put on higher value-added research and development investment, which can broaden innovation capacities.
- **The government should emphasise investments in infrastructure and connectivity.** The Czech Republic, which will hold the EU presidency in the second half of 2022, should leverage the country's export-oriented industry, with an emphasis on promoting interconnection, modernising infrastructure and developing trans-European transport networks.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	5.2	3.2	3.0	-5.8	3.4
Inflation (average)	2.5	2.1	2.8	3.3	2.7
Government balance/GDP	1.5	0.9	0.3	-5.6	-8.0
Current account balance/GDP	1.5	0.4	0.3	3.6	1.6
Net FDI/GDP [neg. sign = inflows]	-0.9	-0.9	-2.4	-1.3	-1.2
External debt/GDP	88.0	81.3	76.5	76.1	n.a.
Gross reserves/GDP	63.4	59.0	59.1	62.9	n.a.
Credit to private sector/GDP	51.8	50.7	50.3	53.1	n.a.

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Covid-19: macroeconomic implications

Export-oriented industries have triggered a swift recovery of gross domestic product (GDP) growth in 2021. Despite a stable and competitive economy, the Covid-19 pandemic had a strong negative impact on GDP, which fell 5.8 per cent in 2020, representing the largest economic downturn in the country's history. Export-oriented industries, however, started driving growth in the third quarter of 2020, and GDP in the first half of 2021 increased by 3 per cent year-on-year. Prolonged containment measures at the beginning of 2021 slowed the improvement of household consumption, but investment growth has contributed significantly to the recovery. By the middle of 2021, industrial production had reached its pre-crisis level, although the automotive sector currently faces global shortages of parts and materials, which affect the continuation of production. The tourism sector has experienced a slow recovery, as expressed by the volume of tourist visits in the first half of 2021, which reached only a third of the level of the same period in 2019.

The employment rate remained stable throughout the crisis, while wages are set to grow. The unemployment rate reached 2.6 per cent in 2020 and increased to 3.2 per cent in the second quarter of 2021, due in part to intensified anti-pandemic measures. This remains one of the lowest unemployment rates in the EU. Nominal wage growth was 3.2 per cent year-on-year in the first quarter of 2021 and is set to grow further. In part, this can be attributed to a deficit in skilled workers. Among other factors, higher energy prices, wage pressures and pent-up demand influenced the rise in inflation, which exceeded 4 per cent year-on-year in September 2021. The Czech National Bank increased the main interest rate to 1.5 per cent in October 2021 in the biggest rate hike since 1997.

Fiscal expenditures continue to grow. To overcome the impact of the recession, the general government deficit in 2020 reached 5.6 per cent of GDP, staying slightly below the EU average. Public debt increased to 37.7 per cent of GDP, below most neighbouring peers. The fiscal deficit is likely to remain elevated in the short term. Public finances will be under additional pressure from the unreformed "pay-as-you-go" pension system.

GDP is expected to continue to grow in the short term. Assuming a further improvement in the pandemic situation, the economy should continue to recover. The main driver of growth will be increased consumer demand and higher investment, especially in the automotive sector, as well as the effective use of EU funds in the short and medium term. Consequently, the European Bank for Reconstruction and Development (EBRD) projects GDP growth of 3.4 per cent in 2021 and 4.6 per cent in 2022. The impact of global supply chain disruptions, the possibly incomplete implementation of the RRF and uncertainty surrounding potential new Covid-19-related measures constitute the main downside risks to the otherwise favourable outlook.

Policy response to Covid-19

The policy response in 2020 successfully supported employment retention. The government's Covid-19 response in 2020 provided around 5.4 per cent of GDP to support employment, the self-employed and specific sectors through compensation, bonuses and financial support. The total amount of guarantees and loans reached approximately 15 per cent of GDP. A total of 1.2 per cent of GDP was spent on support to the health sector.

The 2021 budget envisages an increased fiscal gap. The budget continues to support sectors affected by the pandemic through wage compensation. Along with decreasing personal income tax rates and other tax changes (see below), the government wants to boost economic activity. The period for submitting tax refund applications has been extended and the employment support fund has been increased by more than 60 per cent. In addition to the budget measures in February 2021, bonuses were added for health and social care employees, and entrepreneurs were offered two additional support programmes. The impact of these measures could result in a fiscal gap in 2021 of 8.5 per cent of GDP, according to the Finance Ministry. In August 2021 the Czech National Bank increased the policy rate by 25 basis points to 0.75 per cent.

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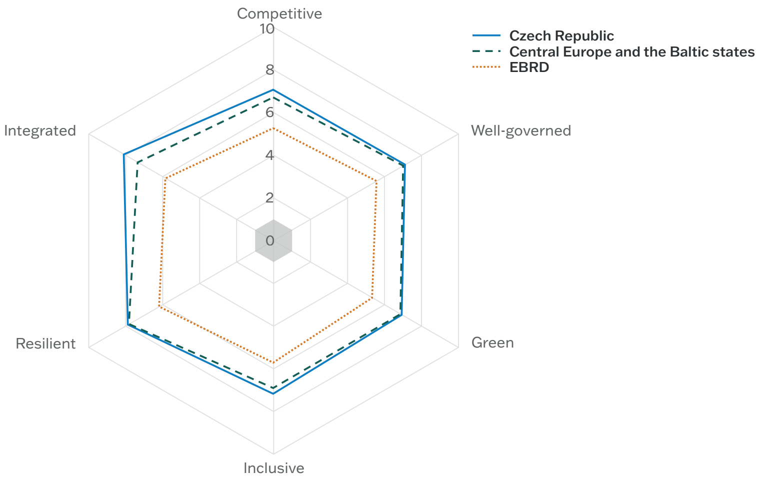
Assessment of transition qualities (1-10)



Structural reform developments

The government’s RRF plan of €7 billion in grants involves a commitment to strengthen reform capacity. The national plan is based on six pillars, with a focus on green transition and digitalisation. Investments in physical railway infrastructure, building renovation and a transition towards clean energy are followed by the digital transition, which envisages the development of a high-speed internet network and an increase in the public administration’s digital capacity. Significant reforms will be dedicated to anti-corruption legislation, support of public investment and creating new financial opportunities for entrepreneurs through the national development bank. More efficient government services will be crucial to the timely selection and implementation of projects that are eligible for financing.

“Kurzarbeit” was introduced to further support employment. This short-time work scheme, introduced in July 2021 as an amendment to the Employment Act, provides state support for reduced-scale employment caused by unexpected events. Employers will be able to use the measure for a maximum of 12 months and 80 per cent of the employee’s salary will be compensated.

The government has reintroduced progressive income taxation. According to the new income tax rules, from the beginning of 2021, two tax rates apply on all income types – 15 per cent on income up to CZK 1.7 million (€67,000) annually and 23 per cent for income above this amount. In addition, the basic annual personal tax deduction has been increased to the average wage for the prior calendar year and the real estate acquisition tax has been eliminated.

An amendment to the Act on the Czech National Bank (CNB) increased the scope of its monetary policy. With the accepted amendment from March 2021, the Senate allowed the CNB to temporarily execute open market operations with all participants in the financial market. With a wider range of financial instruments at the CNB’s disposal, also with maturities of more than one year, these measures are likely to strengthen the country’s financial markets.

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Foreign direct investment (FDI) is subject to stronger supervision. According to the newly introduced FDI control regime, from May 2021, potential risk capital flows will be monitored. More specifically, any foreign investor wanting to acquire at least a 10 per cent share in a company in the Czech Republic will be subject to further supervision by national regulators. Depending on the type of investment, supervision will be exercised by different national regulators.

A new strategy for supporting SMEs has been approved. The strategy, adopted in March 2021, aims to improve the business environment for SMEs for the period 2021-27. Along with facilitating access to finance and the market, aligning market needs with the education system and a broad digitalisation effort, the strategy includes 107 measures that will promote the efficient development of SMEs.

A new reserve fund will be used to cover unforeseen costs in the South Moravian Region, which was affected by a tornado in June 2021. With an amount of approximately €0.8 million, the government supported the initial costs associated with the natural disaster. The compensation for entrepreneurs includes an interest-free loan of up to approximately €1.7 million, as well as subsidies of up to approximately €40,000 for the reconstruction of fixed assets destroyed in the tornado. Subsidies for rebuilding homes amount to approximately €79,000 per household and loans with low interest rates are also planned.

ESTONIA

Highlights

- **After the 2020 recession, gross domestic product (GDP) has rebounded strongly in 2021.** A significant relaxation of anti-Covid-19 pandemic measures in the middle of 2021 has accompanied strong economic growth during the year and a return to the pre-pandemic level of output.
- **The government is prioritising green transition and broad digitalisation.** In addition to investing in digital public services and strengthening research and development as part of the €1 billion plan financed by the European Union (EU)'s Recovery and Resilience Facility (RRF), the government is investing in a green fund for enterprises. The fund will provide additional support to companies that develop green technologies.
- **Guarantees to boost exports have been increased.** The volume of export guarantees offered by the state financial aid fund KredEx has been raised from the current €192 million to €400 million, giving Estonian companies additional support in reaching foreign markets.

Key priorities for 2022

- **The anti-money laundering/combating the financing of terrorism (AML/CFT) framework should be continuously strengthened.** Given the growing number of fintech companies and virtual currency providers registered in Estonia, supervisors in financial regulation should ensure the continued implementation and compliance with the AML/CFT agenda.
- **Reducing skills shortages and gender pay disparities remains a priority.** Active labour market policies such as re-training should raise the employability of workers with lower education. Further improvements in childcare services and removing "glass ceilings" should create a favourable economic environment for reducing the gender pay gap.
- **Exiting from oil shale electricity should be prioritised.** Concrete steps need to be taken to further diversify energy sources by increasing Estonia's links with the European electricity grid, strengthening renewables and encouraging the development of alternative economic sectors to oil shale-dependent areas.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	5.8	4.1	4.1	-3.0	9.0
Inflation (average)	3.7	3.4	2.3	-0.6	3.5
Government balance/GDP	-0.5	-0.6	0.1	-5.6	-2.9
Current account balance/GDP	2.3	0.8	2.5	-0.3	-1.8
Net FDI/GDP [neg. sign = inflows]	-3.9	-4.8	-3.9	-10.4	-7.5
External debt/GDP	83.4	78.2	76.3	91.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	64.4	62.6	60.2	65.2	n.a.

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Covid-19: macroeconomic implications

After the downturn in 2020, the economy is recovering solidly in 2021. GDP in 2020 contracted by 3.0 per cent, less sharply than the EU average. Due to the recovery of exports and investments and expanded government spending, GDP growth reached 8.5 per cent year-on-year in the first half of 2021. The increase in private consumption was also boosted by accumulated savings, while disposable income is expected to grow further due to the ongoing pension reform. Industrial production in the second quarter of 2021 increased by 3.2 per cent quarter-on-quarter and has already returned to 2019 levels. Significant growth in exports, primarily to Finland and Sweden, was noticeable in the first half of 2021 in the production of mineral oils, wood and electrical equipment. In contrast to most EU countries, Estonia recorded positive retail trade turnover year-on-year throughout 2020, which has continued in 2021.

The labour market has still not fully recovered from the Covid-19 crisis but a rebound in labour demand is supporting wage growth. The Covid-19 pandemic led to higher unemployment, which peaked at 7.7 per cent in the third quarter of 2020, falling to 6.9 per cent in the second quarter of 2021, still above the pre-crisis level. An increase in labour demand contributed to a 7.3 per cent year-on-year rise in the average wage in the second quarter of 2021. Together with the strengthening of economic activities, wage growth has contributed to inflationary pressures, with annual inflation reaching 6.4 per cent in September 2021.

The fiscal deficit has widened due to Covid-19-related expenditures. The general government deficit in 2020 reached 5.6 per cent of GDP and the gross debt level increased to 19 per cent of GDP, from 8.6 per cent in 2019. Contrary to expectations, the first half of 2021 was marked by a decrease in the total expenditure of state budget institutions, because fewer subsidies to the economy were needed and state payments to the second pension pillar are still suspended. Nevertheless, the deficit is still expected to exceed 6 per cent of GDP in 2021 before falling in 2022.

GDP growth is expected to continue to rebound strongly in the short term. Amid higher government expenditures, household consumption improved substantially and this trend is expected to gain in magnitude in the coming quarters. Household disposable income jumped by nearly €1 billion due to a withdrawal of the second pension pillar in September 2021. EU funds, including from the RRF, are expected to further boost investment, especially in infrastructure. Overall, GDP growth is forecast to reach 9.0 per cent this year, before slowing to 4.0 per cent in 2022.

Policy response to Covid-19

A supplement to the 2021 budget aims to mitigate some of the crisis effects. In March 2021 parliament approved a bill for a €641 million supplementary budget, similar to a measure taken a year previously. According to the government's plan, additional costs in the health sector, such as the need for further medical facilities, Covid-19 testing and vaccinations, will be covered by an additional €150 million. To support employment and education and to reduce social exclusion, subsidies continue to be paid to partly cover labour costs if employees' working hours or wages have been reduced. As part of the additional budget from 2020 remained unspent, a decision was made that those subsidies could be used until the end of 2021.

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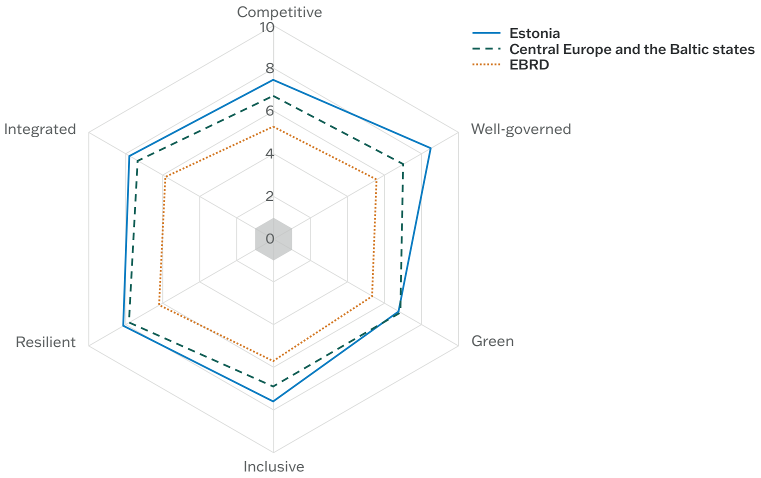
Assessment of transition qualities (1-10)



Structural reform developments

The "Estonia 2035" action plan was approved. With this action plan, which the government approved in October 2020, a long-term development strategy is now in place for the next 15 years. In addition to regaining competitiveness, the emphasis is placed on five areas: people (increasing labour market participation and lifelong learning); society (reducing relative poverty and promoting inclusion); economy (investing in research and development and a favourable business environment); living environment (promoting safe living and overall well-being); and governance (promoting efficiency of public services and participation in decision-making).

Estonia will receive €1 billion from the RRF. The requested allocation should enhance post-Covid-19 pandemic recovery by supporting green transition and digital capacities, primarily e-services, accompanied by investments in infrastructure, energy efficiency renovation and the decarbonisation of public transport. The goal of the envisaged reforms and investments is to achieve balanced regional development and make economic growth more resilient to future crises.

Estonia and Finland signed a memorandum of understanding in the area of infrastructure. The agreement, signed in April 2021, promotes the integration of the two Baltic countries through projects such as Rail Baltica, the Helsinki-Tallinn Tunnel, the Trans-European Transport Network and the North Sea-Baltic Corridor. A joint Helsinki-Tallinn Tunnel working group is being relaunched to make the proposed tunnel eligible for EU funding via the Trans-European Transport Network programme.

A new state budget strategy for 2022-25 will lead to higher investment. In April 2021 the government approved a new strategy to decrease the expenditure of ministries by 5 per cent, with savings used to support government sector investments of at least €2 billion a year, as well as to make the budget more transparent and easier to understand. Among other measures, the budget approval process will be shortened from two to one budgetary negotiation per year.

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The government has announced an exit from oil shale electricity but implementation details remain unclear. The government declared two phase-out dates: exiting oil shale electricity by 2035 and shale oil production by 2040 at the latest. However, details on the alternatives remain to be fully developed. An amount of €340 million from the EU's Just Transition Fund for the period 2021-27 will be mostly allocated to the north-eastern Ida-Viru region, which has relied strongly on the oil shale sector, in order to facilitate its economic diversification.

The Estonian start-up economy recorded strong growth despite the Covid-19 pandemic. According to data for the first quarter of 2021, the overall turnover of Estonian start-ups increased by 26 per cent year-on-year following a recovery of business activities shortly after the Covid-19 pandemic started. Start-ups are mainly concentrated in the IT software and services industry, product development and financial technology. They can profit from favourable loans and subsidies provided by the "Startup Estonia" state programme, which has been cooperating with the state financial aid fund KredEx since 2016.

HUNGARY

Highlights

- **Gross domestic product (GDP) is recovering steadily.** Following a decline in GDP of 4.7 per cent in 2020, the export-oriented sectors and a gradual easing of epidemiological measures have propelled a vibrant economic recovery in 2021.
- **The European Union (EU)'s Recovery and Resilience Facility (RRF) plan envisions investment to strengthen competitiveness and promote green transition.** The national plan is worth €7.2 billion in grants. Investment in its five strategic areas (green transition, healthcare, research, digital, and cohesion and public administration) will be important in supporting the country's economic recovery. The European Commission has still not approved Hungary's RRF plan, so the government is pre-financing its RRF programmes.
- **The issuance of forint-denominated green government bonds has been welcomed by the market.** The first issue of a 30-year forint-denominated green bond met strong investor demand.

Key priorities for 2022

- **Fiscal policy needs to remain supportive and targeted.** Government support for the labour market and certain sectors should continue, to assist the recovery until all Covid-19 restrictions are lifted. Measures should then be oriented towards strengthening the innovation capacity of small and medium-sized enterprises (SMEs) and employability through upskilling.
- **For EU funds to be properly absorbed and the RRF to be implemented successfully, there needs to be enhanced reform capacity and political will, including with regard to the rule of law.** Hungary has been allocated €38 billion of cohesion, regional development and other EU funds, while the RRF national plan envisages €7.2 billion in grants – all EU funds to be used up until 2027.
- **Policies that address skills shortages and improve inclusivity would strengthen and make better use of labour supply.** Policies that embrace diversity and inclusion practices, including for the LGBT+ community, and better migrant job matching could attract and retain talent, such as in the tech and creative industries.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	4.3	5.4	4.6	-4.7	7.7
Inflation (average)	2.4	2.9	3.4	3.4	5.0
Government balance/GDP	-2.5	-2.1	-2.1	-8.0	-6.6
Current account balance/GDP	2.0	0.2	-0.7	-1.6	0.6
Net FDI/GDP [neg. sign = inflows]	-1.6	-1.9	-0.5	-1.6	-0.8
External debt/GDP	83.3	79.8	73.6	83.6	n.a.
Gross reserves/GDP	19.5	19.6	19.5	25.6	n.a.
Credit to private sector/GDP	64.4	62.6	60.2	65.2	n.a.

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Covid-19: macroeconomic implications

A substantial recovery in exports has boosted GDP growth. Being an open and export-oriented economy, the Covid-19 pandemic hit the Hungarian economy hard, with a drop in GDP of 4.7 per cent in 2020. The recovery of industry and exports, especially in the automotive sector, in the first half of 2021 led to GDP growth of 7.6 per cent year-on-year, bringing the level of GDP above pre-crisis levels. The industrial sector began to recover at the end of 2020 and its production is also above pre-pandemic levels, with the highest growth rate in the manufacturing sector. However, the Hungarian automotive sector, which generates almost 15 per cent of Hungary's GDP (including suppliers), has been facing a global semiconductor shortage, which has hampered production. Despite that, economic confidence indicators have been recovering solidly since February 2021 and a large investment by Mercedes-Benz and BMW in electric-vehicle production continues.

Unemployment remains below the regional average, while wage pressure is building. With restrictive measures still partially in place, especially in the services sector, the unemployment rate did not change significantly during the Covid-19 pandemic, reaching 4.1 per cent in the second quarter of 2021, below the average for central Europe and the Baltic states (CEB). As the economy recovers, real wage growth is set to increase further, from 6.2 per cent in 2020, underpinned by a lack of skilled workers. Due to further pressure on wages, higher energy prices and demand recovery, inflation could exceed 5 per cent in 2021.

The fiscal deficit rose sharply. On account of the government's fiscal stimulus during the Covid-19 pandemic, the general government deficit totalled 8.0 per cent of GDP in 2020, exceeding that of all other CEB economies. Public debt increased to a relatively high 80.1 per cent of GDP. These ratios are likely to remain elevated in the short term.

Strong growth will continue, but higher energy prices and global shortages of components and chips are risk factors. GDP growth is expected to remain strong throughout 2021, at 7.7 per cent, before slowing to 4.8 in 2022. The post-crisis recovery is likely to be boosted by investment, co-financed by EU funds. While Hungary is still waiting for the European Commission to approve the RRF, the government has sold the equivalent of €4.5 billion in Eurobonds to pre-finance RRF projects. As higher energy prices and global shortages hamstring the manufacturing sector, however, especially automotive companies, this is likely to weigh on Hungary's exports in the short term.

Policy response to Covid-19

The policy response in 2020 alleviated some of the Covid-19 pandemic's negative effects. The government's overall response to the crisis was wide ranging. Through the newly established anti-epidemic fund, the increased needs of the health sector were addressed, while the Economic Protection Fund provided support for the labour market, businesses and households. The overall size of the fiscal response was around 12 per cent of GDP.

The 2021 budget assumes continued support for the economy. The budget envisions continued support for employment and subsidies for wages in vulnerable sectors. In December 2020, part of the central budget, amounting to 2 per cent of GDP, was transferred to public-sector institutions and the remaining funds can be used throughout 2021. A general reduction in social-security contributions has been ongoing and, as a part of the new family care plan, families with children can benefit from duty exemptions when purchasing residential properties, as well as from a one-off income tax rebate for 2021.

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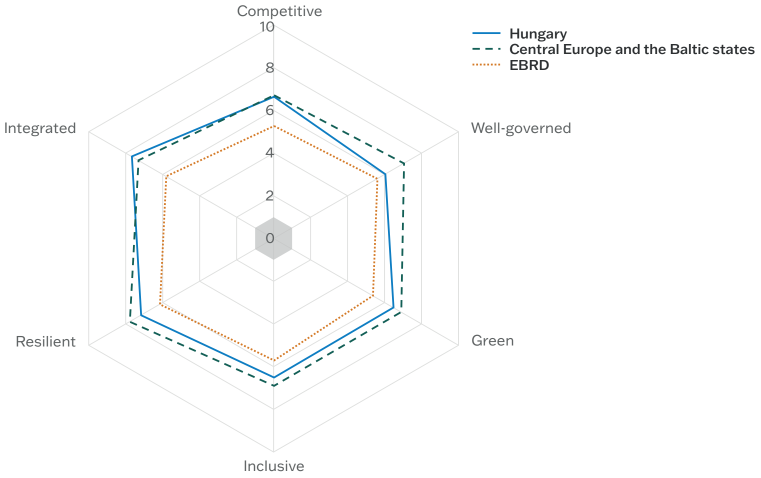
Assessment of transition qualities (1-10)



Structural reform developments

The government's plan for the use of RRF funds will support further economic transformation. The national plan, worth €7.2 billion in grants, is based on five pillars: green transition, healthcare, research, digitalisation, and cohesion and public administration. The government decided not to use loan financing under the RRF, but to limit it to grants. To address the country-specific recommendations of the European Commission, the national plan foresees a digital upgrade to the prosecution service, fewer informal payments in the health sector and an improved legal framework for public procurement.

The government has introduced new measures to support investment. To facilitate larger investments, the government is adding more regions where investments of more than €5 million will receive state support. With regard to research and development, investments worth more than €1 million (up from €3 million previously) will be considered for additional support. From 2021, medium-sized enterprises with an investment value of at least HUF 300 million (equivalent to around €0.8 million) will be eligible for development tax incentives. Lastly, foreign-owned companies can now employ up to 20 per cent non-residents, rather than 10 per cent.

The central bank embarked on a monetary tightening cycle to control inflation. Rising inflation, brought about by the economic recovery and global market disruption, prompted the National Bank of Hungary (NBH) to raise the central bank base rate already five times since mid-2021, from 0.6 per cent to 1.8 per cent in October 2021. The monetary tightening cycle is likely to continue until the inflation rate stabilises within the NBH's target range of 2 per cent to 4 per cent.

The authorities started to issue forint-denominated green bonds. The first issue of a 30-year forint-denominated green bond took place in April 2021. Registering high demand and with an average yield of 3.69 per cent – a percentage point above its usual 10-year bonds – primary dealers' bids reached HUF 30 billion (€86.1 million equivalent). The second issue was in July 2021 and Hungary will continue to issue quarterly to fund green transition projects, such as a more energy-efficient railway. In addition, the central bank announced the launch of a green mortgage bond-buying programme and green loans from October 2021.

CONTINUES

The state is bidding for majority ownership of the airport in Budapest. Sixteen years after privatisation, the government submitted a bid in July 2021 to retake majority ownership of the airport. Currently, the biggest shareholder in Budapest Airport, with a 55 per cent stake, is AviAlliance. The offer was self-initiated and the government claims it is in the country's strategic interest.

The government is advocating regional cooperation projects within the Visegrad Group (V4). From the beginning of July 2021, Hungary chairs the V4. As a goal of its presidency, the country is emphasising regional cooperation in the field of financial regulation, with a focus on fintech and digitalisation. Regional integration will be further promoted through working group meetings on V4 high-speed rail links and negotiations to finance the project with EU funding.

LATVIA

Highlights

- **The economy is recovering after a moderate decline in 2020.** Following a gross domestic product (GDP) drop of 3.6 per cent in 2020, the economy has started a solid recovery in 2021 towards pre-Covid-19 crisis levels, mainly due to improvements in the manufacturing and services sectors.
- **The European Union (EU)'s Recovery and Resilience Facility (RRF) plan for Latvia reflects the government's reform priority areas.** The €1.8 billion plan foresees not only investments to improve energy efficiency and sustainable mobility, but also a broad digital transformation of business and administration, along with reduced regional socio-economic disparities.
- **The Economic Affairs Court has been established to help improve the business environment and reduce the shadow economy.** The newly constituted court, which began operating in March 2021, is the first specialised court in Latvia with jurisdiction including certain civil matters and economic, financial and corruption cases.

Key priorities for 2022

- **A strategy to sustainably reduce the fiscal deficit is needed.** Following recovery from the Covid-19 crisis, the level of general government debt should not exceed 50 per cent of GDP. However, the medium-term strategy of a return to budgetary prudence should not be at the expense of important planned investments in key sectors.
- **Further strengthening of absorptive capacities is needed for successful RRF implementation.** Along with the structural reforms and proposed implementation plan, it is necessary to improve the public expenditure process and continue with advancing public procurement transparency to absorb the funds effectively.
- **The government should continue to promote innovation.** The innovation capacity of the private sector should be strengthened by targeted policy incentives, such as increasing digital capacities or facilitating access to capital markets.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.3	4.0	2.5	-3.6	4.5
Inflation (average)	2.9	2.6	2.7	0.1	2.4
Government balance/GDP	-0.8	-0.8	-0.6	-4.5	-8.6
Current account balance/GDP	0.7	-0.3	-0.6	2.9	-1.0
Net FDI/GDP [neg. sign = inflows]	-2.0	-2.2	-2.9	-2.2	-1.7
External debt/GDP	142.3	123.7	117.7	125.4	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	43.5	38.0	36.6	35.6	n.a.

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Covid-19: macroeconomic implications

The first half of 2021 saw a recovery in economic activity. Latvia recorded a milder GDP decline in 2020 than the EU average. The effects of the Covid-19 pandemic were mitigated by stable exports to Nordic trading partner countries and the country's relatively limited dependence on tourism. Intensified containment measures at the end of 2020 slowed the economy, but the recovery of the manufacturing and services sectors, as well as consumption, in the second quarter of 2021 contributed to GDP growth in the first half of the year of 5.2 per cent year-on-year. In the second quarter of 2021 industrial production increased by 2.4 per cent quarter-on-quarter, surpassing pre-Covid-19 crisis levels, while the manufacturing and energy sectors have been recovering from the beginning of the year. An additional positive signal comes from data on retail trade turnover, which from May 2021 exceeded comparable 2019 levels.

The labour market still shows the impact of the Covid-19 pandemic, but wages are rising. The unemployment rate peaked at 8.8 per cent in July 2020, falling marginally to 7.9 per cent by the second quarter of 2021. The real growth of the average wage in 2020 amounted to 9.0 per cent, and the increase in the minimum wage from the beginning of 2021 and the recovery of economic activities is contributing to further wage growth and inflationary pressures.

To stimulate economic recovery, the fiscal deficit is likely to remain elevated this year. Due to the temporary support measures introduced when the Covid-19 pandemic struck, the general government deficit in 2020 reached 4.5 per cent of GDP, interrupting a track record of budgetary prudence in recent years. The gross public debt level increased to 43.2 per cent of GDP, above the relatively stable pre-Covid-19 crisis level of 37.0 per cent of GDP. As the government still needs to allocate additional expenditures for economic recovery in 2021, the fiscal deficit is likely to be close to 9.0 per cent of GDP in 2021 before declining sharply in 2022.

Short-term growth prospects are favourable, but vaccine hesitancy is a risk. EU funds, especially through public sector investments, are likely to add to the GDP growth rate in 2021, which is expected to be 4.5 per cent. In 2022, GDP growth is likely to accelerate to 5.5 per cent. However, compared with the EU average, Latvia was relatively resistant to vaccination against Covid-19, but the vaccination rate improved by the end of October, with 62 per cent of people receiving at least one dose of the jab. A lack of herd immunity creates a risk of new lockdowns, as temporarily reintroduced in October 2021, aggravated by potential new variants of the virus.

Policy response to Covid-19

The government's policy response to Covid-19 prevented major disruptions to the economy. With stimulus packages implemented in 2020 that amounted to around 7 per cent of GDP, Latvia has managed to support its health system and compensate for losses in vulnerable sectors, for example, through coverage of 75 per cent of the cost of workers' downtime. Most support was directed towards loans and guarantees for businesses. Due to market shocks, the European Central Bank and Latvia's financial sector supervisor granted banks forbearance measures; using liquidity and capital buffers, banks could therefore support businesses and households through the Covid-19 pandemic. A loan payment moratorium up to 12 months for firms and individuals was valid until the end of 2020.

The 2021 budget is providing further support for the post-Covid-19 recovery. In December 2020 parliament adopted the 2021 budget, which assumed a €744 million increase in expenditures compared with 2019. The largest share of increased budgetary funding has been directed to healthcare, including increased wages for healthcare workers, a guaranteed minimum income and an increase in the minimum pension and state social insurance benefit. Following a budget revision in the middle of 2021, the Finance Ministry now expects the budget deficit to be smaller than expected.

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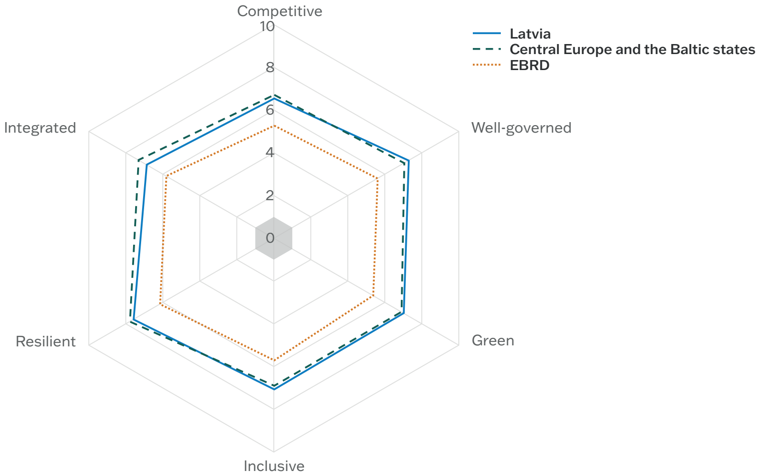
Assessment of transition qualities (1-10)



Structural reform developments

The RRF is targeting the green and digital transitions. More than half of the €1.8 billion allocation is dedicated to two priority areas: green transition (38 per cent of total funds), including the electrification of public transport and investments in energy efficiency and renewables, and digital transition (21 per cent), including the digitalisation of public administration and fostering a rising level of digital skills. Additional actions will address productivity and research and development investments, which are below the EU average. Further upskilling of the administration will be needed to maximise funds absorption.

An 18-month programme to improve the insolvency framework was completed in March 2021. Through improving the insolvency framework and debt restructuring, the Ministry of Justice, in cooperation with the European Commission and the European Bank for Reconstruction and Development (EBRD), has issued guidelines for identifying and managing the financial difficulties of corporates. Targeted at small and medium-sized enterprises, the aim is to increase their resilience and encourage timely reactions before insolvency.

Latvia has confirmed its credibility in the financial markets despite the impact of the Covid-19 pandemic. The relatively moderate GDP contraction in 2020 and the sustainable debt burden have given the country a stable credit rating and the prospect of favourable borrowing. In March 2021 the government issued a €1.25 billion 10-year Eurobond, with a zero coupon and yield of 0.105 per cent, the lowest coupon level of Latvian debt security issuance. In addition, in June 2021, the government issued a €500 million seven-year Eurobond, also with a zero coupon, and a yield of 0.003 per cent.

The newly established Economic Affairs Court began operating in March 2021. The new court has been set up to improve the quality of judicial institutions and address the shadow economy. Specifically, the court will expedite the resolution of commercial disputes, investigate financial fraud and resolve issues of company law, investor dispute and competition law. The establishment of the court is a continuation of work to prevent money laundering and financial crime. More concrete and closer cooperation with the United States of America in this area started after a bilateral cooperation agreement was signed in November 2020.

CONTINUES

The parliament adopted a covered bond law in May 2021. With covered bonds, Latvia will be able to get a source of long-term, secure and low-risk funding, as well as strengthen its competitiveness and regional integration. The legal part was financed through the EU Structural Reform Support Programme and supported by the EBRD.

The tax changes package introduced in 2021 should mitigate the effects of the Covid-19 crisis. To support business activities, a 30-day deadline for value added tax (VAT) overpayment refunds was introduced. Employers were given the opportunity to compensate employees for expenses related to remote working, and social insurance rates were reduced by 0.5 per cent for both employers and employees. Concerning personal income tax, the income threshold was increased from €1,200 to €1,800, up to which the non-taxable amount applies. After three years, the monthly minimum wage was raised from €430 to €500, still among the lowest in the EU (adjusted for purchasing power standards).

LITHUANIA

Highlights

- **The economy has returned to its pre-Covid-19 crisis level.** Stable goods exports and a fast recovery in consumption meant that gross domestic product (GDP) in 2020 was similar to 2019 levels. A swift improvement in industry contributed to a broad recovery in the first half of 2021.
- **Developing wind and solar energy plants and rising digitalisation stand out as main priorities in the government's recovery plan.** It is projected that 38 per cent of the €2.2 billion plan, financed through the European Union (EU)'s Recovery and Resilience Facility (RRF), will be invested in clean energy and an increasing share of energy efficient transport. A broader high-speed internet network will support an increase in digitalisation.
- **The government introduced new incentives for scaling up investments.** To strengthen competitiveness, special tax-exempt conditions, including a corporate tax exemption for a period of up to 20 years, will be offered to large-scale investors in strategic business areas, such as the manufacturing, information and communication technology (ICT) and science sectors.

Key priorities for 2022

- **Social and labour disparities should be better addressed.** Priorities include further investment in education in rural regions, re-training and increasing digital services and teleworking.
- **Energy sustainability needs further strengthening.** Following the need to increase the domestic production of electricity, important aspects of the country's energy strategy include implementing the announced offshore wind farms in the Baltic Sea and promoting renewable energy sources.
- **The five-year development plan for the fintech sector should be implemented vigorously.** After a steadily growing number of licences for electronic money institutions, the Ministry of Finance has announced the creation of a development plan for the fintech sector. Successful implementation could attract new investment and strengthen competencies in supervisory institutions, with an emphasis on anti-money laundering and counter-terrorist financing by strengthening governance, internal controls and the compliance culture.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	4.3	4.0	4.6	-0.1	4.5
Inflation (average)	3.7	2.5	2.2	1.1	3.0
Government balance/GDP	0.4	0.5	0.5	-7.2	-5.2
Current account balance/GDP	0.5	0.3	3.5	7.3	6.7
Net FDI/GDP [neg. sign = inflows]	-2.0	-0.5	-2.3	-1.1	-1.3
External debt/GDP	82.6	78.3	70.1	75.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	41.0	40.5	39.6	37.8	n.a.

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Covid-19: macroeconomic implications

After one of the mildest GDP downturns in the EU in 2020, the economy is recovering strongly in 2021. Due to Lithuania's stable export sector and targeted government measures, annual GDP was similar to 2019 levels, with a decline of just 0.1 per cent in 2020. A recovery in domestic demand, together with the strengthening of manufacturing and exports, drove strong GDP growth of 5.0 per cent year-on-year in the first half of 2021. Industrial production in the second quarter of 2021 was also above the level seen in 2019. Retail trade turnover, which fell during 2020, has bounced back strongly.

A shortage of skilled labour contributed to higher wages and inflation. Unemployment reached 9.9 per cent in September 2020, falling to 7.2 per cent by August 2021 but still above pre-Covid-19 crisis levels. Labour market mismatches have led to a lack of skilled labour, putting a strong pressure on wages and contributing to an elevated inflation rate. However, the current sharp increase in annual inflation, which stood at 6.4 per cent in September 2021, is mostly driven by external factors.

After four consecutive years of surplus, the general government balance turned negative in 2020. Increased government expenditure, especially on social protection, healthcare and subsidies, contributed to a general government deficit of 7.2 per cent of GDP in 2020. Public debt increased to 46.6 per cent of GDP as of the end of 2020, versus 35.9 per cent in 2019. As the economy and tax revenues are growing again, the government plans to increase its expenditure, with additional funds allocated to social protection and government sector wage increases. The government aims to return to a balanced budget in the medium term, projecting a 0.5 per cent of GDP deficit in 2024.

Investment is likely to support the economic recovery. GDP growth is likely to reach 4.5 per cent this year, boosted by accelerated public sector investment, and to slow somewhat to 4.0 per cent in 2022. However, exports, especially of services, are likely to be further negatively affected by the sanctions placed on Belarus by the Office of Foreign Assets Control (OFAC) of the US Department of the Treasury in August 2021. About one-third of all freight at Lithuanian ports is from Belarus, in particular, potassium chloride, which is used in fertiliser production; its loss is estimated to cost Lithuania approximately 0.4 per cent of GDP.

Policy response to Covid-19

The government's policy response to Covid-19 has been comprehensive. With the fiscal support packages implemented in 2020, which accounted for around 6 per cent of GDP, Lithuania has managed to support the health system and compensate for most of the losses in affected sectors, such as the services sector. Employment was supported by job retention schemes, subsidised rates for enterprises and allowances for the self-employed. At the same time, vulnerable groups, such as pensioners, the unemployed and social benefit recipients, received a one-off payment of €200. A temporary deferral of credit obligations for private clients affected by the Covid-19 crisis remained in place until March 2021.

The 2021 budget has earmarked around €1.7 billion to support the post-Covid-19 crisis recovery. In December 2020 parliament adopted the 2021 budget, which included almost 6 per cent of GDP for the mitigation of Covid-19 pandemic effects and financial recovery support. The largest part of it was dedicated to subsidies during downtime and sickness for workers and the self-employed. Additional grants, soft loans and partial interest compensation were offered to crisis-affected companies, and funds for medical bonuses and the purchase of Covid-19 vaccines and tests and medical equipment were also provided. The national budget was revised in May 2021 and an additional €581 million was allocated to the healthcare sector and social security. In July 2021 the government issued a 30-year Eurobond worth €750 million, with the annual coupon set at 0.75 per cent.

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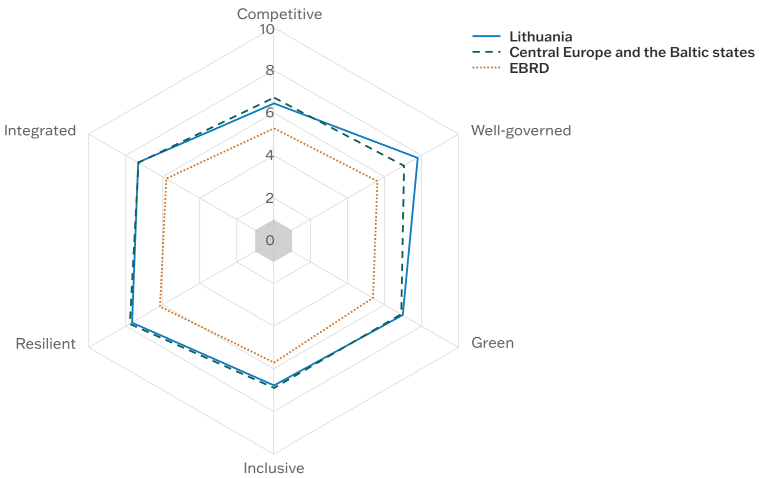
Assessment of transition qualities (1-10)



Structural reform developments

Lithuania's RRF plan aims to support long-term sustainable growth. It is projected that 38 per cent of the €2.2 billion in grants will be invested in meeting climate targets through developing offshore and onshore wind and solar power and storage facilities (€242 million), increasing the share of clean public transport from 9 to 18 per cent, and bringing about a 15-fold growth of charging points for electrical cars. Digitalisation will be additionally addressed through an allocation of €70 million for broadening the high-speed network and 5G development. Long-term challenges related to learning outcomes, vocational education and upskilling will be addressed with projects worth a combined €312 million.

The Centre of Excellence in Anti-Money Laundering has begun its work. As a model of public- and private-sector collaboration in identifying and managing the risks of money laundering, the Centre of Excellence in Anti-Money Laundering started its activities in May 2021. It was collectively established by the Ministry of Finance, the Bank of Lithuania and other commercial banks, with the aim of collecting, analysing and sharing information on types of money laundering and terrorist financing (ML/TF) typologies through a special information platform at the national level. The centre will work, among other priorities, on guidelines and policy proposals to tackle ML/TF activities, as well as organise training programmes and strengthen the competencies of the public and private sectors in the ML/TF field.

New measures to attract foreign direct investment (FDI) are in place. In April 2021 the government approved a comprehensive mechanism that will ease administrative procedures for investors. Large investors in manufacturing, ICT or data processing that create at least 150 jobs and invest €20 million in fixed assets outside of the capital city, or create 200 jobs and put €30 million in fixed assets in Vilnius, can benefit from a corporate tax exemption for 20 years.

Support to small and medium-sized enterprises (SMEs) has been stepped up. The SME sector accounts for 99.6 per cent of all enterprises and more than 70 per cent of total employees. With a growing share of micro enterprises, companies operate mostly in the trade and transport sectors. SMEs in Lithuania tend to use traditional funding measures and, according to a Bank of Lithuania survey in 2019, more than 50 per cent of SMEs were not satisfied with credit conditions and access to capital. Following the signing of two guarantee agreements with the European Investment Fund for a maximum of €50 million in April 2021, the financial intermediary PayRay Bank will be able to offer SME financing for a period of three months to 10 years, with a loan amount per entity of up to €6 million.

CONTINUES

The government adopted the Renovation Strategy 2050. Together with the long-term strategy Lithuania 2050, the authorities are targeting climate-neutral building renovation, while preserving biodiversity. In line with the country's green transition goals, the Lithuanian Public Investment Development Agency (VIPA) signed a €67.5 million loan with the European Bank for Reconstruction and Development (EBRD) in August 2021. It is expected that the energy efficiency of old residential buildings in Lithuania will increase by at least 40 per cent.

Energy security and sustainability stand high on the national and regional agenda. Together with Estonia and Latvia, Lithuania continues to integrate its power system into Continental Europe's. After European Energy began building a wind farm of 49.5 MW capacity in August 2021, the government approved legislation which will enable the development of a 700 MW offshore wind farm in the Baltic Sea, with a possible first tender in 2023. By 2030 the government plans to produce 70 per cent of the country's electricity needs domestically.

POLAND

Highlights

- **There has been a steady increase in economic activity in the first half of 2021.** The 2.5 per cent drop in gross domestic product (GDP) in 2020 was significantly lower than the European Union (EU) average and, since the beginning of 2021, investment growth and rising consumption have been driving a robust recovery.
- **Potentially one of the EU's largest Recovery and Resilience Facility (RRF) packages envisages major investment in energy transition and broad-based digitalisation.** The national plan is based on €23.9 billion in grants and €12.1 billion in loans and, in addition to the green and digital transition, it foresees strengthening health sector capacity and supporting businesses in their post-Covid-19 pandemic recovery. A legal dispute on rule-of-law reforms could postpone the roll-out of the RRF, however.
- **The energy policy strategy up to 2040 has been approved.** With an emphasis on renewable energy, it is projected that by 2040, coal's share of energy generation will be between 11 and 28 per cent, while larger cities should introduce zero-emission public transport by 2030.

Key priorities for 2022

- **High energy prices should be addressed in a market-friendly way.** While rising energy prices could provide greater incentives for energy efficiency investments, they directly affect households, especially those at risk of energy poverty. Instead of subsidising energy prices, cash transfers should be provided to the most vulnerable households.
- **The transparency of public finances needs to be improved.** While the Covid-19 pandemic triggered higher and more targeted government expenditure, including through off-balance-sheet special-purpose funds, such as those of Polish development bank BGK, budgetary transparency deteriorated sharply. Greater harmonisation of definitions with Eurostat, the EU's statistical office, would be a step forward.
- **Policies that address skills shortages and improve inclusivity would strengthen and make better use of the labour supply.** In regions dependent on the coal industry, increasing skills and targeted training would enable job transitions to the renewable energy projects announced in the national RRF plan. Policies that embrace diversity and inclusion practices, including for the LGBT+ community, and better migrant job matching could attract and retain talent, such as in the tech and creative industries.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	4.8	5.4	4.7	-2.5	4.9
Inflation (average)	1.6	1.2	2.1	3.7	4.7
Government balance/GDP	-1.5	-0.2	-0.7	-7.1	-4.2
Current account balance/GDP	-0.4	-1.3	0.5	2.9	2.3
Net FDI/GDP [neg. sign = inflows]	-1.4	-2.6	-2.0	-2.2	-1.1
External debt/GDP	67.0	64.2	58.8	60.6	n.a.
Gross reserves/GDP	21.4	19.9	21.5	25.8	n.a.
Credit to private sector/GDP	52.0	50.9	50.2	48.0	n.a.

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Covid-19: macroeconomic implications

The economy is growing robustly after the downturn in 2020. The Covid-19 pandemic had a relatively mild impact on the Polish economy, causing GDP to decline 2.5 per cent in 2020. Some recovery had already begun in the third quarter of 2020, but a moderate tightening of restrictive measures at the end of the year constrained GDP growth in the first quarter of 2021. After a pick-up in the second quarter, economic output increased by 4.6 per cent year-on-year in the first half of 2021, largely due to greater activity in the manufacturing sector. Restrictive measures did not significantly affect household consumption, which, along with imports of goods and services, registered a positive trend in the first half of 2021. Economic sentiment started to recover from February 2021. Industrial production so far in 2021 has exceeded pre-pandemic levels, with particularly strong activity in the automotive industry.

The labour market fallout from the pandemic was limited and wage pressures persist. The unemployment rate increased only slightly, to just 3.7 per cent, in the second quarter of 2021, with job losses limited by anti-pandemic measures. Wages are growing at a brisker clip once again, with nominal wage growth of 9.6 per cent year-on-year in the second quarter of 2021. The rise of economic activity and substantially higher energy and other utility prices has resulted in a rise in HICP inflation, to 5.6 per cent year-on-year in September 2021. In October 2021, to limit the risk of inflation staying above the central bank's target of 2.5 per cent (plus/minus 1 percentage point band) in the medium term, the Narodowy Bank Polski (NBP), the Polish central bank, increased interest rates and withdrew the bill discount credit.

Fiscal expenditure is increasing to support the economy. As a consequence of the government's comprehensive stimulus package, the general government deficit in 2020 reached 7.1 per cent of GDP, slightly above the EU average. Public debt increased to 57.4 per cent of GDP as of the end of 2020. A gradual decline in these numbers is projected in the coming years, supported by high nominal GDP growth.

Real interest rates remain negative amid persistently low financing costs and improving business sentiment, which should lead to further investment and GDP growth. Overall, GDP growth is forecast at 4.9 per cent and 4.8 per cent in 2021 and 2022, respectively. However, the delayed disbursement of the EU's RRF funds constitutes a negative risk to that scenario, especially for public-sector investment. According to the Finance Ministry, the RRF funds could add 0.4 percentage point to annual GDP growth. Another downside risk to the generally positive outlook is the population's relative reluctance to vaccinate against Covid-19, with only 53 per cent of people vaccinated as of mid-October 2021. This could lead to sporadic lockdowns this winter, aggravated by potential new variants of the virus.

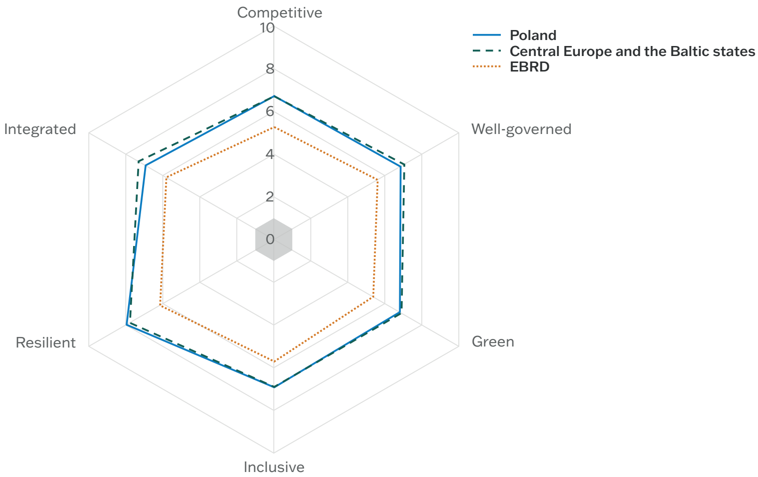
Policy response to Covid-19

Crisis-response measures in 2020 alleviated the effects of the Covid-19 pandemic. The government responded to Covid-19 with fiscal measures to support the economy through the BGK and with discretionary measures. These included a job protection scheme, with co-financing of wages in the affected sectors and compensation to entrepreneurs, moratoria on loans and solidarity allowances. Total government support through various programmes is estimated at 15 per cent of GDP. Monetary policy followed economic developments, with the NBP reducing the policy interest rate three times in 2020, from 1.5 per cent to 0.1 per cent in May 2021. Some of the Polish central bank's other supportive measures have included purchasing government and government-guaranteed securities on the secondary market and offering bill discount credits with a view to refinancing bank loans to companies.

CONTINUES

The 2021 budget envisages selective but continuous support to the economy. As the impact of the crisis is still visible in some sectors in 2021, most of the job support measures have been extended. Small and medium-sized enterprises (SMEs) in sectors heavily affected by the restrictions, such as the services sector, can receive financial support of up to 70 per cent of fixed costs. Liquidity guarantees for large companies and exemptions from social security contributions for specific industries are in place. Within the increase in expenditure, the 2021 budget envisages an increase in healthcare spending, bringing it to 5.3 per cent of GDP.

Assessment of transition qualities (1-10)



Structural reform developments

Large RRF funds, if cleared by the European Commission and Council, could further target key sectors, including the green and digital transitions. The Polish national plan is based on €23.9 billion in grants and €12.1 billion in loans. It consists of five pillars: economic resilience, green energy, digital transformation, sustainable transport and the health system. Investment in renewable energy sources such as wind farms, however, has received little emphasis to date and it remains to be seen how hydrogen and natural gas will be used in line with the EU's energy strategy. With the European Commission not having endorsed the plan as of late October 2021, Poland has expressed concerns about the timeliness of its response. The European Commission, meanwhile, has requested that the European Court of Justice (ECJ) impose financial penalties on Poland to ensure its compliance with the Court's interim measures order on the functioning of the Disciplinary Chamber of the Polish Supreme Court.

Disagreements between Poland and the EU institutions over judicial reform have escalated to new levels. In October 2021, the Polish Constitutional Tribunal ruled that some articles of the EU treaties were incompatible with the national constitution. Earlier – and further to requesting the financial penalties in relation to the functioning of the Disciplinary Chamber – the European Commission had sent a letter of formal notice to Poland for not taking the necessary measures to comply fully with the judgement of the ECJ (of 15 July 2021), which found Polish disciplinary legislation against judges incompatible with EU law.

CONTINUES

The government approved a new energy policy strategy to 2040. Adopted in February 2021, the strategy presents a vision for transforming the economy into a low-carbon one. Although it shows a slower energy transition plan than EU climate targets, coal's share of energy generation is projected to drop from about 70 per cent in 2020 to between 11 and 28 per cent by 2040, depending on emission prices. The strategy emphasises the need to further expand the capacity of wind farms and solar power plants. It also says that greenhouse gas emissions should fall by 30 per cent by 2030 and larger cities should introduce zero-emission public transport by 2030.

The government has presented a tax reform and economic support package. The new package, presented in May 2021, includes an increase in the tax-free income allowance and other measures leading to more progressive income tax. The health-insurance contributions of the self-employed will increase in proportion to their income, in line with the rules that apply to employees. The government also plans to introduce relief for taxpayers settling in Poland, as well as state guarantees for mortgage loans on social housing or for families with four children or more. These changes in taxation are expected to come into force from January 2022.

Uncertainty remains high with regard to the possible outcome of legal disputes over foreign-currency mortgages. In September 2021 the Supreme Court again postponed a decision on how to deal with cases involving foreign-currency loans – specifically, a large number of mortgages in Swiss francs, which may result in high costs for banks due to exchange-rate changes since the loan origination dates. The court has decided to seek the opinion of the ECJ on the composition of judicial benches. At the same time, several commercial banks have taken measures to facilitate the conclusion of voluntary settlements with their customers.

The roll-out of a high-speed internet network is focused on lower-population-density areas. Following the introduction of the National Broadband Plan to connect all households to high-speed internet by 2025, a project to develop fibre-to-the-home infrastructure in five less-populated regions was contracted in August 2021. The value of the project is approximately €227 million. It is planned that, by 2023, more than 500,000 households and 1,400 schools will get a high-speed internet connection.

SLOVAK REPUBLIC

Highlights

- **The economy is recovering in 2021, but some supply chain problems are emerging.** Following a gross domestic product (GDP) decline of 4.4 per cent in 2020, the Slovak economy has started to recover, reaching almost 5 per cent year-on-year growth in the first half of 2021. Rising car production is driving growth but supply chains have been disrupted recently by shortages in key inputs.
- **The government's plan for implementing European Union (EU) funds emphasises the green transition.** It is projected that the largest share of the €6.6 billion plan, financed through the Recovery and Resilience Facility (RRF), will be put into raising energy efficiency, encouraging decarbonisation and increasing the share of renewable energy sources.
- **"Kurzarbeit" was approved as a permanent work scheme from 2022.** As a new instrument in labour market policy, it will be available in extraordinary situations, whereby employers will be granted up to 60 per cent of the employee's average earnings. Alongside the continuation of hybrid work schemes due to the Covid-19 pandemic, remote working was further regulated.

Key priorities for 2022

- **The announced tax changes should aim to encourage employment and investment.** The tax changes expected in 2022 should reduce the tax burden on labour to boost employment and increase disposable income. At the same time, tax incentives should be targeted at attracting new investment.
- **Implementation of green transition reforms requires enhanced public administration and greater local capacities.** Steps need to be taken to significantly strengthen administrative capacities and digital skills, also at the local and regional levels, as they can enable the timely implementation of energy-related projects, which will facilitate the country's access to the grid of clean energy sources.
- **Active labour market policies should promote labour market inclusion.** The government should make efforts to address the low participation of women in the labour market through regular upskilling, expanding the childcare system and granting tax allowances and compensation for fathers taking a share of parental leave.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.0	3.8	2.6	-4.4	4.0
Inflation (average)	1.4	2.5	2.8	2.0	2.4
Government balance/GDP	-1.0	-1.0	-1.3	-5.5	-7.5
Current account balance/GDP	-1.9	-2.2	-3.4	0.1	-0.9
Net FDI/GDP [neg. sign = inflows]	-2.8	-1.3	-2.3	2.1	-1.3
External debt/GDP	108.4	114.9	112.4	121.2	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	60.4	62.7	63.5	68.1	n.a.

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Covid-19: macroeconomic implications

The economic downturn in 2020 was less severe than the EU average. The annual fall in GDP of 4.4 per cent in 2020 was the first decline since 2009. More resilient external demand and the recovery of car production ensured a return to positive growth in late 2020. After intensified containment measures from the end of 2020 and a gradual increase in activities in 2021, in the first half of 2021, GDP grew 4.9 per cent year-on-year. While economic sentiment and retail turnover started to recover from March 2021, the automotive industry and foreign trade have already surpassed figures from the pre-Covid-19 period. However, despite the growth in orders, the latest global chip shortage has resulted in a pause in production at some facilities, such as Jaguar.

Containment measures limited the decline in unemployment, while wages are rising moderately. After the unemployment rate reached 6.7 per cent in 2020, it increased further to 7.0 per cent in the second quarter of 2021, mainly due to the retention of certain restrictions in the services sector. Real wage growth in 2020 amounted to 1.7 per cent, with a rising trend in the industry sector. It also contributed to inflation pressure throughout 2021, with the level of inflation reaching 4 per cent year-on-year in September 2021.

Government spending will continue to support economic recovery. Due to the sizeable fiscal stimulus, worth 5.1 per cent of GDP, the general government deficit in 2020 reached 5.5 per cent of GDP. It interrupted a track record of low deficits. Public debt increased to 59.7 per cent of GDP in 2020, significantly higher than the pre-Covid-19 crisis level of 48.1 per cent in 2019. As the government will continue to use expenditure measures to combat the impact of the Covid-19 pandemic, the fiscal deficit is likely to exceed 6 per cent of GDP in 2021 before declining in 2022. According to the independent Council for Budget Responsibility, the long-term sustainability indicator of public finances continues to stay in the "high-risk zone", which suggests that general government gross debt should be reduced, accompanied by measures to achieve a structural budgetary surplus.

Short-term growth will continue, but the homogenous nature of the Slovak economy is a risk. On the upside, EU funds, including the RRF, of which the first tranche was already distributed in mid-October 2021, are expected to fuel investment, especially in the public sector. GDP growth will, therefore, likely reach 4.0 per cent this year and accelerate further to 5.0 per cent in 2022. However, the dominant automotive sector relies heavily on imports of components and chips, of which shortages are being experienced globally. As a result, disruptions in the supply of subcomponents have already hurt production, which could well lead to renewed job shedding and harm the recovery in household consumption. In addition, only 45 per cent of the population is at least partially vaccinated, creating a risk of sporadic new lockdowns.

Policy response to Covid-19

A broad stimulus package prevented a stronger economic downturn in 2020. With a stimulus package implemented in 2020 that amounted to 5.1 per cent of GDP, the government supported employers and the self-employed through the partial compensation of wages in sectors affected by the Covid-19 pandemic (such as the services sector), allowances and exemptions from social and health payments and extra spending on the social and health sectors. As a eurozone member, the Slovak Republic also took advantage of the quantitative easing policies of the European Central Bank.

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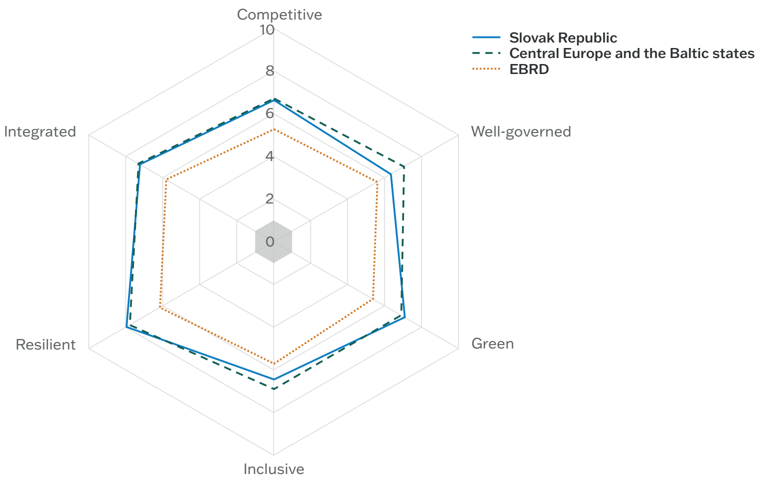
The 2021 budget is marked by increased expenditure for the recovery. Approved in December 2020, the budget provides for increases in expenditure on health, pensions, compensation and family support. Fiscal packages include extended wage compensation and unemployment benefits, along with a prolonged deferral of payroll and corporate tax payments for employers. In addition, the budget assumed a 1.1 per cent of GDP reserve for unforeseen developments related to the Covid-19 pandemic, which was increased with extra budgetary funds in May 2021, raising the target fiscal gap. The most significant change from June 2021 relates to financial aid linked to the so-called "Covid Automat". Under this system, regions are divided into green, orange, red, dark red and black districts, depending on their epidemiological situation. The support system includes four phases. Phase 0 means that at least 40 districts are in the green tier and no financial assistance is paid. In phase three (when most districts are in the dark red or black tiers), employers are able to ask for support amounting to 100 per cent of total labour costs and the self-employed can get up to €870 of assistance.

Assessment of transition qualities (1-10)



Structural reform developments

The implementation of the RRF plan will increase the use of renewable energy sources. The national plan, worth €6.3 billion in grants (6.9 per cent of 2020 GDP) is based on five key components: green economy, education, health, public administration/digitalisation, and research, development and innovation. A significant amount of planned investments is dedicated to the green transition and will include decarbonisation and new investments in renewable and clean energy. The planned investments in the digital area will include strengthening the digital capacities of government services but also improving general digital skills – an area where the Slovak Republic lags the central European and Baltic state average.

Parliament approved the permanent short-time work scheme from 2022. As a new permanent instrument for supporting labour markets, "Kurzarbeit" will be provided to employers and the self-employed in extraordinary circumstances that they cannot prevent, such as a state of emergency or *force majeure* event. The maximum support will be 60 per cent of the employee's average hourly earnings in the calendar month for which the support is provided. The support will be valid for a maximum of six months, to be taken within 24 consecutive months.

CONTINUES

Digitalisation was set as a priority of the government. At the beginning of 2021 the authorities announced that digital reforms worth €1.2 billion would be based on: interconnectedness, cyber security, the digital economy, digital skills, innovations and access to state-related administration via mobile phones. Besides achieving a more effective public administration, a concrete goal is that, by 2025, all schools and, by 2030, all households should be able to access high-speed internet.

A new act on the protection of competition came into force. In May 2021 the Slovak parliament adopted a new competition act, following an EU request to empower the competition authorities. With the new act, the Antimonopoly Office of the Slovak Republic (AMO) will have more control over existing cartels and is likely to discourage the creation of new ones. The AMO will also be authorised to apply measures, fines and penalties in cases of suspected cartels or abuse of a dominant position.

Flagship projects were selected for funding through the Just Transition Fund. In the project implementation period, from 2022 to 2030, the Slovak Republic will have €459 million at its disposal. The highest amount is destined for the coal-dependent Upper Nitra region. Some of the selected projects include the construction or renovation of hospitals, renovation of public buildings and energy-efficient transport to improve living standards and promote the diversification of economic activities.

New investments in the automotive industry are likely to boost economic growth. As a major sector, the automotive industry has maintained its investment plans, despite the Covid-19 crisis. Jaguar Land Rover has announced the employment of 600 workers in the Nitra plant and an additional 300 jobs in the sub-supplier firm. Volkswagen Slovakia is expanding its production by €1 billion and, by 2023, will move production of the Superb model from the Czech Republic and the Passat model from Germany to Bratislava.

SLOVENIA

Highlights

- **The economy is recovering strongly in 2021.** After a 4.2 per cent fall in 2020, gross domestic product (GDP) recovered by 8.8 per cent year-on-year in the first half of 2021, supported by domestic demand.
- **Digitalisation has accelerated since the start of the Covid-19 pandemic.** The authorities have prioritised enhancing online public services in light of containment measures, while new structures in the government were created to coordinate and enhance the delivery of the digital transformation.
- **The National Recovery and Resilience Plan (NRRP) has been approved.** Following the plan's approval in July 2021, Slovenia received the first tranche of €231 million from the European Union (EU) in September, part of its total allocation of €2.5 billion.

Key priorities for 2022

- **EU funds should be targeted towards productivity growth.** The authorities will need to prepare operational programmes for absorbing the funds from the next EU budget, which should complement the areas covered by the NRRP, namely, green, digital and smart growth.
- **A renewed commitment to fiscal consolidation is needed.** In line with the conclusions of the Fiscal Council and international partners, fiscal consolidation will need to accelerate after a year of Covid-19-induced delay.
- **Governance-related structural reforms should continue.** Further improvements are needed to the governance of state-owned enterprises and in the overall business environment, such as strengthening the public procurement system and further reducing administrative barriers.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	4.8	4.4	3.3	-4.2	6.0
Inflation (average)	1.4	1.7	1.6	0.0	1.4
Government balance/GDP	-0.1	0.7	0.4	-7.7	-7.0
Current account balance/GDP	6.2	6.0	6.0	7.4	6.4
Net FDI/GDP [neg. sign = inflows]	-1.2	-2.0	-1.6	0.6	0.9
External debt/GDP	101.9	91.8	90.5	101.9	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	44.4	43.0	42.3	43.5	n.a.

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Covid-19: macroeconomic implications

Growth has exceeded expectations in the first half of 2021. Following the -4.2 per cent recession in 2020, the economy expanded by 8.8 per cent year-on-year in the first half of 2021, almost reaching pre-Covid-19 pandemic levels. Domestic demand was behind the strong rebound, with private consumption growing by 8.9 per cent year-on-year and investment recovering by 13.4 per cent year-on-year in the first half of 2021 after a steep fall in 2020. Consumption has been supported by employment preservation schemes, with the unemployment rate falling to 4.3 per cent in the second quarter of 2021, a level comparable with the pre-pandemic situation. Exports have also reached 2019 volumes, but higher import growth, accelerated by domestic demand, resulted in a slightly negative contribution of net exports to growth.

Fiscal expansion is aiding the recovery but also increasing fiscal risks. The government deployed a comprehensive support package of 6.5 per cent of GDP in 2020, which, in combination with decreasing revenues, led to a fiscal deficit of 8.3 per cent of GDP. In 2021 the authorities initially projected a deficit of 5.7 per cent of GDP, but another wave of Covid-19 infections in the spring forced the government to adopt additional support measures. The resulting budget revision from September targets a deficit of 7.9 per cent of GDP. The deficit is then expected to fall to 5.4 per cent of GDP in 2022 and 3.3 per cent in 2023. As a result, public debt will remain at current elevated levels in the short term and will gradually fall to a projected 70 per cent of GDP at the end of 2024.

The short-term outlook is positive. We forecast GDP to grow by 6.0 per cent in 2021, moderating slightly to 4.5 per cent in 2022. Domestic demand will remain the key growth driver in the short and medium term. Risks to the current forecast are on the upside if consumption and investment continue the robust expansion seen in the first half of 2021. EU funds will also make a notable contribution to investment from 2022. The key downside risk remains the Covid-19 pandemic and the possibility of further containment measures amid new infection waves.

Policy response to Covid-19

The authorities have continued fiscal support for businesses and workers in 2021. In 2020 the key support measures were the furlough and short-time work schemes, a credit guarantee scheme, help to cover fixed expenses for affected firms, and financial support to the self-employed and part-time workers. Most of these measures were extended until at least mid-2021. Nevertheless, only half of the initially announced support has been used since the start of the Covid-19 pandemic; credit guarantees have not been used much by firms due to the relatively stable level of liquidity. In May 2021 the authorities approved an eighth support package, worth €320 million, which extended the furlough scheme and provided subsidies to firms to compensate for the higher minimum wage, which entered into force in 2021.

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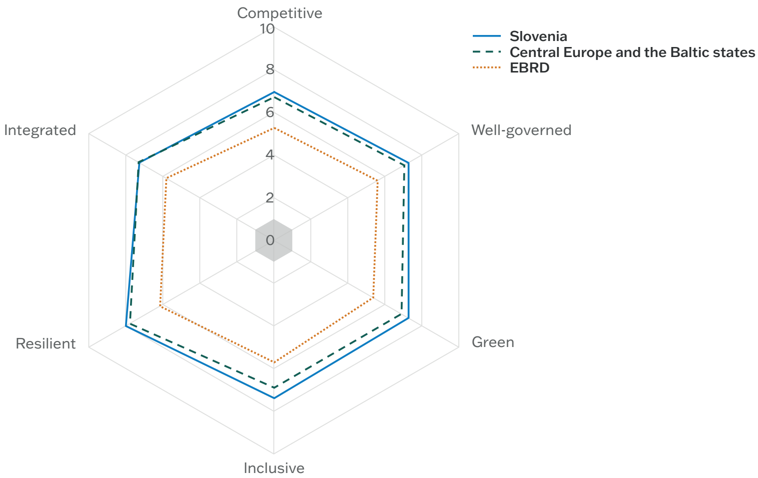
Assessment of transition qualities (1-10)



Structural reform developments

The NRRP prioritises the green and digital transitions. The approved plan allocates 42 per cent of the budget to green measures, such as addressing flood risk, mobility and improving the power network and energy efficiency of buildings. The digitalisation component of the NRRP focuses on modernising existing e-governance systems, digital education, enhancing civil servants' skills and boosting cybersecurity. The plan also includes reforms to improve long-term care, the pension system and social housing, and to modernise the healthcare system.

An omnibus bill targeting the reduction of red tape has been passed. The bill, passed by the government in March 2021, covers multiple areas, including: increased use of digitalisation in administrative services, changes to official registries and payment rules, increased powers to state secretaries and a cap on social security contributions of €6,000 per month. The latter measure sparked controversy, as it is not directly related to red tape and reduces fiscal space.

The digitalisation of public services has advanced. The Electronic Identification and Trust Services Act, adopted in April 2021, will enable the use of new biometric identity cards as electronic identification. In July 2021 the government created the Government Office for Digital Transformation and appointed a new minister for digital transformation to coordinate all digitalisation initiatives in the government.

A framework bill on long-term care is in place. The new bill, passed in June 2021, connects long-term care to the health, social care and pension systems under a more comprehensive system. Both institutional and community-based facilities will be developed to allow everyone to receive the required services, regardless of income or social status. The new system will be financed through a special mandatory contribution for long-term care, which will be implemented by mid-2024. Until the new financing mechanism is in place, existing resources and the national budget will cover the costs of developing relevant services.

OTP Group has agreed to acquire Nova KBM to become the largest bank in Slovenia. Nova KBM, the second-largest bank in Slovenia, has agreed to an acquisition by Hungarian OTP Bank, resulting in a market share for OTP Bank of about 30 per cent. The deal follows the completed merger between Nova KBM and state-owned Abanka in September 2020. The deal is still pending regulatory approval and is expected to be finalised in the second quarter of 2022, marking an end to the restructuring of the banking sector following the crisis in 2013.

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Planned tax cuts will put additional pressure on fiscal neutrality in the medium term. The key measures include an increase in personal income tax breaks, a reduction in capital gains tax from 27.5 per cent to 25 per cent, a rental income tax cut from 27.5 per cent to 15 per cent, and a reduction in the rate of personal income tax in the top bracket from 50 per cent to 45 per cent. Most of these tax breaks have not been included in the 2021-24 fiscal framework and will require an update of the current fiscal plan. A modelling exercise conducted by the Fiscal Council shows mixed effects on GDP, while the impact on public finances is likely to be negative, with a total estimated cost of 5.3 to 6.3 per cent of 2019 GDP between 2022 and 2025.

The government has committed to phase out coal in the coming decade. In line with EU targets, coal-powered plants will be closed by 2033. To support a "just transition", €235 million will be allocated to the Savinjsko-Šaleška region, where the only coal-fired plant is still operating, to support the creation of 5,000 jobs. However, some local stakeholders have put the cost of the plan at significantly higher levels, while increasing carbon costs could force an earlier shutdown and bring forward most expenses to earlier than currently planned.