CROATIA

Highlights

- **Croatia has been severely affected by the coronavirus crisis.** In 2020, a sharp recession is under way, largely because of disruption in tourism, a mainstay of the Croatian economy, but a recovery is expected in 2021.
- **The authorities have employed considerable fiscal and monetary measures to mitigate the effects of the crisis.** Despite the country's high public debt, the government responded to the crisis with a sizeable and comprehensive crisis package, while the Croatian National Bank (CNB) focused on stabilising the kuna and providing liquidity to the banking sector.
- **Croatia has joined the Exchange Rate Mechanism II (ERM 2) and Banking Union.** This is one stage ahead of joining the eurozone, which may happen in two years at the earliest – contingent on the country meeting the Maastricht criteria.

Key priorities for 2021

- **The authorities should implement the key structural reforms needed to improve the country's competitiveness.** While important reforms have been undertaken so far, more progress is needed, particularly with regard to improving the overall quality of institutions and governance.
- **Business environment reforms should be prioritised.** Eliminating unnecessary red tape and facilitating doing business is important for economic recovery.
- **Additional efforts should be devoted to diversifying the economy.** The current pandemic has exposed the danger of relying on one or two key sectors. Supporting the development of, for instance, the export-oriented tradeable sector could decrease Croatia's dependence on tourism.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.5	3.4	2.8	2.9	-8.5
Inflation (average)	-0.6	1.3	1.6	0.8	0.4
Government balance/GDP	-0.9	0.8	0.2	0.4	-7.1
Current account balance/GDP	2.1	3.5	1.8	2.8	-3.2
Net FDI/GDP [neg. sign = inflows]	-4.3	-2.3	-1.6	-1.9	-0.6
External debt/GDP	91.4	94.6	80.3	75.7	n.a.
Gross reserves/GDP	27.6	34.0	32.8	34.4	n.a.
Credit to private sector/GDP	57.7	55.2	54.1	53.8	n.a.

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Covid-19: macroeconomic implications

Economic activity has been severely affected by the coronavirus crisis. After five years of economic recovery (2015-19), with average annual growth of 3 per cent, a sharp decline is under way in 2020 because of the coronavirus pandemic. GDP inched up by 0.4 per cent year-on-year in the first quarter, but in the second quarter, the crisis took full hold as the government introduced a strict lockdown in mid-March, with tough restrictions on travel and economic activity, to fight the pandemic. Output in the second quarter contracted by the highest decrease on record, of 15.1 per cent year-on-year. The resulting economic decline in the first half of 2020 was -7.8 per cent year-on-year, with private consumption expenditure falling by 7 per cent, investments by 6 per cent and exports by 26 per cent (driven by a 50 per cent drop of exports of services).

A key channel for disruption is tourism, a mainstay of the Croatian economy. Tourist activity has been badly hit by the travel restrictions and the lockdown imposed to curb the pandemic in Croatia and across the European Union (EU) and elsewhere. Tourist spending normally accounts for more than 20 per cent of GDP. There was a drop of more than 75 per cent in tourist arrivals in March year-on-year, and a near halt to tourism in April and May. A partial recovery followed in the third quarter, as travel within the EU was relaxed on 15 June, mitigated by the nature of Croatia's tourism industry, which is based on private accommodation and easily reachable by roads from the tourists' main countries of residence such as Germany, Austria, Slovenia, Hungary and the Czech Republic. In July tourist arrivals were down 40 per cent compared with 2019, and 30 per cent year-on-year in August. Spillover effects were felt in the labour market, with the unemployment rate rising to 8.6 per cent in July 2020 from about 6.2 per cent in February.

The fiscal accounts have deteriorated. As the 2020 recession has curbed fiscal revenue, due to the lockdown imposed in response to the pandemic and measures to tackle the crisis (see below), the budget deficit is expected to substantially increase in the short term. The government revised the 2020 budget in mid-May, keeping expenditures unchanged (but reallocating funds for new priorities), and thus projecting a deficit of 6.8 per cent of GDP rather than a near-balanced budget as originally planned (assuming a recession of 9.4 per cent). However, the country remains at investment grade with the main credit ratings agencies, and access to funding seems satisfactory so far. In June 2020, the government successfully issued an 11-year Eurobond, raising €2 billion with an annual coupon rate of 1.5 per cent. The bond was heavily oversubscribed, implying that investors valued the confirmation of Croatia's investment rating and its progress in the euro adoption process.

Economic performance is expected to recover in 2021. We expect GDP to fall by 8.5 per cent in 2020 but recover partially with 3.5 per cent growth in 2021. This is based on the assumption of a gradual normalisation of economic activity in Croatia and among its main economic partners. Nevertheless, the risks are strongly to the downside, including through a possible resurgence of Covid-19 infections.

Policy response to Covid-19

The government has adopted a considerable crisis response package. Despite the country's high public debt, the government responded to the Covid-19 pandemic with a relatively strong set of stimulus measures, costing about 7 per cent of GDP. Preserving jobs, keeping businesses in operation and improving the social position of vulnerable categories were at the core of the crisis response measures. Some of the key government measures adopted in the first months of the crisis included: (i) interest-free loans to local governments, health and pension insurance funds to cover deferred payments; (ii) salary increases in the healthcare sector; (iii) full subsidisation of net minimum wages and social contributions for the first three months of the crisis in the affected sectors; (iv) an increase in the minimum wage of 23 per cent (to €530), (v) early refund of taxes; (vi) deferral (or full exemption) of public obligations (that is, taxes and social contributions) for three months (or more) for firms, depending on their revenue impact and size; (vii) a loan repayment moratorium for three months; and (viii) further state support, including from the Croatian Bank for Reconstruction and Development (HBOR), in the form of liquidity loans and guarantees. In late June 2020, the government announced that it would support the preservation of jobs through part-time work for the second half of the year.

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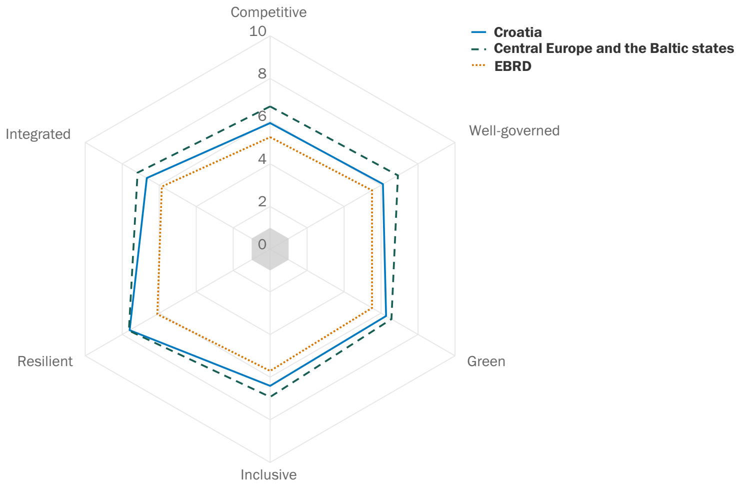
The Croatian National Bank (CNB) focused on stabilising the kuna and providing liquidity to the banking sector. The CNB has been using its foreign exchange reserves to intervene on the foreign exchange market to mitigate significant depreciation pressures and thus managed to preserve the stability of the kuna, which peaked at 7.62 HRK per euro in early April, compared with 7.45:1 during the pre-crisis period. In mid-April, the CNB agreed a precautionary currency swap line of €2 billion with the European Central Bank (ECB), to be in place until the end of the year and which can be activated if needed. The line allows the CNB quick access to euro liquidity, without using its own international reserves. In September 2020, the ECB's euro liquidity line was extended by six months. Liquidity was provided via: (i) the structural repurchase agreement (repo) facility (five-year HRK liquidity at 0.25 per cent); (ii) regular weekly repo (at 0.05 per cent); and (iii) a reduction of the reserve requirement ratio from 12 to 9 per cent. In addition, the CNB has introduced a repurchase of government bonds, in a quantitative easing-like move, to support the crisis response.

Assessment of transition qualities (1-10)



Structural reform developments

Croatia has been admitted into the Exchange Rate Mechanism (ERM) II. In July 2020 the ERM II parties, that is, the ECB together with the eurozone member states and Denmark, decided to include the Croatian kuna in ERM II, following the request sent by Croatia in July 2019. The central rate of the Croatian kuna is set at 1 euro = 7.53450 kuna, and the standard fluctuation band of plus or minus 15 per cent may be observed. After two years, a new assessment will be taken, and if positive, Croatia will join the eurozone. Before entering the ERM II, Croatia carried out a number of important reforms, including: (i) further strengthening the supervision of the banking system; (ii) strengthening the framework for implementing macro-prudential policies; (iii) strengthening the framework for anti-money laundering; (iv) improving the system for collecting, processing and publishing statistical data; (v) improving public sector governance; and (vi) reducing the administrative and financial burden of red tape on the economy.

Croatia has joined the EU's Banking Union. In parallel to joining the ERM II, Croatia also became a member of the Banking Union. From 1 October 2020, the ECB is in charge of the direct supervision of the major banks in Croatia, as well as the oversight of others. As part of Croatia's application to the Banking Union, the ECB had performed a comprehensive asset quality review and stress test of major systematically important banks, including Zagrebačka banka (Italian UniCredit), Privredna banka Zagreb (Italian Intesa), (Austrian) Erste & Steiermärkische Bank, (Hungarian) OTP banka and the locally owned Hrvatska poštanska banka. The results of the assessment were published in early June 2020, showing that these banks do not face any capital shortfalls.

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New energy capacities are being developed. The construction of a liquefied natural gas (LNG) terminal on the island of Krk has continued. This project, worth €234 million, is partially covered by a €101 million grant from the European Commission, which has listed it as an EU project of common interest. The Krk LNG terminal will have a capacity of 2.6 billion cubic metres of natural gas per year as of 2021, and should have an important role in diversifying the natural gas supply as well as ensuring its security not only for Croatia but also for the wider region. In June 2020, the Croatian power company Hrvatska elektroprivreda laid the cornerstone of the Cres solar power plant, which is meant to be the largest solar power plant in Croatia. It will strengthen the security of energy supply of the islands of Cres and Losinj in the northern Adriatic Sea, and increase their self-sufficiency especially during their peak tourist season.

Croatia has advanced on a number of social reforms. The country has started the incremental implementation of curricular reform in all primary and secondary schools. In addition, the experimental programme Dual Education in VET is being expanded. However, the adoption of occupation and qualification standards is proceeding slowly. Ongoing investments in early childhood education and care aim to increase availability and access. The package of active labour market policy measures has been refocused to make them more effective, while the Croatian Employment Service has developed a new IT tool aimed at improving mediation and referrals.

The moratorium on the sale of agricultural land to foreigners has been extended. In June 2020, the European Commission gave the go-ahead to Croatia for an extension to the moratorium of three years. Croatia joined the EU in July 2013, and its EU accession treaty granted a transitional period of seven years, during which a ban on the sale of agricultural land to citizens of other EU member states applied. This transition period was agreed to prevent growth in the prices of agricultural land in Croatia after EU accession.

ESTONIA

Highlights

- **GDP is falling sharply.** Containment and lockdown measures have strongly affected private consumption, exports and investments, but a fiscal stimulus of around 9 per cent of GDP is mitigating the impact by supporting employment, firm liquidity and local development.
- **The government has prioritised an insolvency framework reform.** The authorities have made progress on facilitating insolvency-related proceedings by establishing a new monitoring unit and partially increasing the efficiency of the process.
- **The pension system has been altered, with uncertain effects on capital markets development.** The adopted change to voluntary contributions to the second pillar brings short-term fiscal benefits but limits liquidity in the capital markets and makes the stability of the system crucially dependent on statutory retirement and minimum pension decisions.

Key priorities for 2021

- **EU recovery funds should be used to stimulate the recovery by boosting innovation and greening the economy.** Around €6.8 billion has been earmarked for Estonia in the next European Union (EU) budget, including the EU recovery instrument. The authorities should use these funds in investments that would improve the long-term growth potential of the economy, including the reduction of the carbon footprint of its energy sector.
- **Anti-money laundering and countering the financing of terrorism implementation needs to be finalised.** Despite some noteworthy progress and political commitment to address the shortcomings flagged by the European Commission (EC), gaps still exist and should be addressed, including cooperation at the level of the three Baltic states.
- **Addressing inequality gaps, especially following the coronavirus crisis, will become more important.** Income inequality and relative poverty remain elevated, and the risk of an increasing gap is high as containment measures significantly affected those in lower-paid jobs.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.2	5.5	4.4	5.0	-4.0
Inflation (average)	0.8	3.7	3.4	2.3	0.2
Government balance/GDP	-0.5	-0.8	-0.6	-0.3	-6.8
Current account balance/GDP	1.2	2.3	0.9	2.0	4.0
Net FDI/GDP [neg. sign = inflows]	-2.4	-3.9	-4.7	-3.5	-2.0
External debt/GDP	88.0	83.4	77.4	73.8	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	69.4	64.3	62.3	59.4	n.a.

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Covid-19: macroeconomic implications

Estonia entered the Covid-19 crisis after a year of robust growth. GDP grew by 4.3 per cent in 2019, with investments and net exports driving most of this growth. However, in the first half of 2020, the economy was significantly affected by the pandemic, with GDP declining by 3.9 per cent year-on-year, and by 6.9 per cent in the second quarter year-on-year. Although consumption expenditure edged up by 0.2 per cent, investment fell by 13.1 per cent and exports dropped by 2.6 per cent in the first half of 2020. Nevertheless, good economic fundamentals, such as the solid fiscal stance, current account surplus, and a financial sector in good shape, have enabled a strong policy response to the crisis so far, which together with an effective health response allowed the economy to swiftly begin recovering. Retail turnover declined by 15.8 per cent year-on-year in April 2020, the lowest point, but started gradually recovering as of May. On the other hand, industrial production declined by 16.9 per cent in April, but was slower to recover because of similar difficulties in trading partners.

Unemployment has risen while prices declined. The unemployment rate reached 8.0 per cent in July, triggering a slowdown of wage growth in the first half of the year to 2.9 per cent year-on-year. Prices have been declining during the lockdown and in the months following it, given the shock to demand. The steepest fall was recorded in May at -1.7 per cent year-on-year, driven mainly by price drops in transport, housing, and catering services.

The fiscal deficit has widened considerably. In the first half of 2020, the deficit had already reached 3.3 per cent of GDP (versus 0.3 per cent in 2019) and it is expected by the International Monetary Fund (IMF) to reach -6.8 per cent for the year as a whole. Public debt is forecast by the IMF to be 18.7 per cent of GDP by the end of 2020, up from 8.4 per cent at the end of 2019 but still exceptionally modest by EU standards. To finance the deficit, the government raised €1.5 billion through a 10-year bond in June 2020, and borrowed €750 million from the Nordic Investment Bank as a 15-year loan and €200 million from the Council of Europe Development Bank.

GDP growth is expected to recover in 2021 but uncertainty remains. As the bottom of the crisis was likely reached in April 2020, the economy has started to go through a long recovery phase since the relaxation of containment measures. As such, we forecast a 4.0 per cent fall in GDP in 2020, followed by a strong recovery of 4.0 per cent in 2021. This is of course contingent on, among other things, whether other Covid-19 outbreaks will happen this year or in 2021 in Estonia and elsewhere.

Policy response to Covid-19

A significant stimulus package was adopted. In addressing the socio-economic impact of the health crisis, the parliament approved a supplementary budget on 15 April 2020. Under this budget, the government earmarked a support package of almost 9 per cent of GDP. Key measures include support to the Unemployment Insurance Fund to finance the job retention scheme, covering 70 per cent or up to €1,000 per month for affected companies, and reduced to 50 per cent or €800 in June (at a total cost of €250 million). The health system will also receive about €200 million. In terms of liquidity support, the government, both directly and through the state-owned KredEx, will offer guarantees for bank loans to allow for rescheduling of payments (€1 billion), subsidised working capital loans (€500 million), and investment loans (€50 million). Budgetary support to local authorities was also earmarked (€130 million), while rural companies will be able to receive business loans, guarantees and land capital through the rural development fund (€200 million).

The central bank has released additional liquidity in the banking sector. As part of the eurozone, Estonia has benefited from the quantitative easing mechanism adopted by the ECB, the €1,350 billion pandemic emergency purchase programme (PEPP). Additionally, the Eesti Pank reduced the systemic risk buffer for the commercial banks from 1 per cent to 0 per cent to release liquidity in the banking sector, with a total impact estimated at about €110 million. The Eesti Pank also announced that it would allocate three-quarters of its 2019 profits, equivalent to €18.9 million, to support the state budget in addressing the Covid-19 crisis.

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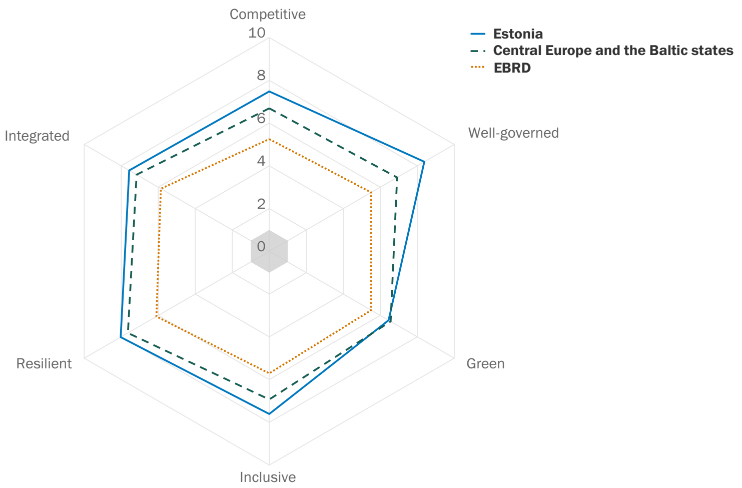
Assessment of transition qualities (1-10)



Structural reform developments

The parliament fully transposed the fifth EU Anti-money laundering Directive. The government initiated the Act on Amendments to the Money Laundering and Terrorist Financing Prevention Act, which was passed by parliament in June 2020. The act aims to strengthen the prevention of money laundering, and it transposes the remaining EU recommendations into national law. The key provisions are focused on whistle-blower protection, the development of a register of bank accounts which can be accessed by the Financial Intelligence Unit (the agency responsible for the supervision and prevention of money laundering), and more information exchange between entities. In addition, the Financial Intelligence Unit will become an autonomous institution under the Ministry of Finance. The EC and the IMF, however, have suggested that gaps remain in the capacity of the Financial Supervision Authority and in the overall implementation of regulation, such as the number of onsite inspections.

The insolvency framework reform is progressing. The government has prioritised the reform of the insolvency regime and proposed amendments, which passed the first reading in parliament in June 2020. The revised bill established, among other things, an insolvency service, greater specialisation of courts and more transparent remuneration of trustees. Resolving insolvency is the second-lowest ranked dimension for Estonia in the World Bank's *Doing Business 2020* report, and institutions such as the EC, IMF and OECD have all highlighted the need to streamline the restructuring process, debt discharge and, ultimately, to transpose the EU Restructuring and Insolvency Directive.

The pension system has been amended, stimulating consumption but possibly holding back capital markets development. Under the new rules, joining and leaving the second pillar will be voluntary. Requests to be released from payment will be accepted starting January 2021, while the payments will become voluntary as of October 2020. The change may result in a short-term consumption stimulus, but it will likely hold back capital markets development.

The gender pay gap is being addressed. The authorities have initiated several measures aimed at decreasing the gender pay gap, which reached an estimated 22.7 per cent in 2018 according to Eurostat. As of July 2020, parental leave will increase from 10 to 30 days, while the leave period will be flexible for the first three years. This is to help women return to work by encouraging a more flexible leave system. These two regulations are the final provisions of the reform of the parental leave and benefits system, which was approved at the end of 2017 and introduced gradually from 2018 to 2020.

HUNGARY

Highlights

- **The coronavirus crisis has pushed the economy into recession.** Hungary had already entered a cyclical slowdown in 2019, although GDP growth had been impressive relative to its regional peers. A stringent lockdown introduced in March 2020, including shutdown of businesses and schools, halted much economic activity and resulted in the first recession in the country since 2012.
- **A comprehensive set of crisis response measures was introduced.** The expected total value of all government measures for tackling the economic effect of the pandemic is between 18 and 20 per cent of GDP.
- **The banking sector has softened loan repayment conditions.** Domestic banks were instructed by the central bank to ease loan repayment conditions for all borrowers (individuals and businesses). Interest and amortisation payments on loans were suspended until the end of 2020, short-term loans were extended and interest rates on consumer loans were capped at five percentage points above the base rate.

Key priorities for 2021

- **Fiscal measures to restart growth should target innovation and upskilling of the labour force.** The current scarcity of skilled labour suggests that boosting education and employment opportunities would go a long way to addressing private sector needs.
- **A funding ecosystem to manage the rising wave of corporate succession should be further developed.** In September 2019, the Hungarian Development Bank set up the first fund to provide financing for corporate succession. Currently, about 75 per cent of Hungarian private companies are first-generation businesses, versus 33 per cent globally.
- **Further financing is needed to develop the green economy and promote environmental sustainability.** The demand-side interest for green products has soared for both the first government green bond and those provided by corporates.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.1	4.3	5.4	4.6	-5.0
Inflation (average)	0.4	2.4	2.9	3.4	3.7
Government balance/GDP	-1.8	-2.5	-2.1	-2.0	-8.3
Current account balance/GDP	4.5	2.0	0.3	-0.2	-1.6
Net FDI/GDP [neg. sign = inflows]	-2.2	-1.6	-2.0	0.1	0.0
External debt/GDP	95.4	83.5	80.1	73.6	n.a.
Gross reserves/GDP	20.1	19.5	19.6	19.5	n.a.
Credit to private sector/GDP	69.4	64.3	62.3	59.4	n.a.

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Covid-19: macroeconomic implications

Pandemic-related containment measures have led to a recession. Hungary had registered the strongest GDP growth in the central Europe and Baltic states (CEB) region, at 4.9 per cent, in 2019, largely induced by a solid double-digit investment growth and strong household consumption. Nevertheless, the lockdown, introduced by the government in March 2020 to prevent uncontrolled transmission of Covid-19, brought much economic activity to a halt. In the first half of 2020, the economy shrank by 6.1 per cent, weighed by a massive slide in net exports (the drop in exports was higher than that of imports), investment and tourism revenues. The unemployment rate increased to 4.9 per cent in June 2020, after registering an historic low of 3.4 per cent in January 2020. Tourism and exports represent 13 and 98 per cent of GDP, respectively. The automotive industry (28 per cent of manufacturing output) is at the core of the country's high global value chain integration. The temporary closures of all four car plants weighed significantly on short-term GDP growth and employment. (For illustration, a one-month closure of the car plants is estimated to cost 0.4 per cent of annual GDP.) Some car plants restarted production at the end of April, and the majority of lockdown restrictions were gradually lifted from May. Moreover, some automotive suppliers started complaining again about labour shortages in September 2020.

Investment has dropped from high rates, but large projects remain in the pipeline. In 2019, investment to GDP amounted to 28.6 per cent, above regional peers, but it then dropped by 9.2 per cent in the first half of 2020 as a result of the pandemic and associated lockdowns and disruptions. The fall in investment, especially in the second quarter of 2020, was severe, despite the lending support by government and the central bank. However, the pipeline of large investment projects remains promising. Scheduled (but delayed) projects include South Korean investments in the electric car industry, the construction of a BMW car plant in eastern Hungary, a Lidl logistics base near Budapest, and the Budapest-Belgrade railroad upgrade, completion of which is scheduled in 2025.

The fiscal deficit is rising because of the weaker economy and generous economic stimuli measures. The expected total value of all government measures (see below) for tackling the economic effects of Covid-19 is between 18 and 20 per cent of GDP. According to the International Monetary Fund's October 2020 estimates, the general government deficit is expected to rise to 8.3 per cent of GDP in 2020, before falling again in 2021 as the economy rebounds. Similarly, public debt is expected to jump to 77.4 per cent of GDP in 2020 but projected to return to a downward trend as of next year.

Positive GDP growth is likely to return in 2021. Given Hungary's exposure to trade and global value chains, the magnitude of the expected recovery will largely depend on external developments in the EU (European Union) and outside the EU. GDP is forecast to fall by 5.0 per cent in 2020 and then recover to 4.0 per cent growth in 2021. The forecasts are subject to major uncertainty, and depend to a large extent on whether targeted shutdowns of economic activities are needed because of a possible resurgence of Covid-19 cases.

Policy response to Covid-19

The Covid-19 pandemic-related restrictions were rapidly followed by protective measures. The government and the National Bank of Hungary launched various relief measures to preserve employment, support companies in a state of hibernation and support household incomes to soften the already historically deep recession in 2020. Under measures announced by the government in April 2020, businesses that suffered more than a 40 per cent drop in revenues were able to delay payroll deductions for their staff and advance corporate income tax (CIT) payments. Employers and the compulsorily insured self-employed, who saw their turnover or income fall by 40 per cent or more, were able to delay the owed social security contributions, unemployment and health insurance payments until the end of July. In May 2020, the government launched another wage subsidy programme to enhance new employment. If a newly employed person remains on the job for a period of nine months, the monthly salary is subsidised by HUF 200,000 (€570).

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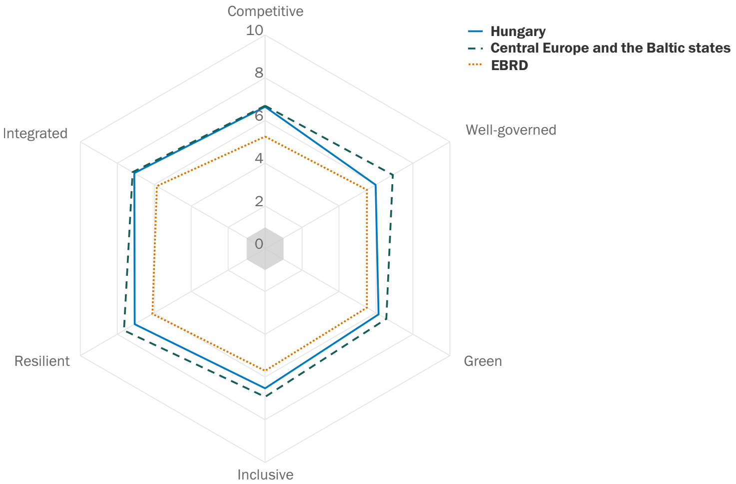
Further changes to the economic protection package were adopted by parliament in June 2020. These included a cut in social contributions by 2 percentage points to 15.5 per cent and a reduction in small business taxes. At the same time, the exemption from CIT for reinvested profits was expanded from 50 to 100 per cent for a period of four years and capped at HUF 10 billion (€28.5 million). Financing of the economic protection package comes partly from new and relatively small retail and banking taxes. In addition, in June 2020 the government created an economic protection operating committee, consisting of up to 10 state institutions such as the tax administration or the consumer protection office, to work on a further reduction of administrative burden on companies.

Domestic banks softened loan repayment conditions for all borrowers. In March 2020, the National Bank of Hungary (NBH) introduced a moratorium on corporate and retail loan repayments under its Funding for Growth Scheme + until the end of 2020 and instructed other banks to do the same for other borrowers. As a result, the interest and amortisation payments on loans were suspended until the end of 2020, short-term loans were extended and interest rates on retail loans capped at 5 percentage points above the base rate. According to the NBH's estimates, a full use of the moratorium will mean a deferral of HUF 3,600 billion (€10.2 billion) of loan payments by the end of 2020. However, the actual impact of the moratorium is likely to be lower as between 30 and 50 per cent of those loans have remained serviced so far. In April 2020, the NBH launched a new cheap lending scheme called Funding for Growth Scheme Go! to support small and medium-sized enterprises from the impact of the coronavirus pandemic. The scheme is available through the banking system with a fixed interest rate capped at 2.5 per cent. In May 2020, the NBH launched quantitative easing, targeting mainly government bonds with at least three years to maturity. In July 2020, the NBH eliminated capital requirements for eight systemically important banks, to be gradually rebuilt over a three-year period starting from 2022.

Some of the 2014-20 EU funds were re-allocated to economic protection. In May 2020, the government re-allocated HUF 420 billion (€1.2 billion) of unused EU funds to economic support measures related to the pandemic. About 75 per cent of the funds will be spent in the form of grants, while the remaining resources will be used for interest-free loans under the economic development programme. The larger part of the funds will finance the government's wage subsidy scheme. The upcoming 2021-27 EU funds will consist of two pillars, the regular multiannual financial framework (MFF) and an extraordinary Covid-19 recovery fund. Hungary is expected to receive a total of about €41 billion from both pots, and the rule of law conditionality is expected to be in place.

Assessment of transition qualities (1-10)



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Structural reform developments

Magyar Bankholding was created. In June 2020, three domestic banks – MKB, Takarekbank and Budapest Bank – set up Magyar Bankholding. The new structure is expected to be a vehicle for the potential merger of the three institutions, and potentially a privatisation of Budapest Bank. Nevertheless, according to the government, the state, which is the sole owner of Budapest Bank, is likely to keep a minority stake in the new bank. MKB and Takarekbank are privately owned and controlled by domestic entrepreneurs. Should a potential merger materialise, the new bank would be the second largest in terms of assets (HUF 5,800 billion or €16.5 billion) and would have the largest branch network, accounting for almost half of the total network in Hungary.

Disagreement over the rule of law has remained unresolved. The European Parliament (EP) and the Hungarian government have continued to engage in the rule-of-law dialogue in the framework of the Article 7(1) procedure of the Treaty on European Union triggered by the EP on 12 September 2018. Changes adopted with the Act CXXVII on 17 December 2019 have allowed the introduction of structural changes that may have a significant impact on the organisation of the justice system. This has caused concern from the Council of Europe Commissioner for Human Rights and a number of other international bodies over their possible impact on judicial independence. The European Commission took action against Hungary on 8 November 2019 at the European Court of Justice (ECJ) on the asylum legislation adopted in 2018. On 18 June 2020, the ECJ concluded that Hungarian law on foreign-funded non-governmental organisations violates EU law on the free movement of capital and fundamental rights.

LATVIA

Highlights

- **The Covid-19 crisis halted economic growth in 2020.** After moderate growth in 2019, GDP is falling significantly in 2020 due to the coronavirus-induced effects on domestic demand, investments and exports.
- **Anti-money laundering/combating the financing of terrorism (AML/CFT) reform is progressing.** A Moneyval assessment concluded that the regulatory framework updated in 2019 is generally compliant with Financial Action Task Force (FATF) standards.
- **The administrative-territorial reform has been passed.** Under this reform, the number of municipalities will be reduced from 119 to 42 following the next municipal elections in 2021. The reform aims to streamline local and regional development and improve public service delivery.

Key priorities for 2021

- **Stimulating infrastructure investments, including through effective EU funds absorption, will be critical for the recovery phase.** Besides financing public infrastructure projects to address existing gaps and stimulating private investment, the authorities should ensure that regional and income inequalities are addressed, including through improving access to quality healthcare and education.
- **Effective implementation of new AML legislation is needed.** This will contribute to a sound banking sector, which is crucial for the resumption of credit growth, as well as the development of capital markets and alternative financial instruments.
- **Education reform should continue in spite of limited fiscal space.** Structural reforms targeting vocational and adult education are critical in increasing employment and productivity, given the country's unfavourable demographics. As such, the authorities and stakeholders should prioritise and ensure the implementation of ongoing reforms and projects, such as the OECD-led skills strategy.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.4	3.3	4.0	2.1	-5.0
Inflation (average)	0.1	2.9	2.6	2.7	0.6
Government balance/GDP	0.2	-0.8	-0.8	-0.2	-5.4
Current account balance/GDP	1.3	0.7	-0.3	-0.6	2.0
Net FDI/GDP [neg. sign = inflows]	0.0	-2.0	-2.2	-2.9	-0.5
External debt/GDP	149.1	142.3	123.7	117.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	48.6	43.5	38.0	36.8	n.a.

CONTINUES

Covid-19: macroeconomic implications

The economy declined sharply in the first half of 2020. GDP growth had already been slowing in 2019 (2.2 per cent growth), and in the first half of 2020 Latvia had the steepest decline in GDP among the Baltic states. In the latter period, Latvia's GDP decreased by 5.4 per cent year-on-year, on the back of a significant fall in output in the second quarter of 8.9 per cent year-on-year. The drop in output was driven by the decrease in private consumption, which fell by 20.9 per cent year-on-year in the second quarter, caused by the imposed containment measures. Nevertheless, the relatively successful management of the epidemic led to a swift recovery of private consumption, as retail turnover recovered to 2019 levels by June 2020 on the back of pent-up demand. On the other hand, industrial production has been slower to recover.

The unemployment rate has ticked up considerably despite robust wage growth. The unemployment rate reached 8.6 per cent in June 2020 compared with 6.3 per cent before the pandemic, mainly due to the affected services sector. Nevertheless, in July 2020, driven by recovering labour demand, unemployment decreased to 8.2 per cent. As the employment support schemes will be discontinued by the end of the year, unemployment is likely to stabilise at current levels. On the other hand, wage growth was still positive in the first half, but did not have an effect on prices as deflation continued by August.

The general government budget deficit will widen considerably. The government deficit was just 0.2 per cent of GDP in 2019 but, given the significant fiscal stimulus package to address the coronavirus crisis, the International Monetary Fund (IMF) expects the fiscal deficit to be 5.4 per cent of GDP in 2020. The IMF also forecasts government debt to increase from 36.9 per cent of GDP in 2019 to 44.1 per cent of GDP by the end of 2020. The government is able to access diversified sources of financing, including eurobonds, the Nordic Investment Bank and the Council of Europe Development Bank.

The medium-term outlook is tilted to the downside. In line with the relaxation of measures, a rebound in the third quarter of 2020 took place on the back of recovering private consumption, but the recovery will likely be subdued by the end of 2020, in line with the wider EU economy. As such, the EBRD projects GDP to decline by 5.0 per cent in 2020 and recover by 3.5 per cent in 2021. This is nonetheless contingent on no other major outbreaks of Covid-19 in the second half of 2020. In the medium term, adverse demographics and the limited availability of financing may hold back output growth.

Policy response to Covid-19

The economic stimulus package has been comprehensive. In March 2020 the government announced a support package of about €2 billion (7 per cent of GDP). Key measures include: loans and guarantees amounting to €250 million; a sectoral support package of €875 million covering the air and transport industry, the health and education sectors as well as infrastructure projects; deferral of tax payments worth €196 million; and the job retention scheme covering 75 per cent of salaries or €700 per month for affected firms. Other measures include subsidised working capital loans and export credit guarantees through the state-owned development institution ALTUM. ALTUM will also manage a €100 million investment fund targeted at impacted large enterprises. Lastly, the EC approved the state's €250 million investment in airBaltic, which was aimed at stabilising the aviation industry, alongside state aid earmarked for the agricultural, forestry and tourism sectors.

The economy will likely benefit from the expected EU stimulus. Following the EU recovery fund deal, Latvia has been earmarked around €10.5 billion for the 2021-27 period. A plan to absorb these funds towards improving the innovative potential of the economy, addressing infrastructure, education and healthcare gaps, and accelerating the green transformation will be crucial, on top of ensuring the recovery post-2020. At the same time, it will require state capacity to effectively deploy such funds.

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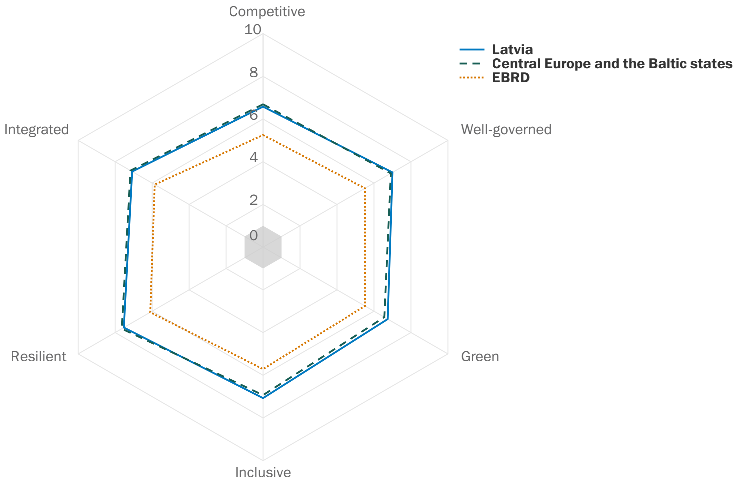
Assessment of transition qualities (1-10)



Structural reform developments

Latvia has improved the AML framework, as per the latest Moneyval evaluation. Following the adoption of new laws in 2019, Latvia has strengthened the Financial and Capital Market Commission, enabled the government to expel banks involved in money laundering, and focused the courts and prosecutors on more serious financial crimes. The number of sanctions and investigations has increased, although the EC has noted the need for further efforts to ensure effective supervision and enforcement. A generally positive report from Moneyval, published in January 2020, rating Latvia as largely compliant with EU regulations, means that the country avoided being placed on the FATF grey list.

The territorial administrative reform is consolidating local administration. In June 2020 the parliament adopted the administrative-territorial reform for consolidating local authorities from 119 to 42 municipalities. This reform is intended to create economically viable administrative territories that are able to provide cost-effective public services. The reform has been met by calls from municipalities and the Chamber of Local Authorities to postpone the process until sufficient consultations are conducted. The comprehensive reorganisation of local administration will enter into force after the local elections in mid-2021.

Tax system reform is ongoing despite a lack of political consensus and economic uncertainty. The current government recently proposed the reform of the tax system aimed at reducing the labour force tax burden, which includes lowering the social tax by 1 per cent, increasing the differentiated non-taxable minimum application threshold, as well as adopting minimal social contributions. The labour tax burden in Latvia is one of the highest in the OECD region, while additional tax revenue sources are needed to ensure enough funding for supporting the healthcare and education systems.

Regional gas market integration has progressed along with greening of the energy market. The roadmap for the regional gas market integration with Finland and the Baltic states was adopted in April 2020, and further progress is expected based on the common gas market that became operational in January 2020 between Finland, Estonia and Latvia. The reform aims to create a more competitive regional market that also supports the energy security of the Baltic states. In January 2020 the government adopted the national energy and climate strategy for 2030, which targets greater energy efficiency, an increase in the share of renewable sources in final consumption to 50 per cent, and reduced emissions by 6 per cent compared with levels in 2005.

LITHUANIA

Highlights

- **The Covid-19 crisis has brought a period of robust macroeconomic performance to a halt.** With strong GDP growth, current account surpluses and fiscal stability, Lithuania had made progress towards European Union (EU) convergence in the past few years, but the coronavirus crisis has reversed this positive trend in 2020, as containment measures strongly affected consumption, investment, trade and the fiscal account.
- **The policy response to the Covid-19 crisis has been comprehensive.** The government announced an economic stimulus package of 11 per cent of GDP, which together with an effective control of the epidemic, allowed the economy to start its economic recovery relatively quickly.
- **A plan facilitating large investment has been announced.** In July 2020 the government announced a comprehensive plan of amendments that will create a "green corridor" for large investments in regional development.

Key priorities for 2021

- **Addressing inequalities should continue, including through education and healthcare reform.** As levels of poverty and income inequality are still among the highest in the EU, the minimum wage, universal child benefits and pensions have been increased. There is a risk that the Covid-19 crisis will exacerbate existing inequalities, both at social and regional levels, which reinforces the case for comprehensive reforms of education and healthcare.
- **Increasing tax collection is critical for a balanced fiscal stance.** As social spending is expected to increase, fiscal revenues will have to increase likewise. Improved tax collection is seen as one of the main solutions, as the shadow economy is still considerable in size, while the value-added tax gap is one of the highest in the EU.
- **An enhanced focus on innovation could stimulate the economic recovery.** The announced investment plan up to 2022, which focuses on innovation, human capital, energy transformation and infrastructure, is an important step forward, but its success will rely on effective implementation.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.5	4.3	3.9	4.3	-2.0
Inflation (average)	0.7	3.7	2.5	2.2	1.3
Government balance/GDP	0.2	0.5	0.6	0.3	-6.7
Current account balance/GDP	-1.1	0.5	0.3	4.2	7.2
Net FDI/GDP [neg. sign = inflows]	-0.9	-2.0	-0.8	-1.5	-0.5
External debt/GDP	86.2	82.6	78.1	67.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	42.7	41.0	40.5	39.5	n.a.

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Covid-19: macroeconomic implications

The economy is in recession but has shown resilience. Services such as retail trade, transport, accommodation and catering account for a relatively large share of economic output (32 per cent of GDP) and have been the most affected branches of the economy during the Covid-19 crisis. Disruptions in global value chains have affected manufacturing, reflected by the decrease in industrial production, which, nonetheless, almost recovered to 2019 levels by July 2020. Private consumption has also been hit, but the effect was short-lived, as in June 2020, retail sales have increased relative to 2019. The impact on exports has also been relatively shallow, thanks to the high share of food products in its exports structure. Investment activity has been most affected, declining by 20 per cent year-on-year in the second quarter, and remains a drag on recovery as credit growth has been negative in the summer months. As such, GDP growth dropped by only 1 per cent year-on-year in the first half of 2020.

Wage growth is expected to slow amid rising unemployment. Boosted by public sector and minimum wage increases, wage growth remained high in the first quarter of 2020 at 9.4 per cent year-on-year after rising by 8.8 per cent in 2019. However, Lithuania's first-quarter unemployment rate rose to 7.1 per cent, up by 0.6 percentage points compared with 2019, and further increased to 8.5 per cent in the second quarter.

A significant fiscal deficit has emerged. After the government recorded a surplus of 0.3 per cent of GDP in 2019, the situation has changed in 2020 as a result of a significant fiscal stimulus package and lower economic activity and revenues. Government revenues were 8.8 per cent lower than planned in January to April 2020, and the International Monetary Fund (IMF) forecasts the fiscal deficit for 2020 at -6.7 per cent of GDP in 2020 and -3.8 per cent in 2021. The IMF also forecasts that public debt will reach 48.3 per cent of GDP by the end of 2020.

The short-term outlook is positive but significant uncertainty remains. Currently, the EBRD forecasts GDP to fall by 2.0 per cent in 2020, given the resilience shown in the first half of the year but remaining uncertainty about the evolution of the pandemic. In 2021, a rebound by 4.0 per cent in 2021 is expected, driven by already-announced significant investments in infrastructure and innovation. However, these forecasts are contingent on no further major outbreaks of the pandemic that could halt the path of recovery.

Policy response to Covid-19

A major economic stimulus package was adopted. The package amounts to about 11 per cent of GDP and is focused on firm liquidity and employment support. In the first stage, a fiscal package of €2.5 billion (5 per cent of GDP) was announced in March 2020. Key measures include additional funds to the healthcare system, income support for the self-employed, wage subsidies for employees in affected firms, and expansion of state guarantee schemes. Support was extended by €1 billion in May with a focus on economic recovery, and includes wage subsidies for returning from unemployment, and increased unemployment benefits and social benefits. Monetary policy was also relaxed, as the Bank of Lithuania lowered the counter-cyclical capital buffer from 1 to 0 per cent and offered loans to liquidity-strained financial institutions.

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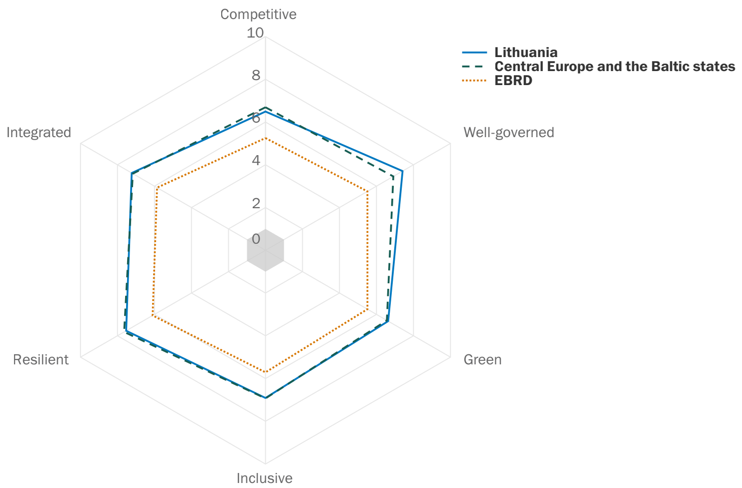
Assessment of transition qualities (1-10)



Structural reform developments

A new investment plan has been announced. In June 2020, the government published its public investment plan, called "The DNA of the Future Economy" worth €6.3 billion (13 per cent of 2019 GDP) to be invested between July 2020 and January 2022. Of the total amount, €2.2 billion will be new investments and the remainder is already-planned investment that will be accelerated, including by absorbing EU funds. The plan covers investments in human capital, the digital economy and business, innovation and research, infrastructure and climate change and energy.

Reforms to the business environment are advancing. The investment climate is being enhanced by a package of amendments to attract large investments through faster procedures in construction, land use, migration, as well as tax incentives, which will enter into force in January 2021. The goal of the "green corridor" is to attract investments in the post-Covid-19 possible reconfiguration of global value chains.

A new insolvency framework has entered into force. The new law came into force in January 2020 and aims to increase the efficiency of insolvency proceedings of legal persons, create conditions for the timely initiation of bankruptcy proceedings and greater satisfaction of creditors' claims, and promote the restructuring and preservation of viable legal persons in financial difficulty. The law states that insolvency occurs when liabilities are equal to assets or when a firm fails to meet its obligations, instead of overdue liabilities exceeding half of assets in the previous version. Thus, there is a risk that the new concept will create bankruptcy proceedings for firms in temporary financial difficulty, increasing the number of insolvencies.

The authorities have initiated plans to establish a National Development Bank and an Innovation Promotion Fund. The parliament has recognised the establishment of a state development bank as a project of national importance. The government has requested the EC's technical assistance in establishing this institution. Separately, a law initiated by the government will enable the Innovation Promotion Fund to be established in 2021. The idea is to facilitate innovative ideas for the financing of businesses.

The tax regime has been adjusted to cover additional social spending. To increase tax revenues, the Law on the Vehicle Registration Tax was adopted in December 2019, which introduces passenger vehicle taxation based on CO_2 emissions from July 2020. Second, the real estate tax brackets were adjusted downwards to cover up to 75 per cent of properties in Vilnius. Lastly, as of January 2020, the progressive personal income tax rate was reintroduced, increasing the rate from 27 per cent to 32 per cent for high earners.

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Progress in the energy sector has been notable. In May 2020 the parliament approved the liberalisation of the retail electricity market, which brings competition to the sector in a staged way depending on households’ consumption levels. Energy security is also improving, as Lithuania has already reached interconnection targets for electricity and is now developing a new electricity interconnector with Poland. The development of a natural gas interconnector pipeline is also advancing, boosted by a state guarantee in Klapeida LNG terminal. Moreover, there has been progress in identifying the location of a new 700 MW offshore wind farm.

POLAND

Highlights

- **Poland entered a recession in 2020.** Nevertheless, the drop in economic activity in the first half of 2020 turned out to be less severe than anticipated by most forecasters.
- **Several anti-crisis measures have been introduced to fight the negative impact of the pandemic.** The estimated value of the measures exceeds 15 per cent of GDP, including guarantees, to support employment, businesses and the healthcare sector.
- **The central bank launched its first quantitative easing (QE) programme.** The National Bank of Poland has been buying treasury bonds and government-guaranteed debt instruments on the secondary markets.

Key priorities for 2021

- **Tapping the EU recovery fund and implementing the Just Transition initiative can support Poland's green economy transition.** Investment in digitalisation and green technologies can boost the post-recession recovery. This also includes investing in human capital and reskilling the workforce in the most polluting sectors, such as electricity production from coal.
- **Further business environment reforms are needed to attract investment.** The pandemic-driven restructuring of production locations of multinationals constitutes an opportunity for Poland, especially for enhanced usage of modern smart technologies and automation.
- **Policies that enhance inclusivity should be strengthened.** A diverse workforce can improve the bottom line of a business, lead to happier and more productive teams and drive innovation among employees. Any discriminatory language and measures, for example regarding sexual orientation, by the central and local governments will likely play against that.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.1	4.9	5.3	4.5	-3.5
Inflation (average)	-0.2	1.6	1.2	2.1	3.3
Government balance/GDP	-2.4	-1.5	-0.2	-0.7	-10.5
Current account balance/GDP	-0.8	-0.3	-1.3	0.5	3.0
Net FDI/GDP [neg. sign = inflows]	-0.9	-1.4	-2.6	-1.6	-0.5
External debt/GDP	76.4	67.0	63.8	58.8	n.a.
Gross reserves/GDP	24.3	21.4	19.9	21.7	n.a.
Credit to private sector/GDP	52.4	52.1	50.9	50.6	n.a.

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Covid-19: macroeconomic implications

The Covid-19 outbreak and resulting restrictions pushed the economy into recession. GDP growth had continued strongly in 2019 at 4.5 per cent but the outbreak of the coronavirus pandemic and the imposed administrative lockdown caused GDP to fall in the first half of 2020, by 3.2 per cent year-on-year, pushing the economy into recession for the first time since early transition. While Poland is highly integrated into global value chains and has a large exposure to trade, it still managed to show a positive net export contribution to growth in the first half of 2020. The Labour Force Survey unemployment rate remained stable, reaching 3.1 per cent in August 2020, helped by companies retaining employees thanks to the support measures introduced by the government.

Investment remains subdued. The investment-to-GDP ratio, which reached 18.5 per cent in 2019, has continued to be the lowest in central Europe and the Baltic states and has fallen during the first half of 2020. The investment growth rate in this period was down by 6.0 per cent year-on-year, and outlays on means of transport dropped by 24.6 per cent. According to various surveys referenced by the National Bank of Poland's July 2020 report on the conditions of enterprises in Poland, 80 per cent of companies were planning to reduce investments and 75 per cent of small and medium-sized enterprises (SMEs) had not planned any investments during the 2020 summer months.

Public finances have deteriorated. The deterioration of the general government balance in 2020 stems mainly from the new measures undertaken by the government in response to the Covid-19 pandemic and the macroeconomic slowdown. According to the International Monetary Fund's October 2020 estimates, the general government deficit is expected to rise to 10.5 per cent of GDP in 2020, before falling to a deficit of 4.3 per cent of GDP in 2021 as the economy rebounds. At the same time, gross public debt is expected to reach an historic high of 60 per cent of GDP by the end of 2020 and rise further in 2021.

A recovery is expected in 2021 but significant risks remain. The domestic market has proved to be relatively resilient to the effects of Covid-19, but the magnitude of the recovery will depend largely on external factors next year. We anticipate GDP will fall by 3.5 per cent in 2020, and rise by 3.0 per cent in 2021. Key risks to the forecast refer to the direction and magnitude of the development of the pandemic. No severe country-wide lockdowns are expected, although the financial capability of the state to offset any potential local and temporary closures of businesses remains limited. The unemployment rate is likely to rise, weighing somewhat on the recovery of household consumption.

Policy response to Covid-19

The Covid-19 pandemic-related restrictions triggered rapid crisis protective measures. At the beginning of March 2020 the government put in place strict containment measures, including a shutdown of businesses and schools, causing a sharp reduction in economic activities. As a result, the government and the National Bank of Poland launched various relief measures to preserve employment, support companies in a state of hibernation and support household incomes – all designed to dampen the effects of the pandemic. While the majority of restrictions were gradually lifted from May 2020, including those on international travel, some were re-imposed in the third quarter of 2020 on a regional basis where a surge of new cases became evident.

A series of anti-crisis measures have been introduced. In March 2020 the president signed the first of the anti-crisis shields into law, worth about 10 per cent of GDP and comprising dozens of measures to support employment, companies and the healthcare sector, and widen the competences of the state-run Polish Development Fund (PFR). The announced measures include furloughs and preferred loans (with a grant option) for companies with a decline in turnover due to Covid-19 that maintain employment, social security breaks for micro enterprises and reductions for small companies, and cash stipends for the self-employed. The crisis legislation was extended in April to include a PLN 100 billion (about 4.5 per cent of GDP, €23 billion) liquidity scheme, called "the PFR financial shield for companies and employees", managed by the PFR. The scheme includes loans to micro companies, SMEs and large firms, of which some 75 per cent are in the form of grants. Guarantees mostly come from the Polish Development Bank (BGK), announced

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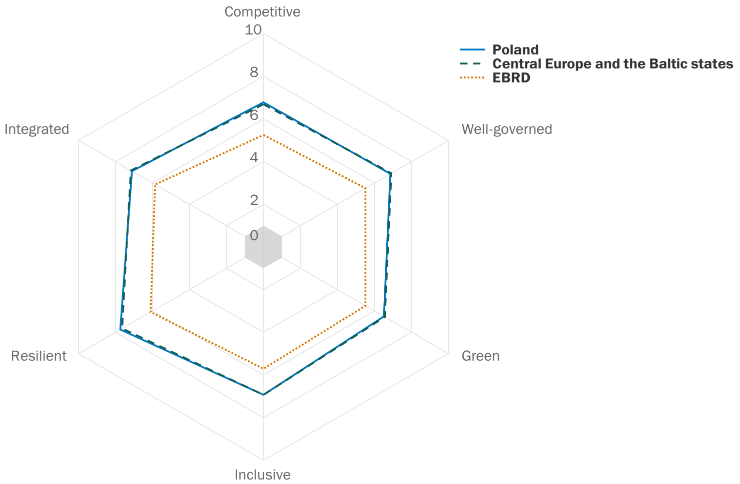
at PLN 100 billion (€23 billion). In June 2020 the president signed into law “anti-crisis shield 4.0”, which includes subsidised interest rates on bank loans, support for local government finances, protection for Polish firms from takeover by investors outside the EU, credit holidays and extended care allowances. Financing of the BGK and PFR programmes has been mostly provided through bond placements, also acquired in the secondary market by the central bank through its QE programme. The ultimate value of the anti-crisis measures may differ from the announced figures, in line with policy changes and emerging financial needs.

Assessment of transition qualities (1-10)



Structural reform developments

The government introduced a two-year voucher programme to support the tourism sector. In July 2020 parliament approved a bill to give families tourism vouchers worth PLN 500 (€115) per child, in a programme that will cost an estimated PLN 4.0 billion (€0.9 billion). About 6.5 million Poles are eligible to receive the vouchers, and disabled children receive an additional PLN 500 each. Initial take-up of the programme was slow. However, its fully electronic form should contribute to digital inclusion and take-up of the e-government services. The tourism sector in Poland normally accounts for about 5 per cent of GDP.

The central bank launched its first QE programme. The National Bank of Poland (NBP) started its first QE programme, announced in mid-March 2020, through buying treasury bonds and, since April 2020, government-guaranteed debt instruments on the secondary markets from banks. The ultimate size of the QE was not announced. In addition, through its three rate cuts, the reference rate went down to an historically low rate of 0.1 per cent in May 2020 (from 1.5 per cent in March). The NBP has also conducted repurchase agreement operations to extend liquidity to banks. Other measures introduced by the NBP include bill discount credit aimed at refinancing bank loans granted to enterprises. Furthermore, the Minister of Finance, based on the recommendation of the Financial Stability Committee (KSF), fully released the systemic risk buffer (from 3 per cent to zero).

More EU funds became available to fight the impact of the pandemic, but some funds have been blocked. In July 2020 the European Commission (EC) approved the redirection of about €2.2 billion from cohesion funds to anti-pandemic measures, especially to support SMEs, to enable the remuneration of professions at risk in healthcare, and to purchase medical equipment. The upcoming 2021-27 EU funds will consist of two pillars: the regular multiannual financial framework (MFF) and an extraordinary Covid-19 recovery fund. Poland is expected to receive €139 billion as grants and €34 billion as loans. In July 2020, however, the EC blocked some payments (a total of less than €0.2 million) to six municipalities which had announced themselves as “LGBT-free zones”. In September 2020 the European Parliament adopted a resolution that, among others, expresses concerns regarding fundamental rights in Poland.

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Disagreement raised by judicial reform has remained unresolved. The EC and the Polish government have continued to engage in a rule-of-law dialogue within the framework of the Article 7(1) procedure of the Treaty on European Union triggered by the EC in December 2017. On 29 April 2020 the EC launched its fourth infringement procedure against Poland, this time regarding the new law on the judiciary, which was adopted in December 2019 and entered into force in February 2020. The EC concluded that several elements of the new law undermined the judicial independence of Polish judges and violated EU law. On 8 April 2020 the European Court of Justice (ECJ) ruled that Poland must suspend the application of the law until the ECJ's final judgment.

SLOVAK REPUBLIC

Highlights

- **The Covid-19 pandemic has led to lower external demand and ruptured supply chains, causing a GDP contraction.** The situation is exacerbated by the homogeneity of the economy and heavy concentration on one industry – car manufacturing – which has been badly affected by the crisis.
- **Crisis response measures have supported employment and business liquidity.** The "First Aid" package, approved by the government in March 2020, amounted to about 1 per cent of annual GDP each month.
- **The bank levy has been removed.** The €1 billion already collected from past payments of the levy will be moved to the Slovak Development Fund to support development programmes, such as investments in healthcare and significant infrastructure projects.

Key priorities for 2021

- **Measures designed to restart the economy should also be targeted at long-term development.** Building an adequate skills base and a better innovation environment can ensure that the economy remains competitive and resilient through further productivity growth and relevance in global value chains, including beyond the automotive industry.
- **Further simplification and legislative amendments are needed to ensure that European Union (EU) funds are used in the most effective way.** This is particularly important as the unused money in the 2014-20 EU budget can still be spent in a more flexible way, especially on activities to fight the effects of Covid-19. Persistent trouble over the years with the investment co-financed with the EU funds have highlighted the need to improve the effectiveness and capacity of the administration at various levels of government.
- **Investments in energy efficiency and the green economy need to be substantially increased.** Greening of the economy should be a priority. So far the country has had limited success in delivering financial instruments to support the greening of small and medium-sized enterprises (SMEs), energy efficiency in the building sector (single-family homes and municipal buildings in particular), renewable energy capacities or waste management.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	2.1	3.0	3.9	2.4	-7.0
Inflation (average)	-0.5	1.4	2.5	2.8	1.5
Government balance/GDP	-2.5	-1.0	-1.0	-1.3	-8.8
Current account balance/GDP	-2.7	-1.9	-2.2	-2.7	-3.1
Net FDI/GDP [neg. sign = inflows]	-0.8	-2.8	-1.3	-2.2	0.8
External debt/GDP	92.5	108.3	114.6	112.0	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	57.3	60.4	62.5	63.4	n.a.

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Covid-19: macroeconomic implications

The coronavirus crisis prompted economic activity to plunge. GDP growth in 2019, at 2.4 per cent, was already on a downward path, and the lockdown imposed country-wide in March 2020 and the collapse of external demand pushed the Slovak economy into a deep recession in the first half of 2020. GDP dropped by 8.1 per cent year-on-year in this period, mostly weighed by a double-digit plunge in investment and private and government expenditures. The latter dropped more abruptly than the expenditures of households, reflecting major delays in the provision of support measures by the new government in the second quarter of 2020. The homogeneity of the economy has long been a risk factor, which is currently materialising. Car manufacturing, including smaller domestic suppliers, accounts for almost half of industrial production and 47 per cent of total exports. The country's four car makers stopped production completely in April 2020, but partially re-started a month later.

Car manufacturers' investments are on hold but remain in the pipeline. Despite the cyclical slowdown registered already in 2019, investment grew by 6.8 per cent, mainly because of major infrastructure construction projects and improved absorption of EU funds. The Covid-19 pandemic put the majority of investment projects on hold, as seen by the substantial drop of gross fixed capital expenditures of 10.1 per cent year-on-year in the first half of 2020. On the upside, several car manufacturers are considering new investments. Porsche is planning to build a new production plant for e-cars, worth €250 million, near Piestany in the west of the Slovak Republic. Volkswagen (VW), another German car maker, is planning to invest at least €500 million in the next five years, as a result creating an additional 2,000 jobs while not introducing any Covid-19-related redundancies by 2023. The government pledged to support the construction of residential housing near VW's plant in Bratislava.

The government deficit increased substantially. According to the International Monetary Fund's October 2020 estimates, the general government deficit is expected to rise to 8.8 per cent of GDP in 2020, before falling again in 2021 as the economy rebounds. As elsewhere, the deterioration of public finances is directly linked to the shortfall of tax revenues and government measures to mitigate the negative impact of the coronavirus outbreak on the economy. In June 2020 the government suspended the cap on state expenditures, approved in January 2020, due to the extraordinary circumstances linked to the pandemic. In March 2020 the European Commission invoked the General Escape Clause from the Stability and Growth Pact, so that market access and long-term fiscal sustainability became the only constraints on the size of public spending programmes.

Post-crisis recovery will largely depend on the condition of the automotive sector. GDP will fall sharply in 2020 by 7.0 per cent, according to our current forecasts. However, we anticipate some improvement in external demand next year, which together with improved absorption of EU funds, including the EU recovery package, and significant investments by the automotive industry, should bring a recovery of 5.0 per cent growth in 2021. The high reliance of the economy on the automotive industry remains a key risk factor. Any adverse shock to the industry, such as a drop in demand for cars or any break of supply chains, could delay the recovery.

Policy response to Covid-19

The Covid-19 pandemic-related restrictions triggered rapid crisis protective measures. As an accompaniment to the lockdown imposed in March 2020, the government launched various relief measures to preserve employment, support companies in a state of hibernation and support household incomes. The majority of restrictions were gradually lifted from May 2020, including international travel and a return of production in all car plants.

Crisis response measures have been largely targeted at supporting employment and business liquidity. In March 2020 the outgoing government approved 31 measures to prevent the economy from collapsing. Key measures included the provision of liquidity to businesses through the Slovak Guarantee and Development Bank (SZRB) and the Eximbanka, tax and social security contribution deferrals, wage subsidies, extended sickness benefits, and negotiations with

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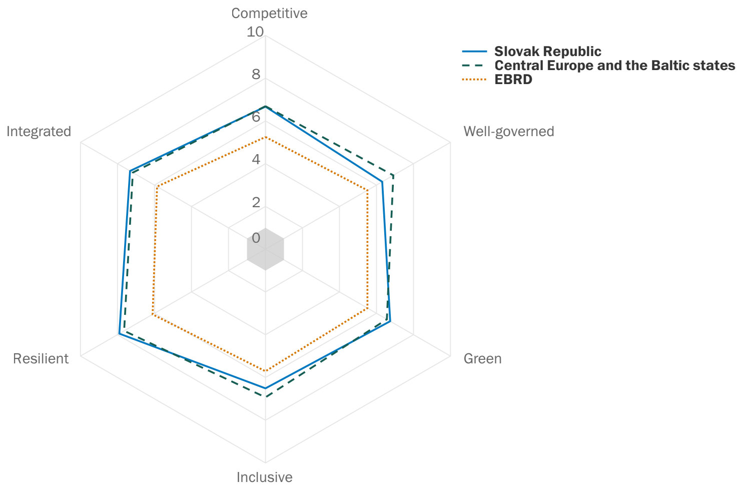
the banking sector on a moratorium on loan repayments. Later in March 2020 the government approved a "First Aid" package, worth about 1 per cent of annual GDP each month, to support businesses, the self-employed and employees. The package consisted of about €1 billion of direct aid and €500 million as bank guarantees. Further, in April 2020, the so-called "Kurzarbeit" – a reduction of working time and salaries as a means to avoid redundancies – and additional aid for entrepreneurs via preferred loans were introduced, followed by state assistance in rent payments to affected small businesses, such as shops or restaurants. In June 2020 the government approved an additional 114 measures, the so-called "Lex Corona", to improve the business environment and revive the economy. As a eurozone member, the Slovak Republic has been eligible for the European Central Bank's Pandemic Emergency Purchase Programme of €750 billion.

Assessment of transition qualities (1-10)



Structural reform developments

The government has set out plans for an employment preservation fund. In August 2020 the government proposed a scheme to preserve employment in future crises, such as the current coronavirus crisis, but also when other local problems emerge, such as floods. According to the proposal, employees who would otherwise be dismissed should receive 80 per cent of their net salary, of which 60 per cent is to be covered by the created employment preservation fund and the remaining 20 per cent by employers. The fund should also be available to the self-employed. According to the labour ministry, the current employment preservation scheme, as a part of the "First Aid" package, saved 500,000 jobs as of mid-August 2020.

The bank levy has been removed. In June 2020 the finance ministry and the Slovak Banking Association signed an agreement to remove the special bank tax on banks' assets, starting from July 2020. In return, banks agreed to boost their core capital, among other things, by not paying dividends. In addition, banks pledged to invest an additional €500 million in loans for households and businesses until 2023. The €1 billion collected from past payments of the levy will be moved to a new Slovak Development Fund, which will be established by the end of 2020 and which will focus on supporting and financing development programmes, such as investments in healthcare and significant infrastructure projects. The special bank levy was introduced in 2012 to create a buffer fund to help cope with potential crises.

Rules for use of EU funds have been simplified. In March 2020 the European Commission approved a request by the Slovak government to move uncontracted money between funds and to simplify the bureaucratic rules. Effectively, 100 per cent of the EU funds can now be used to mitigate

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the impact of the pandemic, without national co-financing. As a result, in April 2020 the government reallocated €1.25 billion of EU funds to five key areas: the healthcare system, jobs, SMEs, the emergency rescue system and education. As of the end of July 2020 the Slovak Republic had absorbed 32.5 per cent of EU funds under the 2014-20 EU budget. The upcoming 2021-27 EU funds will consist of two pillars: the regular multiannual financial framework (MFF) and an extraordinary Covid-19 recovery fund. The Slovak Republic is expected to receive €18.6 billion under the MFF 2021-27, and €7.5 billion in grants under the Covid-19 recovery fund, and it will be eligible to draw soft loans of up to €6.8 billion, repayable by 2058.

SLOVENIA

Highlights

- **The economy is undergoing a serious downturn.** The Covid-19 pandemic has put the economy into recession and is particularly affecting private consumption, investments, goods exports and tourism.
- **A sizeable crisis-response support programme has been adopted.** The government has adopted, in four stages, a significant fiscal package, helping to preserve jobs and firms' liquidity; the fifth package is awaiting parliamentary approval.
- **Structural reforms have slowed, due partly to political changes as well as the pandemic.** A new government was appointed amid the Covid-19 crisis and has focused on addressing the health and economic impacts of the pandemic.

Key priorities for 2021

- **More effective absorption of EU funds is important for a quicker recovery.** Slovenia will receive more than €10 billion during the next European Union (EU) programming period, and the commitment of the authorities to improve the use of funds is a welcome signal.
- **Progressing with important structural reforms is important for further convergence with the richer EU countries.** Key priorities include further enhancing corporate governance of state-owned enterprises (SOEs), developing capital markets and removing unnecessary barriers to doing business.
- **Further fiscal adjustments will be needed to maintain sustainable public debt.** In light of increasing public debt levels amid the significant fiscal stimulus, the authorities should define a plan to stabilise medium-term fiscal targets, while in the medium to long term an ageing population highlights the need to begin reforming the pension, health and long-term care systems.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.2	4.8	4.4	3.2	-7.5
Inflation (average)	-0.2	1.6	1.9	1.7	0.2
Government balance/GDP	-1.9	-0.1	0.7	0.5	-7.2
Current account balance/GDP	4.8	6.2	5.9	5.7	4.5
Net FDI/GDP [neg. sign = inflows]	-2.1	-1.2	-2.0	-1.6	-2.4
External debt/GDP	104.5	105.3	88.7	87.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	45.7	44.3	42.7	42.2	n.a.

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Covid-19: macroeconomic implications

Slovenia's economy has been hit hard by the coronavirus crisis. A slowdown in 2019 (to 2.4 per cent GDP growth) has been followed in 2020 by a severe recession, mainly due to the containment measures, which heavily affected private consumption, and the temporary collapse of international trade. In the first quarter of 2020 the economy was already contracting by 2.4 per cent year-on-year, one of the steepest falls in the region. In the second quarter, as the country felt the full effect of the crisis, the contraction reached almost 13 per cent year-on-year, as the lockdown measures, imposed in mid-March, resulted in a significant drop in domestic demand. The economy has also suffered disproportionately from the drop in international trade, due to its high integration in global value chains. Exports of goods, which account for more than 70 per cent of GDP, dropped by 12 per cent year-on-year in the first half of 2020. Another key channel for disruption was tourism, which normally accounts for about 7 per cent of GDP. The number of foreign tourists in the first half was down by about 80 per cent year-on-year, and the sector was relying more on local guests (whose spending was supported by government vouchers). This all resulted in a 7.7 per cent decline in economic activity in the first half of 2020. Unemployment, however, increased only marginally to 4.7 per cent in July 2020 (from 4.0 as of the end of 2019), mainly as a result of the government support schemes to preserve jobs.

The Covid-19 crisis has caused significant fiscal pressures. As a result of falling revenues and rising (crisis-response) spending, the fiscal deficit for 2020 is projected by the government at 9.3 per cent of GDP, with debt forecast to increase to 82 per cent of GDP by the end of the year, the same as at its peak level from 2015, following the banking sector bailouts. Nevertheless, access to funding remains satisfactory. By early September 2020, the government had raised €5.9 billion on the capital markets, covering almost 90 per cent of the estimated financing needs in 2020. Debt characteristics are favourable, as fixed interest debt, euro-denominated debt and long-term debt represents more than 95 per cent of government debt. In June 2020 credit ratings agency Standard & Poor's affirmed Slovenia's rating at AA- with a stable outlook, and in July 2020 Fitch kept Slovenia's rating at A, also with a stable outlook. These decisions reflect the economic resilience to the Covid-19 pandemic and the track record in recent years of fiscal prudence and reduced external and financial imbalances.

Growth is likely to return in 2021. In May, Slovenia was the first EU country to declare the end of the pandemic. While some precautions remained, the reopening of the economy paved the way for the recovery. Notwithstanding the severe immediate impact of the crisis, the recovery should limit the GDP reduction in 2020 to -7.5 per cent, and we expect GDP growth of 3.5 per cent in 2021, partly driven by a strong base effect. Nevertheless, the risks are on the downside. As a small, open economy, Slovenia is highly exposed to economic developments in its key trading partners, particularly the core eurozone economies. Support for the recovery is expected to come from public infrastructure projects, such as the second railway track to the port of Koper and the Karavanke tunnel.

Policy response to Covid-19

The government has supported the economy with several sizeable fiscal packages. A stimulus package of about 13 per cent of GDP is one of the most comprehensive responses in the EBRD regions. Preserving jobs, keeping businesses in operation and supporting those in vulnerable categories were at the core of the crisis response measures in Slovenia. The first economic package was adopted in early April 2020, worth €3 billion (6.7 per cent of GDP), and allowed payment of compensation and pension and healthcare contributions for businesspeople and farmers affected by the coronavirus, as well as to those who temporarily lost their jobs. The second economic package, worth €2 billion (4.5 per cent of GDP), was adopted in late April, and provided state guarantees to firms to take out bank loans to maintain their liquidity amid the crisis. In May 2020 the government adopted a third economic stimulus package, worth €1 billion (2.2 per cent of GDP), which featured subsidies for shortened working time, vouchers for citizens to spend in tourism facilities around the country, and favourable liquidity loans. Further precautionary measures were adopted in July and in September in preparation for a possible second wave of the pandemic. The latest measures include extension of the furlough scheme until year-end for all industries, reversing earlier plans to confine the measure to the

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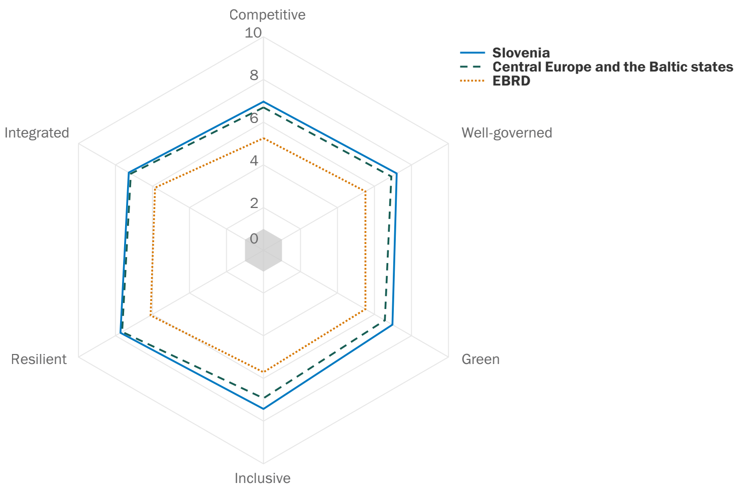
sectors worst hit, but with a stricter eligibility criterion, of at least a 30 per cent drop in turnover compared with last year. In addition, in April 2020 the Bank of Slovenia temporarily restricted banks regarding profits distribution, with the purpose of preserving capital so that the banking system could absorb potential losses and provide liquidity to the real economy. Likewise, the Slovenian Insurance Supervision Agency adopted the same measure.

Assessment of transition qualities (1-10)



Structural reform developments

The public procurement process has been strengthened. In November 2019 the new Act Amending the Legal Protection in Public Procurement Procedures was adopted. The amended act brought three major new features. First, a change in the organisation and formation of the National Review Commission (DKOM) to ensure greater independence and better operation of this authority, which has the status of a tribunal or an independent authority responsible for legal protection in public procurement procedures. Second, it allows administrative disputes against decisions of the DKOM. And third, it adopts measures to speed up legal protection procedures and enhance the effectiveness of legal protection in major projects.

Legislation was adopted to promote a more inclusive labour market. The new Labour Market Regulation Act was adopted in December 2019. The proposed amendments aim to provide better social security for the unemployed and increase the number of elderly persons in employment. They will also enable better integration of foreigners into the Slovenian labour market. Longer active participation in the labour market was also promoted through the pension and tax system reforms adopted in 2019.

Infrastructure development has continued, particularly in rail transport. Modernisation of the railway network includes: upgrading the lines between Zidani Most and Dobova (on the border with Croatia) and between Zidani Most and Celje; the planned upgrade of the line between Ljubljana and Divača (from where one route leads to Italy and the other to the port of Koper); and construction of a direct rail connection between the Primorska and Gorenjska lines (Tivoli curve); together with upgrading Ljubljana station.

Key infrastructure investments are being streamlined. According to new regulations which entered into force in May 2020, the projects benefiting from the new approach will be determined based on statutory criteria, which are that they: (i) implement objectives of national and strategic policies and EU cohesion policy; (ii) exceed €5 million investment; (iii) are ready to

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be implemented by the end of 2020; and (iv) have ensured financing by the end of 2020. They will receive priority treatment in administrative and court proceedings by being declared to be for public benefit. The benefits include obtaining construction permits quickly, allowing construction before a final building permit is issued, and overriding appeals related to environmental aspects. The participation of non-governmental organisations (NGOs) in the appeals process for these projects is being limited, prompting protests from environmental NGOs regarding the potentially harmful consequences of the regulation.

The share of renewables in energy production is increasing. In December 2019 Slovenia's state-owned power utility Dravske Elektrarne Maribor (DEM) began €65 million worth of investments in three wind farms – Ojstrica, Paski Kozjak and Rogatec – with a total installed capacity of 46 MW. Currently there are only two wind turbines in operation in the country, accounting for a negligible share of the country's energy mix, although Slovenia's wind potential is estimated at 415 MW. With this in mind, new wind park projects could help Slovenia meet renewable energy targets, which are set at a 27 per cent share of green energy in final energy consumption by 2030.