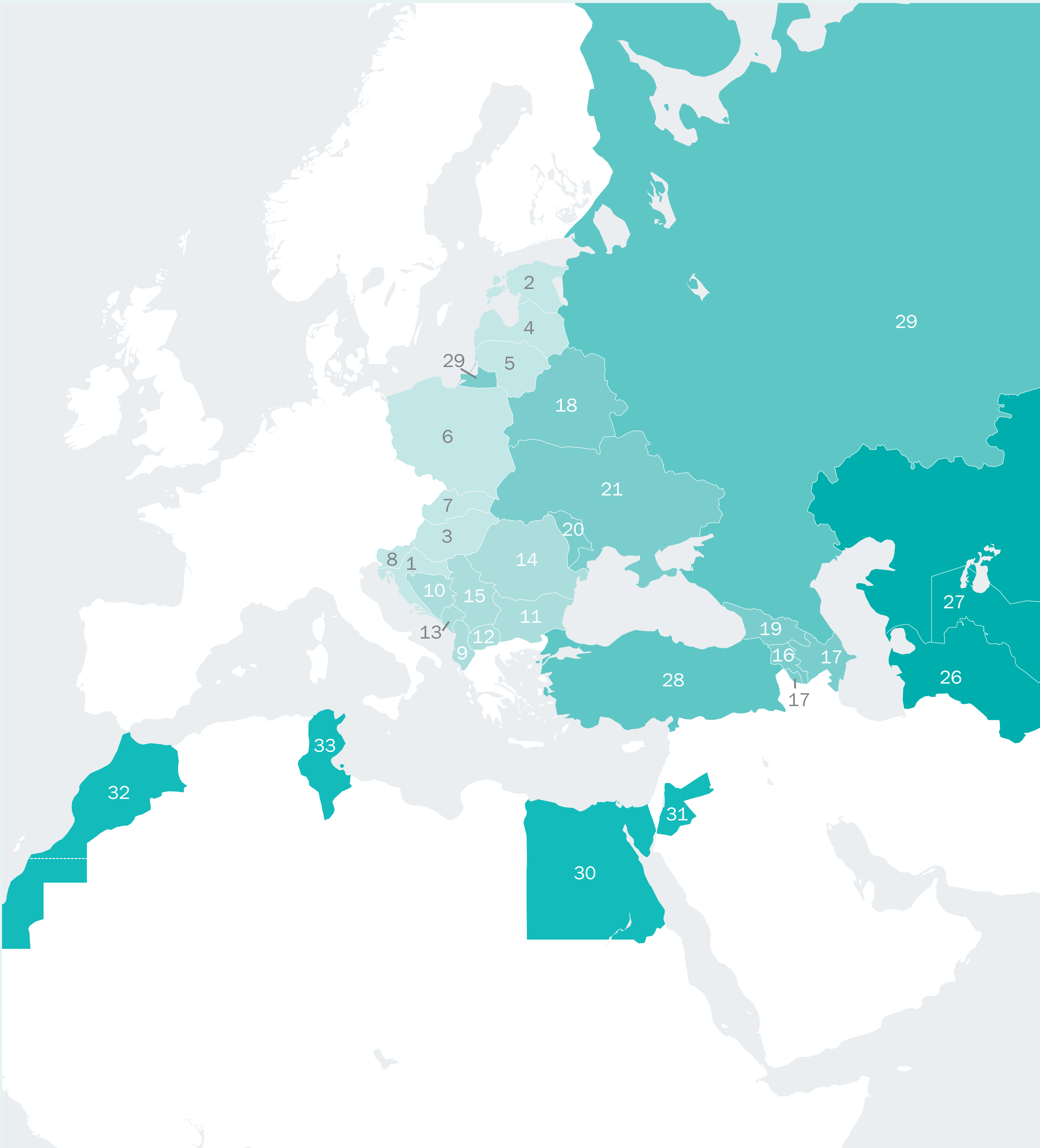
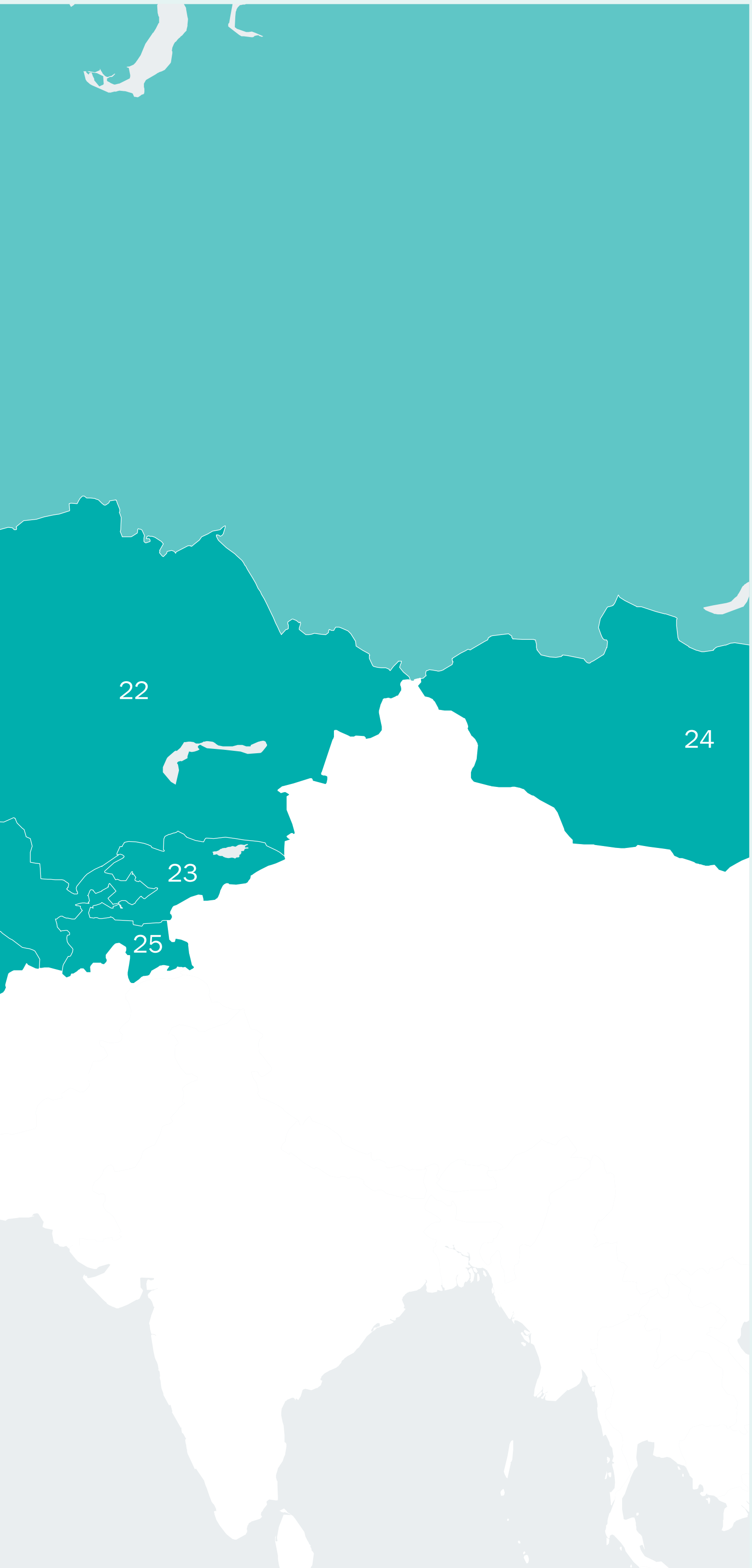
COUNTRY ASSESSMENTS

This part of the Transition Report contains a country-by-country review of reform progress and macroeconomic developments in the transition region from mid-2011 to the third quarter of 2012. It also includes a brief table of key macroeconomic indicators, including forecasts for 2012. The "cut-off" date for data and other information was early October 2012. More detailed data, both historical and current, covering structural, institutional and macroeconomic developments are available at the EBRD web site, at www.ebrd.com/economics


2
4
29
5
18
6
29
21
7
3
20
8
1
14
10
15
11
13
12
9
19
16
17
27
26
28
17
33
32
31
30



Central Europe and the Baltic states

1 **Croatia** 106
2 **Estonia** 110
3 **Hungary** 116
4 **Latvia** 124
5 **Lithuania** 126
6 **Poland** 136
7 **Slovak Republic** 144
8 **Slovenia** 146

South-eastern Europe

9 **Albania** 94
10 **Bosnia and Herzegovina** 102
11 **Bulgaria** 104
12 **FYR Macedonia** 112
13 **Montenegro** 132
14 **Romania** 138
15 **Serbia** 142

Eastern Europe and the Caucasus

16 **Armenia** 96
17 **Azerbaijan** 98
18 **Belarus** 100
19 **Georgia** 114
20 **Moldova** 128
21 **Ukraine** 156

Central Asia

22 **Kazakhstan** 120
23 **Kyrgyz Republic** 122
24 **Mongolia** 130
25 **Tajikistan** 148
26 **Turkmenistan** 154
27 **Uzbekistan** 158

28 **Turkey** 152
29 **Russia** 140

30 **Egypt** 108
31 **Jordan** 118
32 **Morroco** 134
33 **Tunisia** 150

ALBANIA

HIGHLIGHTS OF THE PAST YEAR

- **Growth was robust last year but is declining in 2012, mainly as a result of the eurozone crisis.** Economic growth exceeded 3 per cent once again in 2011, despite significant external pressures. However, various indicators in 2012 suggest a sharp slow-down in economic activity, and vulnerability to spillovers from the eurozone crisis is likely to remain present for some time.

- **Important steps have been taken to protect the banking sector.** These include measures to allow foreign bank branches to be converted into subsidiaries and new legislation to allow for the establishment of a bridge bank. So far, the banking sector has coped well with the pressures from the eurozone crisis.

- **Plans to increase hydropower capacity through private sector involvement are advancing.** The authorities have put a number of generation companies up for sale and have issued public-private partnership (PPP) tenders for new facilities.

KEY PRIORITIES FOR 2013

- **Further reforms are needed to advance in the EU approximation process.** Strengthening democracy and the rule of law are key to achieving this objective.

- **Albania should make further moves towards a sustainable energy sector.** The country has the potential to become a regional player in the renewable energy market, but this will require improved efficiency and viability of distribution and generation, a substantial increase in private sector participation in power generation, and an improved regulatory framework.

- **Continued vigilance is needed to address any fallout from the crisis in the eurozone periphery.** Albania is highly vulnerable to further escalation of the crisis due to its close trade, investment and remittance ties with the countries in the eurozone, particularly Greece and Italy.

MACROECONOMIC PERFORMANCE

The economy contracted in the first quarter of 2012. Albania was the only country in south-eastern Europe that continued to grow during the 2009 global financial crisis and beyond, with robust growth rates of over 3 per cent in 2010 and 2011. Some signs of growth deceleration emerged in the second half of 2011 in light of a weakening performance in some key EU markets, such as Greece and Italy, but it was only this year that the first contraction in output was reported in Albania. According to national statistics, GDP fell by 1.2 per cent in the first quarter of 2012 relative to the previous quarter. The unfavourable external environment is expected to persist this year, and various high-frequency macroeconomic indicators such as industrial production and retail turnover point to continued weak economic activity in the second quarter.

The inflation rate has remained moderate. In January 2012 inflation fell below the target range of 2-4 per cent. With concerns mounting over the weakening economic growth, the central bank began a series of cuts in the base interest rate this year, with the latest – in July 2012 – bringing down the interest rate to a historic low of 4 per cent. The government is targeting a deficit of 3 per cent of GDP in 2012, an ambitious target that will be difficult to achieve in light of the weaker than expected economic performance so far this year. Public debt is only just below the 60 per cent of GDP limit enshrined in the budget law.

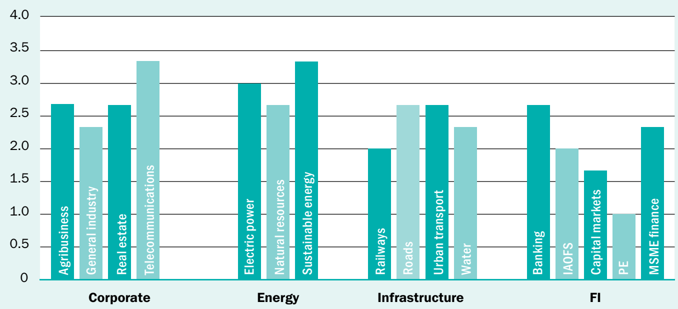
Only limited growth is expected in 2012 and 2013. Under baseline expectations of slow and uneven progress in containment of the eurozone crisis, the external environment will remain unfavourable to a recovery in economic activity following the first quarter decline. Domestic demand is also expected to remain weak, especially in light of weakening credit growth and the observed decline in remittances, which are a vital source of income for many Albanians. As a result, GDP growth in 2012 and 2013 is likely to be below the levels seen in recent years, and vulnerabilities will remain high as long as neighbouring eurozone countries stay in difficulties.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	3.3	3.5	3.1	0.6
Inflation (end-year)	3.7	3.4	1.7	3.1
Government balance/GDP	-7.4	-4.2	-3.5	-3.5
Current account balance/GDP	-14.0	-11.4	-12.3	-11.8
Net FDI (in million US$)	936	1098	989	850
External debt/GDP	32.9	33.6	33.7	na
Gross reserves/GDP	19.0	22.9	18.3	na
Credit to private sector/GDP	36.7	37.7	38.9	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The European Commission (EC) has recommended that Albania be granted EU candidate status, subject to the completion of certain key reforms, including in the judiciary and public administration. This was the main conclusion of the EC's latest Progress Report, published in October 2012, on Albania's track record in reforms. In its report, the EC welcomed the political dialogue in the country. The European Council will make a decision on this recommendation in December 2012.

Privatisation is well advanced, but some significant assets remain to be sold. Parliament approved the sale of state-owned oil producer Albpetrol in December 2011, and the government has confirmed its intention to proceed with the sale of its 100 per cent stake in the enterprise. An attempt to sell the company in 2010 failed. The government has also said it will offer a 15 per cent stake in Albania's only oil refinery ARMO as well as its remaining 16.8 per cent stake in Albtelecom, which dominates the domestic landline market.

Tariffs in the energy sector remain significantly below costs. Pricing issues have been at the core of a dispute between the private distribution company, CEZ, and the state-owned enterprise KESH, which controls nearly all production and transmission in the country. CEZ suffered significant financial losses over the past year because the energy regulator raised the prices at which electricity was sold by the generation company but maintained the final consumer tariffs, thus significantly squeezing CEZ's margins. CEZ was also unable to meet regulatory targets for reducing technical and non-technical losses. However, progress has been made in 2012 in resolving disputes among CEZ, KESH and budget entities, and CEZ has agreed to settle for a payment of approximately €40 million.

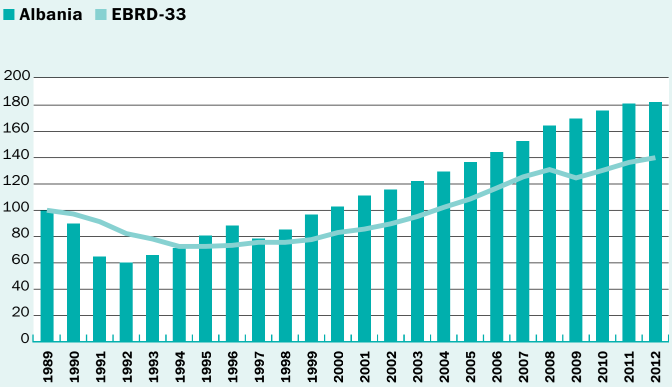
Limited progress has been made in improving the security of energy supply. The 400 kV interconnection line between Albania and Montenegro, which became operational in April 2011, has improved access to electricity imports. However, domestic electricity production remains vulnerable due to the near exclusive reliance on hydropower. In June 2012 the government announced a tender for the concession of the Fier thermal power plant. The plant has not been operational since April 2007 and requires significant rehabilitation before it can resume production.

The government is seeking to further increase its hydropower production capacity. In January 2012 it launched a tender for three hydropower BOT concessions for Vokopola 1, 2 and Gavran. Successful PPPs would enable an increase in private sector participation in the power generation sector, which remains largely controlled by the state-owned company, KESH. Privatisation of hydropower facilities is also under way; the government has sold four hydropower plants – Bistrica 1 and 2, Ulza and Skopeti – in June this year.

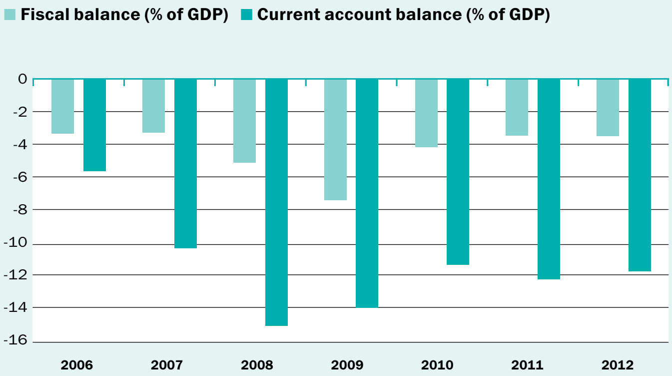
The government has continued to support improvements in the transport infrastructure. Construction is ongoing on two sections of the Tirana-Elbasan motorway. The entire road is expected to be completed by the end of 2012 and the Albanian authorities intend to introduce a toll system after its completion. The government announced a new concession for a motorway linking the port town of Durres with the country's Kosovo border. In August 2012 a new concession was also announced for the maintenance and operation of the eastern terminal of the port of Durres. The government has stated its intention to grant concessions for Albanian railways.

The government has taken important action to reduce risks in the financial sector. These moves are in response to growing concerns over the potential impact of the eurozone crisis on the Albanian banking system. Under the new regulation, which was approved by parliament in November 2011, the central bank can require that Albanian branches of foreign banks be converted into subsidiaries, subjecting them to local supervision. This will strengthen the local regulatory oversight with a view to limiting the risks of sudden liquidity outflows. In a related development, in June 2012 the Bank of Albania approved the establishment of a bridge bank, which would support domestic banks affected by the crisis. If the bank is a foreign subsidiary, the bridge bank will cover the costs of its transformation to a subsidiary. The measures were taken in light of the fact that over 90 per cent of banking assets in the country are controlled by foreign banks, of which about 30 per cent are Greek and Italian banks.

Real GDP (1989 = 100)



Fiscal balance and current account balance



ARMENIA

HIGHLIGHTS OF THE PAST YEAR

- **The authorities have continued to deregulate the economy and establish frameworks for competition and improved governance.** Reforms of business regulations, property rights and public inspections have been introduced, competition legislation was improved and a law on conflict of interest was adopted.

- **A new mining code was approved.** The new code is expected to improve the investment environment in the sector and lead to greater revenues over time, as taxation of the sector will be more closely tied to the sale of ores rather than reserves.

- **The authorities continue to implement policies to stimulate capital market development and reduce dollarisation.** The central bank continued to tighten the regulatory framework to encourage the use of local currency by obliging banks to keep required reserves in AMD. Regulations were adopted to enable issuance of foreign currency bonds by local enterprises and banks.

KEY PRIORITIES FOR 2013

- **It is critical to make a definitive breakthrough in the strengthening of the business environment.** The many recent reforms have to be implemented in letter and spirit, and the review of regulations should continue to ensure any unnecessary obstacles are eliminated.

- **More needs to be done to facilitate domestic and international trade.** Improvement of the transportation and communications infrastructure would aid development of export-oriented sectors and reduce the high implicit transaction costs.

- **The authorities should persevere with developing local capital markets.** The ambitious de-dollarisation agenda should be supported by a consistent shift of the monetary policy framework from *de facto* peg to inflation targeting. The upcoming pension reform should serve as a strategic opportunity to develop domestic markets for government securities, bank deposits and equities through an active institutional investor base providing steady demand for long-term investments.

MACROECONOMIC PERFORMANCE

The pace of recovery from the crisis has accelerated. After increasing by 4.7 per cent in 2011, output growth increased to 6.6 per cent year-on-year in the first half of 2012. Mining and manufacturing remain the main drivers of growth. The largely unreformed agricultural sector has also recovered from the slump of 2010 due to more favourable weather conditions and higher remittances. The construction sector has shown the first signs of recovery since the 2009 crisis. The authorities have continued fiscal consolidation to maintain sovereign debt at a sustainable level, under an IMF-supported programme. The economy continues to benefit from large remittance inflows and substantial official financing. Credit growth has been strong, reflecting a generally low level of financial intermediation. Since November 2011 inflation has remained within the central bank's target range of 4+/-1.5 per cent. External imbalances have been reduced although the current account deficit remains high at around 11 per cent of GDP.

Immediate economic prospects are clouded by the uncertain global environment. Maintaining output growth of around 4 per cent in 2012 and 2013 would require remittances and demand from international partners, in particular Russia, to remain buoyant, and reasonably high world prices on main commodity exports. Inflation is expected to remain in the central bank's target range. Recent depreciation of the dram should help support export competitiveness.

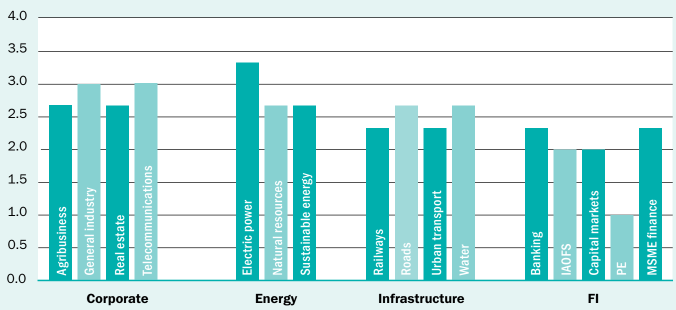
Long-term growth prospects remain uncertain. As a landlocked country with limited access to neighbouring markets, Armenia requires significant reforms of its business environment, increased competition and improved physical infrastructure. The country's relatively monopolised economy remains overly dependent on low value added commodity exports, which makes it vulnerable to negative shocks suffered by its trading partners.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.1	2.1	4.6	5.0
Inflation (end-year)	6.7	8.5	4.7	5.0
Government balance/GDP	-7.7	-4.9	-2.8	-3.0
Current account balance/GDP	-15.8	-14.7	-10.9	-9.0
Net FDI (in million US$)	725	562	447	500
External debt/GDP	56.4	65.6	70.7	na
Gross reserves/GDP	23.2	20.1	19.1	na
Credit to private sector/GDP	24.8	28.4	35.3	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The authorities have continued to implement various measures to improve the business environment. In addition to pursuing an action plan to improve the business environment and governance, in June 2011 the authorities embarked on a "Regulatory Guillotine." Modernisation of the tax administration is ongoing, with the support of the World Bank. The aims of this programme are to increase voluntary tax compliance, reduce tax evasion, reduce compliance costs and increase administrative efficiency. A green channel was introduced by customs at the beginning of 2012, leading to a considerable reduction in the time and complexity of customs formalities.

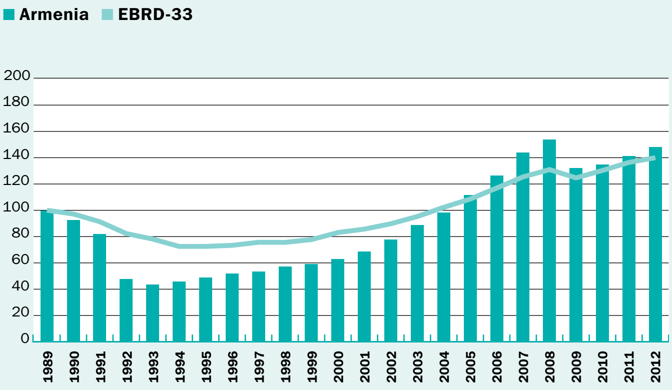
A number of positive changes in the area of competition legislation and policy have taken place. Legislative changes introduced in the course of 2011-12 included amendments and additions to the current laws (including introduction of leniency measures for participants in the anti-competitive agreements), specification of the fine amounts, reinforcement of sanction measures and specification of separate notions. In particular, anti-competitive agreements were divided into horizontal, vertical and mixed, and a qualitative indicator for dominant position in the market was introduced. In terms of enforcement, the State Commission for the Protection of Economic Competition (SCPEC) has further improved its efficiency, which is evident from the significant increase in the number of cases reviewed and decisions reached in 2011 in comparison with 2009. At the same time none of the decisions challenged in the court in 2011 were overturned. Since last year, SCPEC has also intervened in the activities of dominant fuel companies, pharmaceutical companies and medical centres.

Mining legislation has moved towards international standards. In November 2011 parliament approved amendments to the mining code. The new code, to be applied to most types of natural resources except for oil, gas, water and radioactive materials, specifies principles and rules of usage of sub-surface resources and their environmental protection. It streamlines the licensing process, therefore decreasing transaction costs for investors. The transition from exploration to production has been made more transparent and stable as the new code clearly defines the rights and obligations of mining investors and operators. The taxation of minerals was made more transparent, competitive and simpler. The new law is closer to international best practice and is expected to improve the investment environment in the sector and boost government revenues. Compared with the previous legislation, taxation of the sector will be tied more closely to the sale of ores rather than reserves.

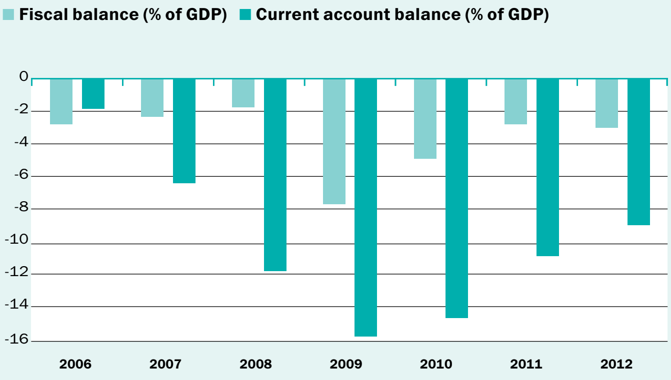
The authorities are pursuing policies to encourage exports. In December 2011 the government adopted an export-promotion strategy, targeting several sectors in which Armenia has a comparative advantage. A dedicated team was established in the Ministry of Economy with the resources and targets needed to ensure results. Free economic zones were also established to help develop the agricultural sector, high-tech industry and trade. The zone in Zvartnots airport, to operate in cooperation with Argentine Corporation America, will facilitate the export of fresh fruits and vegetables. Another zone, to be based at the Mars plant, is expected to develop industry using innovative technologies. The government also agreed to create a free economic zone with Iran for joint investments in the border region. However, the preferential tax treatments offered by these zones may pose risks to the government's tax base. In 2011-13, Armenia is expected to receive €32 million of assistance from the European Union to help prepare for the introduction of a free trade agreement with the EU and harmonisation of Armenia's laws and regulations with EU standards.

Ongoing reforms, in particular in the pension system, should support further de-dollarisation and further development of the local capital market. The Central Bank of Armenia (CBA) has continued to raise the proportion of required bank reserves that has to be kept in the dram, in order to increase banks' demand for local currency. This measure has had limited impact on deposit or loan dollarisation. In fact, foreign currency corporate loans have continued to expand both in absolute terms and as a share of the total. The EBRD launched a technical cooperation project supporting a broader IMF initiative to enhance the central bank's capacities to control inflation, as a lower inflation level and reduced volatility would help strengthen trust, and thus savings, in the local currency. The voluntary contributions into the second pillar of the pension system started in 2011 and will become mandatory in 2013. Although a large portion of the initial pension fund investments may be invested abroad because domestic financial markets are undeveloped, domestic investments are expected to increase over time and will help develop the country's debt and equity markets. In June 2012 the authorities adopted regulations allowing issuance of domestic bonds in foreign currencies. Although it may be initially utilised to place dollar-denominated bonds, the new law may help create the infrastructure needed for ultimate issuance of securities in the local currency.

Real GDP (1989 = 100)



Fiscal balance and current account balance



AZERBAIJAN

HIGHLIGHTS OF THE PAST YEAR

- **Rebalancing of the economy towards non-oil sectors has continued.** As oil output continued to contract, non-oil sectors expanded, stimulated by rising public expenditure.
- **The state-owned International Bank of Azerbaijan (IBA) was recapitalised.** Following an international audit, the government increased its stake in the bank and the central bank provided liquidity. Although the authorities hired an international adviser to support the bank's privatisation, little progress was made in this area.
- **The Shah Deniz consortium chose the Nabucco West pipeline as a potential export route to Europe.** The new pipeline, once built, will transport Caspian natural gas to Austria via Turkey, thus further diversifying export routes for Azerbaijan and import sources for the European Union.

KEY PRIORITIES FOR 2013

- **The authorities should continue to pursue policies needed to support diversification of the economy.** The business environment should be further improved to remove obstacles to private sector development. Opening the country to cross-border trade, which includes completing accession to the World Trade Organization (WTO), should open access of non-oil sectors to the international markets.
- **Competition policy should be further strengthened.** Sector regulators should be made independent and encourage greater competition (especially in telecommunications, transport and the financial sector) and stimulate the entry of foreign strategic investors. Redress procedures in the cases involving anti-competitive practices should be further clarified.
- **The financial sector requires significant reform.** The recent decision to recapitalise the state-owned IBA highlights the need to reduce its role in the banking system and ultimately privatise the bank in a transparent manner with a view to strengthening competition in the sector and reducing its quasi-fiscal activities.

MACROECONOMIC PERFORMANCE

The non-oil economy continued to expand as oil output contracted further. The 10 per cent contraction of the oil sector in 2011 was almost fully offset by the rapid increase of the non-oil sectors, in particular construction and services, mainly stimulated by rising budget expenditures. Real GDP grew by 1.3 per cent year-on-year in the first eight months of 2012, again led by the non-oil sectors. Growth of consumer prices decelerated to -0.2 per cent in August 2012 after peaking at 9.7 per cent in May 2011, with the decline largely due to favourable base effects and lower international food prices. The policy of maintaining a stable exchange rate of the manat against the US dollar has complicated the central bank's ability to maintain price stability. External debt remains low, and the public sector balance sheet is supported by a large oil fund. However, the non-oil fiscal deficit remains very large in light of the finite oil production, raising concerns about the long-term sustainability of the government's fiscal policy. Nevertheless, exports of oil and gas will likely ensure that the current account remains in surplus and the exchange rate remains stable.

Economic growth is expected to remain subdued as energy output stabilises and non-oil sectors reached capacity. As gas fields operate at full capacity and reviving oil output requires investment and time, hydrocarbon production should stay below the pre-crisis levels in 2012-13. Non-oil output growth is expected to reach around 8 per cent, for an overall rate of growth of 3.5 per cent in 2012. If the authorities avoid further fiscal expansion and non-oil sector capacity constraints are not binding, inflation should remain moderate but volatile as long as the central bank is unable to effectively utilise interest rate tools. Export of oil and gas will continue to account for around one half of GDP and ensure a current account surplus and a stable exchange rate.

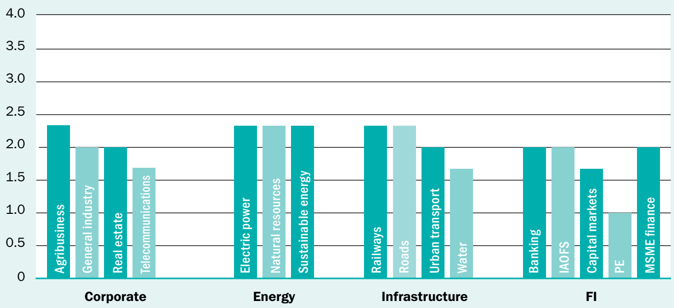
Risks stem mainly from a possible decrease in the oil price or extended disruption of oil export flows and their knock-on effects. In particular, risks are generated by real estate prices, a fall in which would affect the collateral value and portfolio quality of banks, undermining their lending capacity and hence growth in the non-oil sector. Further risks to forecasted growth derive from uncertainty regarding oil and gas production and potential political and external instability. Also, increasing global risks and the looming prospect of medium-term economic growth can affect oil and gas prices through decreasing global demand for hydrocarbons. This in turn will have a negative effect on the oil sector in Azerbaijan, making economic growth even weaker.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	9.3	5.0	0.1	2.0
Inflation (end-year)	0.7	7.8	6.6	1.9
Government balance/GDP	6.6	14.0	11.3	9.0
Current account balance/GDP	23.0	28.4	26.5	25.0
Net FDI (in million US$)	147	113	913	-300
External debt/GDP	20.8	21.3	17.8	na
Gross reserves/GDP	11.7	12.1	16.2	na
Credit to private sector/GDP	19.1	17.9	17.6	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Although the authorities continue to improve the business environment, corruption remains a serious problem. Azerbaijan's ease of doing business score in the 2012 World Bank's *Doing Business* Report improved last year by three places to 66th, as the authorities lowered some tax rates and simplified the process of paying corporate income tax and value added tax. Azerbaijan ranked 46th in the global competitiveness ranking released by the World Economic Forum in September 2012, climbing up by nine places. Access to credit was aided by an online platform allowing financial institutions to provide information to, and retrieve it from, the public credit registry. The new customs code, which came into effect in January 2012, includes strengthened provisions in various areas that are expected to bring regulations into line with international standards (including verification of the country of origin, valuation methods, single-window principle in customs administration, customs audit and electronic submission of information on goods to the customs authorities).

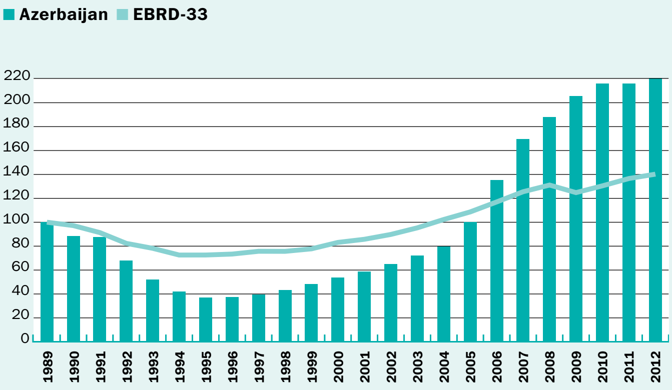
The dominant state bank was recapitalised, but its long-term future is yet to be decided. Following an audit, in February 2012 the government injected new capital into the majority state-owned International Bank of Azerbaijan and the central bank provided liquidity. The recapitalisation increased the share of the state in the bank to 50.2 per cent, thus raising concerns about the authorities' commitment to its privatisation. An international consortium of companies has been advising the state property fund on IBA's privatisation since mid-2011, although little actual progress has been made so far to begin implementing the privatisation. The authorities have made a decision on an export route to the European hydrocarbon markets. In June 2012 the Shah Deniz consortium chose the Nabucco West pipeline as a potential export route to Europe. This is a shorter version of the Nabucco pipeline and it will connect the Shah Deniz field to Austria. Also, Azerbaijan signed an inter-governmental agreement with Turkey on the construction of the TANAP pipeline, which is expected to start at the end of 2013 and will carry gas to Europe and Turkey. The new route should diversify Azerbaijan's export routes to the international markets and Europe's access to energy imports.

Large infrastructure projects to increase trade and capitalise on the country's strategic location are continuing. In March 2012 the government announced a tender for construction works and supply of goods and services for a new international sea port, to be located 65 km south of Baku. Construction of the port, the largest in the Caspian region, is expected to cost around US$ 1 billion. The first of the port's three stages is expected to begin to function in 2014. If successfully completed and run commercially, the port should help strengthen the country's role as a trade link between Europe and Asia.

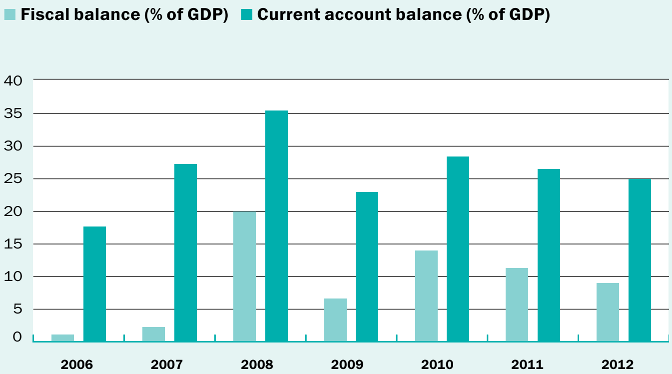
The National Bank of Azerbaijan (NBA) continues to strengthen the regulatory framework and build capacity for inflation targeting. In July 2012 the NBA increased the threshold of aggregate capital of operational banks, as well as authorised capital for newly established banks to AZN 50 million. The new norm on the minimum capital requirement is to take effect from January 2014. Once implemented, the new norms should help strengthen the capital position of Azerbaijani banks. The central bank has also continued developing analytical skills and capacity to pursue the policy of inflation targeting over time, although it has continued to target the exchange rate as a nominal anchor. The capital market is expected to be affected by recent changes of the insurance legislation. The law "on compulsory insurance" regulating the principles and basis for mandatory insurance came into force in September 2011. In November 2011 the authorities established a Compulsory Insurance Bureau with the purpose of stabilisation and development of the system of compulsory insurance and fulfilment of duties prescribed by the law. These reforms are expected to increase the size of the insurance market and, over time, increase the stock of assets in the local capital market.

Negotiations continue on WTO accession.
In February 2012 at the ninth meeting of the working party on the accession of Azerbaijan, members reviewed Azerbaijan's trade-related reforms, examined legislative developments and evaluated the progress made in the bilateral negotiations on market access for goods and services. Azerbaijan is currently negotiating with 10 members and the next meeting of the working group is scheduled for late-November 2012. The progress in negotiations should pave the way for reforms in tariff policy and trade liberalisation.

Real GDP (1989 = 100)



Fiscal balance and current account balance



BELARUS

HIGHLIGHTS OF THE PAST YEAR

- **The economy moved towards stabilisation after a deep balance-of-payments crisis.** Following a large exchange rate devaluation, the authorities pursued tighter monetary and fiscal policies and trimmed the large directed lending programme.

- **Ambitious privatisation plans were abandoned.** The authorities decided to scrap the privatisation lists and instead pursue negotiation of privatisation agreements on a deal-by-deal basis, so far primarily with Russian state enterprises.

- **The authorities continued implementing some deregulation reforms.** Several measures to simplify access to land, lending to SMEs and reduce red tape were approved.

KEY PRIORITIES FOR 2013

- **Establishing a credible policy framework for macroeconomic policy is a key priority.** Output and dollar wage targets should be made consistent with the goal of price and external stability, while the central bank should target low inflation and a wage policy consistent with productivity growth.

- **The authorities should utilise improved terms of trade due to lower energy prices to pursue private sector development.** Public enterprises should be further commercialised, and their role in providing safety nets to employees reduced. Transparent privatisation, aimed at attracting strategic investors, should help modernise the country's industrial base and release some of the labour force into new industries. Directed lending should be reduced and made more transparent.

- **The authorities should improve the sustainability of municipal infrastructure and increase incentives for greater energy effficiency.** Improving municipal infrastructure requires greater commercialisation, based on economically justified user charges and cost recovery principles, while incentives for improving energy efficiency need to be strengthened through market pricing of energy and the establishment of a clear framework for renewable energy.

MACROECONOMIC PERFORMANCE

Belarus has undergone macroeconomic adjustment following a policy-induced balance-of-payments crisis. After generating very large external imbalances during and after the presidential election campaign in late 2010 and introducing various administrative measures in the spring-summer of 2011 to delay adjustment, the authorities devalued the rouble. After peaking at 108.9 per cent year-on-year in January 2012, inflation decelerated to 38.8 per cent in September. Investment activity decelerated as directed lending programmes were curtailed, negatively affecting the construction sector. However, as real wages declined, households switched from imported to domestically produced products and exports increased. As a result, overall output growth has remained positive, at 2.9 per cent in the first half of 2012, with industry being the largest contributor.

However, stabilisation gains may be reversed by the renewed pressure to increase wages and lending. The government is pursuing a high rate of GDP growth, which may require relaxation of the directed lending limits and once again engaging the central bank in providing soft loans. The national bank has been reducing policy interest rates steadily, which is still above the annualised rate of monthly inflation. In June 2012 President Lukashenko ordered a large increase in public sector wages on 1 August and 1 October to bring the average monthly wage to an equivalent of US$ 500 from around US$ 360 in May 2012. There is a high risk that these policies may lead to another bout of macroeconomic instability.

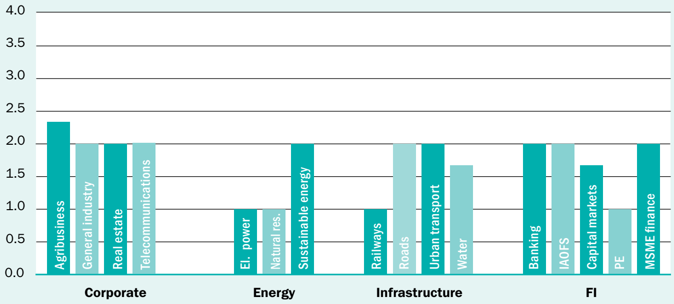
Longer term prospects depend to a large extent on the authorities' ability to pursue structural reforms. In the short run, the economy will continue to benefit from the improved terms of trade as energy prices paid to Russia remain significantly below the international levels. However, as most of the economy is state-owned, and enterprises' operations are not based on commercial principles, it is unlikely that the existing economic model would be able to generate productivity increases consistent with the authorities' real income targets. The government's ability to stimulate domestic consumption and investment is constrained by the rising public debt level and limited external reserves. Therefore, growth prospects continue to hinge on implementation of policies that would rebalance the economy towards new, commercially-operating activities and reforms that are needed to stimulate labour migration to the new sectors. Macroeconomic risks also stem from the economy's low energy efficiency and dependence on energy imports and uncertainty about the quality of assets in the state-dominated banking system.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	0.2	7.7	5.3	5.5
Inflation (end-year)	10.1	10.0	107.8	25.0
Government balance/GDP	-0.4	-1.8	3.3	0.0
Current account balance/GDP	-12.6	-15.0	-10.5	-3.0
Net FDI (in million US$)	1782	1352	3928	2000
External debt/GDP	45.6	52.1	62.5	na
Gross reserves/GDP	11.5	9.1	14.4	na
Credit to private sector/GDP	37.2	44.8	45.8	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government reversed some, but not all, administrative measures implemented during the crisis. Many price controls introduced and expanded in the last year remain, and goods subject to controls now cover around 40 per cent of the consumer basket. Restrictions on exports of consumer goods by individuals, introduced as a response to the balance-of-payments crisis, were eliminated in February 2012. The export limits had been applied to goods and commodities with regulated prices, including cereals, pasta, cigarettes and domestic appliances. Although fuel prices were brought closer to their level within the Eurasian customs union, restrictions on fuel exports remain in place.

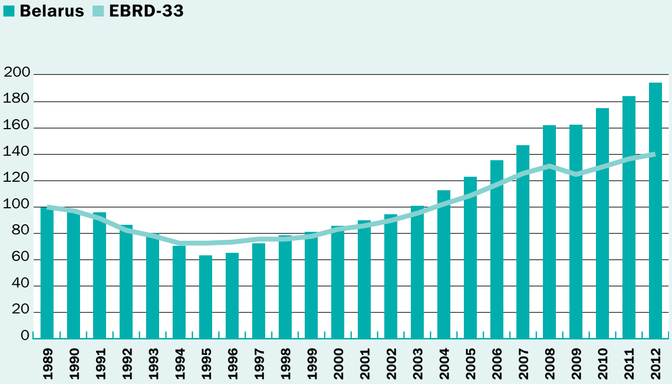
The privatisation process suffered from delays. In May 2012 the government decided to abandon the practice of issuing lists of enterprises designated for privatisation. Instead, it announced that future privatisations are to take place on an *ad hoc* basis. The agency for privatisation and investment, in operation since June 2011, is yet to sell any of its eight enterprises. On a trial basis, a minority stake in the Minsk factory of sparkling wines was made available for purchase by individuals via the local stock exchange, via a "people's IPO". Plans were also announced in July 2012 for the creation of a joint venture between Russia's KamAZ and Belarus' MAZ truck manufacturers.

The authorities made further steps to reduce the regulatory burden on new companies. Over the past year, the government implemented numerous legislation acts to implement the presidential Directive No. 4, approved in December 2010. Access to land for certain business purposes was streamlined and may now be granted without the need for an auction. Legislative reforms are expected to increase access to credit by small and medium enterprises. Since the middle of 2011 the President has signed several decrees to stimulate entrepreneurial activity in the regions.

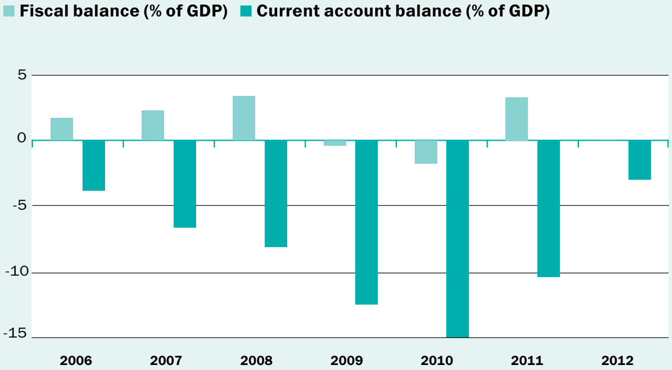
Commercialisation of the financial sector is progressing slowly. The large state banks continue to dominate the banking system. In January 2012 the government recapitalised the state-owned Belarusbank and Belagroprombank with 14.5 trillion roubles (US$ 1.7 billion, about 3 per cent of GDP) in bonds. The recapitalisation should cover some of the decline in capital ratios after the devaluation, as well as protecting against potential deterioration of the loan portfolio. The development bank, established in June 2011 to improve the targeting of directed lending and increase its transparency, is yet to become fully operational. In January 2012 the government announced a strategy to encourage FDI, which envisions *inter alia* the sale of the remaining stakes in the VTB Bank Belarus, controlling stakes in Belinvestbank and Paritetbank and minority stakes in Belarusbank and Belagroprombank.

The country's integration with Kazakhstan and Russia has brought benefits, but also market pressures. The customs union became fully operational in July 2010. Since then, the country has enjoyed an improvement in terms of trade after Russia eliminated export duties on oil and oil products exported to Belarus and reduced the natural gas price. Access of Belarusian products to the Russian and Kazakh markets was also simplified. At the same time, various manufacturing enterprises have suffered from the lowering of the effective rate of protection of their output in Belarus. The pressures are expected to rise as Russia further opens its market and the common external tariff is reduced to comply with Russia's commitments under its recent WTO accession. There is also evidence that labour is migrating from Belarus to Russia to benefit from higher wages and a more competitive market environment.

Real GDP (1989 = 100)



Fiscal balance and current account balance



BOSNIA AND HERZEGOVINA

HIGHLIGHTS OF THE PAST YEAR

- **Economic growth has been weak but some progress has been made on policies.** Only minimal growth has been recorded over the past year. Following the finalisation of the state and entity budgets, progress was made towards re-engaging with the IMF, culminating in the signing of a new programme.

- **Private sector involvement in the road sector is advancing.** A tender for a public-private partnership (PPP) in the transport sector based on best international practice has been announced for a concession of a section of a key international transport corridor in Republika Srpska.

- **Non-performing loans (NPLs) are rising in the banking sector, but liquidity remains sound.** The level of NPLs still remains below that of some regional peers and the direct impact of the international financial crisis on the local banking sector has been limited so far.

KEY PRIORITIES FOR 2013

- **Further progress is needed on EU approximation.** Bosnia and Herzegovina is the only SEE country that has not yet submitted an application for EU membership. Key priorities include political reforms, boosting competitiveness, reforming the social benefits system and improving the country's infrastructure.

- **Some basic investment climate reforms should be introduced.** The country's persistently low scores on many cross-country indicators suggest there is a lack of consensus on the need for deep economic reforms, as well as plenty of scope for improvements in areas such as licences and permits, and enforcement of contracts.

- **Major reforms are needed in the energy sector.** Bosnia and Herzegovina has significant potential in renewables, but the legal and institutional framework for sustainable energy remains weak.

MACROECONOMIC PERFORMANCE

Weak domestic demand, an unfavourable external environment and political stalemate have held back economic recovery. Following a year of anaemic growth in 2010, the economy showed some signs of revival in early 2011. However, weaker growth in the eurozone has negatively affected Bosnia and Herzegovina's exporting activity and capital inflows in the second half of the year and the beginning of 2012. Exports fell by 8.6 per cent between Q2 and Q4 of 2011. At the same time, domestic consumption has remained subdued, largely owing to the austerity measures implemented by the authorities in the past two years as well as the weakened contribution from remittances, which are significantly below pre-crisis levels. As a result, overall growth in 2011 was a modest 1.3 per cent. Inflation remains low. The disinflationary pressures that dominated much of the post-crisis period were reversed for a brief interval in early 2012, but inflation has been on a generally downward path since, and it stood at 1.8 per cent in August 2012.

A new Stand-By Arrangement (SBA) with the IMF was approved in September 2012. The 24-month US$ 520.6 million SBA will provide a buffer against external shocks from the ongoing eurozone crisis as well as an anchor for important structural reforms envisioned in the country's 2012-14 economic programme. The new arrangement follows the expiration of a 36-month SBA, which was put on hold in 2011 due to the political stalemate that left the country without a central government for over 15 months after the October 2010 elections. The authorities are planning a budget deficit of 3 per cent of projected GDP in 2012. The economic programme envisages continued fiscal consolidation accompanied by structural fiscal reforms to safeguard medium-term fiscal sustainability.

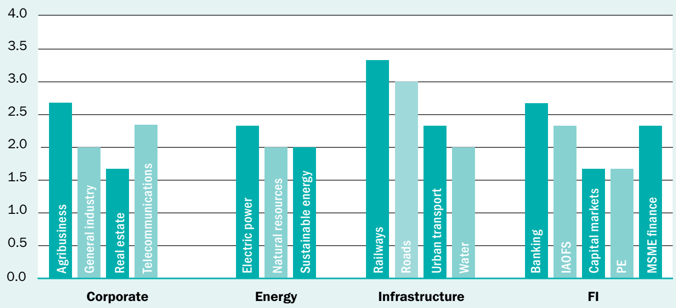
The economic outlook for 2012 and 2013 remains bleak. The weak external and domestic environment will constrain growth in Bosnia and Herzegovina this year and beyond. GDP growth is forecast at close to zero per cent in 2012 and only slightly higher in 2013. The economy remains vulnerable on many fronts, not only because the whole region is struggling but also because the internal complexity of the country's political structure and the poor investment climate are major deterrents to investment.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-2.9	0.7	1.3	0.1
Inflation (end-year)	0.0	3.1	2.7	1.7
Government balance/GDP	-5.9	-3.9	-3.1	-2.8
Current account balance/GDP	-6.3	-5.7	-8.8	-8.0
Net FDI (in million US$)	245	188	416	253
External debt/GDP	55.8	52.3	46.5	na
Gross reserves/GDP	19.0	20.5	19.9	na
Credit to private sector/GDP	54.4	63.8	55.1	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Limited progress has been made on EU approximation over the past year. In its annual Progress Report published in October 2012, the European Commission (EC) once again urged the country to make greater headway on economic and structural reforms. It highlighted the need for reforms to boost the productive capacity and competitiveness of the economy, including labour market reforms, and to improve the business environment and upgrade the country's infrastructure. The EC also emphasised the need for reforms in the social benefits system – particularly the high and poorly targeted social transfers – to boost job creation and reduce the high unemployment rate. Bosnia and Herzegovina is the only SEE country that has not yet submitted an application for EU membership. In June 2012 the European Union and the Bosnian authorities launched a High Level Dialogue on the Accession Process. However, the results so far have been uneven.

Business environment indicators remain poor. In the 2012 World Bank *Doing Business* Report, Bosnia and Herzegovina's ranking rose by two places compared with the previous year, mainly due to improvements in the ease of obtaining construction permits. However, at 125th place, Bosnia and Herzegovina remains the lowest ranked SEE country with respect to the overall ease of doing business and it has the second lowest ranking in the entire EBRD region of operations after Uzbekistan. The country continues to perform particularly poorly on construction permits, starting a business, obtaining electricity connections and enforcing contracts.

Some progress is occurring in promoting private sector involvement in transport. In August 2012 the government in Republika Srpska announced an open, competitive tender, based on best international practice, for the concession to the private sector for the design, construction and long-term maintenance of the Doboj-Vukosavlje motorway, a part of the trans-national transport corridor Vc. If successful, this would be the first PPP in the transport sector in Bosnia and Herzegovina.

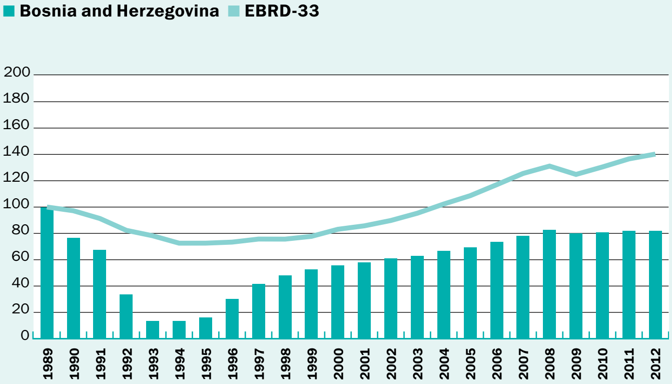
An agreement was signed for the construction of a new thermal power plant. According to the terms of the agreement, the 300MW Stanari thermal power plant will be built by UK-based EFT Group with financing from the Chinese state development bank, and the project will also entail the expansion of the neighbouring EFT-owned Stanari Coal Mine. The benefits of the project, if fully implemented, are twofold. It will provide a welcome increase in domestic power generation capacity and it will increase private sector participation in the energy sector, which is currently very limited.

The quality of, and access to, broadband services are improving. The market for broadband internet and cable TV services in Bosnia and Herzegovina is nascent and dominated by the three incumbent telecommunications operators which operate within the boundaries of their respective entities. The rest of the market, including cable TV operators which offer broadband services, is highly fragmented and cannot effectively compete against the incumbents. Moreover, access to high-speed broadband is limited outside of the largest cities. Financial support is currently being provided for consolidation of small cable TV operators in the regions so as to allow for wider access to better quality internet and telephony services at more affordable prices. The consolidation in the sector will enable certain service providers to operate across the two entities, which is a rare case in the country today.

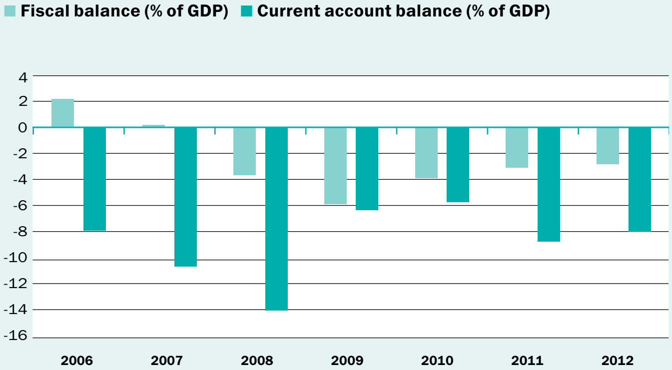
Micro and small enterprises (MSEs) are gaining access to more finance and a wider range of financial services. The key providers of finance for MSEs are non-profit microfinance institutions (MFIs), set up as NGOs and focusing on a narrow range of services while benefiting from favourable tax treatment. Since 2008 the microfinance sector has been in decline with gross loans from MFIs falling from €570 million at end-2008 to only €345 million at end-2011. With support from international financial institutions, the sector is being transformed into a commercially sustainable model, fully integrated with the rest of the financial sector, which will give MSEs better access to financial services and should improve transparency and corporate governance in the microfinance sector.

The banking sector in Bosnia and Herzegovina remains liquid and well-capitalised, but the level of NPLs is rising. Out of the 29 banks that operate across the two entities, 19 are foreign owned. More importantly, the foreign banks accounted for 92.1 per cent of total assets as of the end of 2011. The banking sector was not subject to the large credit outflows to parent banks, and the system remains fairly liquid. However, NPLs have been increasing substantially. In mid-2012 they stood at 12.6 per cent of total loans, compared with 7.1 per cent in 2010 and 5.9 per cent in 2009. Bosnia and Herzegovina has been a participant in the Vienna Initiative since 2009.

Real GDP (1989 = 100)



Fiscal balance and current account balance



BULGARIA

HIGHLIGHTS OF THE PAST YEAR

- **Growth remains limited but fiscal discipline has been strong.** As a result of its strong fiscal performance, Bulgaria was removed from the European Commission's excessive deficit procedure, but economic growth remains low in a difficult global environment.

- **The energy sector has seen mixed reform signals.** The government has responded to outside pressures by stepping up efforts to liberalise the electricity market, but revisions to the access charges for renewable generation may deter investment in the sector.

- **Banking sector stability has been maintained notwithstanding the relatively high share of Greek banks.** This has been achieved largely through strong local supervision.

KEY PRIORITIES FOR 2013

- **Private sector involvement can be further enhanced in infrastructure.** The remaining enterprises to be partly or fully privatised include some energy generation companies and all of the transmission system, transport operators and other municipal utilities, as well as bridges, ports and airports. There is room for further private sector participation in some large-scale construction projects in the transport and energy sectors.

- **Developing a financially strong and well-regulated municipal sector is a key priority.** The necessary steps include reducing the reliance on centrally-managed EU grants, strengthening municipalities' ability to meet contractual obligations and to attract commercial financing, and boosting their capacity to absorb EU funds.

- **Efforts to restructure companies' balance sheets and shift to more productive, export-oriented activities should be stepped up.** The government can also help by encouraging enterprises to improve the efficiency of energy usage.

MACROECONOMIC PERFORMANCE

The economic recovery is slowing down but the impact from the eurozone crisis has been managed relatively well. After virtually zero growth in 2010, the Bulgarian economy was recovering in the first half of 2011. However, in late 2011 and the first half of 2012, the recovery momentum began to slow down, as evidenced by several macroeconomic indicators. GDP grew by less than 1 per cent in the first two quarters of 2012. Export growth, which drove the recovery after the 2009 recession, has been weak or negative and, with consumer confidence feeble and credit growth limited, domestic demand remains subdued. There has also been a significant decline with regard to inflows of FDI. In 2008 FDI inflows accounted for about 19 per cent of GDP and in 2011 they fell to less than 3 per cent of GDP. Inflation remained below 2 per cent throughout the first half of 2012, but jumped to 2.4 per cent year-on-year in July on the back of a hike in electricity prices. Despite the slow-down, Bulgaria has been coping well with the crisis in the eurozone and is forecast to have the strongest GDP growth rate this year in the SEE region.

The government has maintained a prudent fiscal policy. The authorities tightened fiscal policy in 2011 and the general government deficit was kept below the targeted 2.5 per cent of GDP and firmly within the limit of 3 per cent as set by the European Union's stability and growth pact. As part of the reform package, an increase in the retirement age – for men from 63 to 65 and for women from 60 to 63 – became effective on 1 January 2012. In light of Bulgaria's recent strong fiscal performance and demonstrated history of fiscal prudence, the Council of the European Union decided in June 2012 to close its excessive deficit procedure for Bulgaria. The country also had a successful return to international debt markets in July 2012. In the first euro-denominated issue since 2002, Bulgaria sold €950 million of five-year Eurobonds at a yield of 4.25 per cent, which was viewed as highly favourable under existing market conditions. Continued fiscal consolidation is planned this year with the deficit targeted at 1.35 per cent of GDP. The authorities remain committed to the currency board but the government has recently indicated that entry into the ERM-II mechanism is not envisaged in the near future.

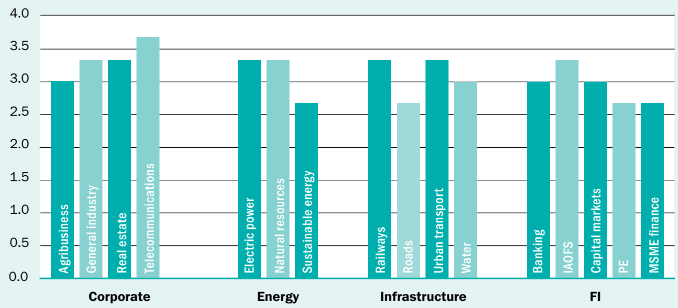
Weak growth is expected in the short term. Problems in the eurozone will continue to impact the economy in Bulgaria because of the close trade and investment links. Growth in 2012 is forecast to be a little above 1 per cent and only a mild recovery is expected in 2013. However, the economy's medium-term growth potential remains good; GDP per capita (adjusted for purchasing power standards) is estimated by Eurostat to be less than half the EU average, therefore implying considerable scope for catch-up growth in the future.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-5.5	0.4	1.7	1.2
Inflation (end-year)	1.6	4.4	2.0	4.5
Government balance/GDP	-0.9	-3.9	-2.0	-1.1
Current account balance/GDP	-8.9	-1.0	0.9	-0.3
Net FDI (in million US$)	3479	1374	1676	1378
External debt/GDP	113.5	102.4	87.1	na
Gross reserves/GDP	35.4	35.0	31.5	na
Credit to private sector/GDP	75.5	74.1	72.0	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Bulgaria continues to make progress in judicial reform and in fighting corruption and organised crime, but some concerns remain. In its annual report under the Cooperation and Verification Mechanism, published in July 2012, the European Commission (EC) noted that Bulgaria had come a long way since accession to the European Union in 2007. The report highlighted some recent reforms, including the establishment of an independent judicial inspectorate and specialised structures to pursue organised crime, and the improvement in asset forfeiture legislation. However, the report also noted the lack of direction in policy and the fact that questions remain about the direction of reform in these areas. The next assessment will be made at the end of 2013, but the EC will continue to monitor progress closely in the meantime.

Absorption of EU funds has accelerated in the past year. By the end of 2011 total financing paid by the European Union under the Structural and Cohesion Funds programme had reached nearly €1.26 billion (out of a total allocation for the period 2007-13 of €6.67 billion), compared with just €681 million a year earlier. By June 2012 absorption had risen further to €1.59 billion. The sharp rise reflects a concentrated effort by the authorities to implement projects, as well as enhanced support from several international financial institutions.

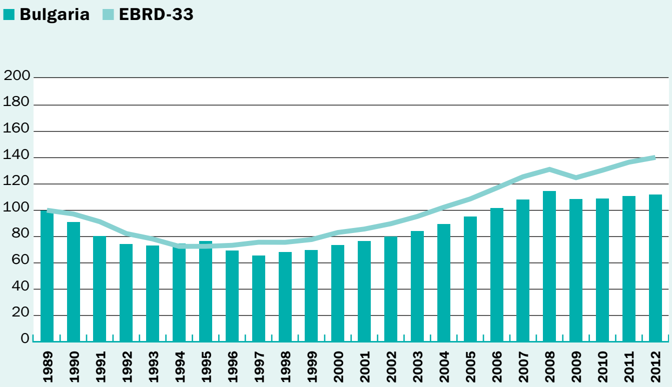
Productivity in agriculture has risen significantly. The progress has been particularly marked with regard to grain yields, which have increased substantially in recent years. Although the food industry overall is rather fragmented, the retail market is well organised in major cities with a number of large players present, and penetration in rural areas is increasing.

Changes to the energy law may boost competition, but concerns persist over delays in liberalisation and unexpected government intervention in the renewables market. In July 2012 parliament adopted a number of amendments to the energy law that are designed to boost competition in the market. Consumers should now be able to shop for an electricity provider, thereby giving an incentive to suppliers to compete for customers and increasing competition. However, these efforts come at a time of ongoing infringement proceedings. Recent cases have related to delays in implementing liberalisation measures and the continued use of regulated prices. In addition, concerns have been raised in recent months over the regulator's recent introduction of grid access fees for renewable generation, which has negatively affected the investment climate.

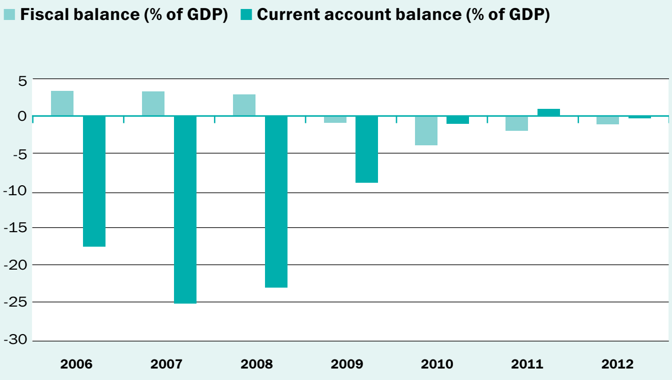
The regulatory framework for telecommunications has been further improved. Efforts have been made in the past year to align the relevant legislation with EU requirements, although implementation in the area of tariff rebalancing has not yet been fully completed. The mobile segment of the market is particularly competitive and broadband penetration has grown substantially over the past few years.

Competition remains strong in the banking sector. There are 31 banks currently operating, and the top five banks account for just over half of total assets in the sector. The capital adequacy rate was 17.5 per cent as of end-2011 and deposits have been growing robustly in the past year at double-digit levels, allowing banks to reduce somewhat their reliance on parent funding. Although the banking sector as a whole has managed to cope well with domestic and global pressures, the level of non-performing loans (NPLs) has been rising, reaching 14.9 per cent as of end-2011 (compared with 11.9 per cent at end-2010). Regulatory measures have been stepped up to deal with the fallout from the eurozone – and particularly Greek – crisis given the high share of Greek subsidiaries in the banking sector.

Real GDP (1989 = 100)



Fiscal balance and current account balance



CROATIA

HIGHLIGHTS OF THE PAST YEAR

- **The completion of EU accession negotiations is a key milestone for Croatia.** The country is scheduled to join the European Union on 1 July 2013 after a convincing endorsement of the Accession Treaty in a referendum and subsequently by parliament.
- **Important progress has been made in the transport sector.** Road sector reform has advanced significantly over the years, a concession for Zagreb airport has been awarded and restructuring of the railways is under way.
- **Economic performance remains exceptionally weak.** Economic output remained constant in 2011 after two years of negative growth, but is falling again in 2012, largely due to adverse external developments. However, efforts are being made to shore up the fiscal position and reduce the government deficit.

KEY PRIORITIES FOR 2013

- **The key priority is the implementation of a credible reform programme to boost growth prospects and prepare the country for EU membership.** This will require strengthening the institutional capacity to absorb EU funds, enhancing competitiveness by overhauling some of the restrictive practices that make the labour market inflexible and hinder the smooth setting-up and running of businesses, and improving payment discipline in public sector companies.
- **Regional connections in the energy sector need further development.** In addition, there is scope to develop further the power transmission and distribution network in order to adapt to increased wind power generation.
- **Successful privatisations in the financial sector could send an important signal about the willingness to reduce the size of the state.** The sale of the postal bank and a major insurance company could attract investments and strengthen competition and the provision of services in these sectors.

MACROECONOMIC PERFORMANCE

The economy is back in recession. Croatia experienced one of the most protracted recessions in the region as a result of the global financial crisis. After two years of declining output in 2009-10, and zero growth in 2011, GDP declined by 1.3 and 2.1 per cent respectively in first and second quarters of 2012 on the back of weak domestic demand and a decline in gross fixed capital formation. These trends reflect both spillovers from the ongoing eurozone crisis and the persistence of deep structural problems. Inflation has been rising since March 2012 and stood at 4 per cent year-on-year as of August 2012. The increase was partly related to a rise in the VAT rate by two percentage points to 25 per cent, which became effective in March, and partly to further deregulation of energy prices. Economic difficulties have resulted in pressure on the kuna this year, and the Croatian National Bank has intervened several times on FX markets to prop up the currency.

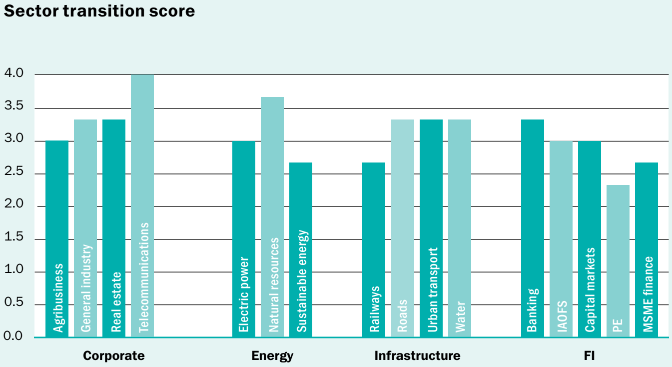
The government has begun to implement a fiscal consolidation plan. Changes in the tax system have been introduced. In addition to the aforementioned increase in the VAT rate, the government implemented a new tax on dividend payouts and abolished a tax on reinvested profits. Proposals for the introduction of property, capital gains and dividend taxes are also planned for later this year. The general government deficit in 2011 was 5.1 per cent of GDP (on ESA methodology), slightly below target. In 2012 the government is targeting a narrower deficit of 3.9 per cent of GDP, but given the worsening economic outlook and the GDP figures for the first quarter, this target will be difficult to achieve.

The prospects for recovery are bleak. The outlook is very uncertain given the protracted crisis in the eurozone and the risks on the downside are high. Under current baseline projections, Croatia will be in recession again in 2012, with output falling by around 1 per cent, and only a modest recovery is likely to take place in 2013. Over the medium term, however, there are hopes that the country will be boosted by EU accession and perhaps by the introduction of long-awaited reforms to public administration and the labour market, as well as the restructuring of publicly owned infrastructure companies.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.9	-1.4	0.0	-1.9
Inflation (end-year)	1.9	1.9	2.0	5.6
Government balance/GDP	-4.2	-5.1	-5.2	-4.4
Current account balance/GDP	-5.1	-1.1	-1.0	-1.2
Net FDI (in million US$)	2122	541	1450	1210
External debt/GDP	104.4	104.7	94.9	na
Gross reserves/GDP	23.5	24.7	23.2	na
Credit to private sector/GDP	65.9	70.1	72.2	na

2012 sector transition indicators



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Croatia is scheduled to join the European Union in July 2013. Following the completion of accession negotiations during 2011, Croatia and the European Union signed the Accession Treaty in December 2011. The Treaty was endorsed in a national referendum on 22 January 2012 and subsequently ratified in March by the Croatian parliament. Ratification by EU member countries is ongoing. Continuing pre-accession screening by the European Commission (EC) of reforms in the areas of judiciary, competition policy, and of the fight against corruption is helping to address remaining problems. In May 2012 the government adopted an action plan of 51 measures needed to fulfil the remaining obligations of EU membership. In its latest comprehensive monitoring report on Croatia, published in October 2012, the EC noted the continued good progress towards membership while identifying a limited number of issues where increased efforts are needed. A final monitoring report will be issued in spring 2013.

A significant privatisation agenda still lies ahead. The government has said it is hoping to raise about HRK 2 billion (€260 million) this year in revenues from the sale of assets such as Hrvatska Postanka Banka, the insurance company Croatia Osiguranje and some smaller assets. In July 2012 the government launched a tender for an adviser on the privatisation of Croatia Osiguranje, for which a 50 per cent stake will be offered for sale. Efforts to restructure and sell the country's shipyards are ongoing, and the first transaction was signed in summer 2012.

Reforms to the business environment are under way. Enterprises in Croatia continue to face a number of persistent problems, according to cross-country studies. The 2012 World Bank *Doing Business* Report places Croatia at 80th out of 183 countries on overall ease of doing business, down one place from the previous year. Dealing with construction permits and protecting investors are identified as particular problems in this report. The government is planning to decentralise the process of granting construction permits to the county level and to introduce e-permitting. In addition, a new law on investment promotion, was adopted by parliament in September 2012.

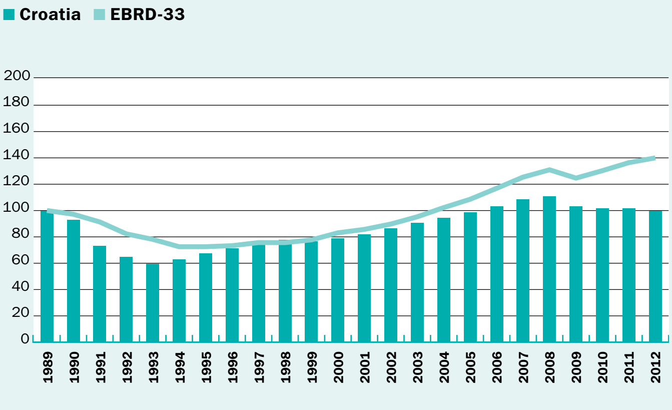
Road sector reform is at an advanced stage. All contracts for road construction, rehabilitation and periodic maintenance are tendered on a competitive basis to the private sector. An automatic tolling system is now in place as of 2011 and procurement practices have been improved. Several road concession projects have been or are being implemented, although not always in line with best international practice.

Railways restructuring is being prepared. Reforms in this sector have been limited to date. There is limited private sector participation and competition in the market, and the state-owned railway company, Hrvatske Zeljeznice (HZ) continues to receive significant subsidies from the central government. The government has prepared a restructuring programme under which the holding structure will be dismantled, the cargo company privatised and a labour restructuring programme implemented. Plans are under way to restructure the airline company, Croatia Airlines, as well as the state-owned motorway companies, HAC and Rijeka-Zagreb Motorway.

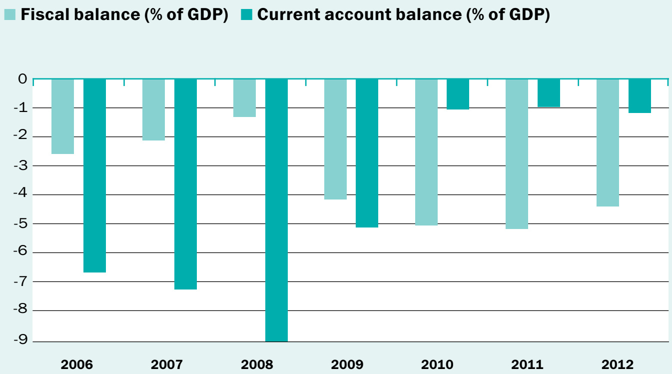
The banking sector is well developed but credit is falling. The banking system is well developed by regional standards, and the capital adequacy ratio is strong at above 20 per cent as of June 2012. However, the overall non-payment of suppliers is severely affecting working capital, with an increasing number of corporate accounts blocked due to the failure to meet official payments. The level of non-performing loans had risen to 13.3 per cent by June 2012. Deleveraging intensified in the second quarter of 2012. Negative credit growth was recorded for five consecutive months to July 2012.

Pension and labour market reforms are envisaged. The new government is facing a number of persistent problems with regard to the functioning of labour and pension markets in Croatia. The unemployment rate is 17.3 per cent as of June 2012, and the employment rate is just over 50 per cent, well below the EU average. Although the stagnant economy and restrictive labour practices are factors underlying low levels of employment, part of the reason is the structure of the pension system: the retirement age is officially 65 but the average age of pensioners is significantly lower, because previous governments had promoted early retirement for "excess" labour. The country has a three-pillar pension system, with a ratio of pension funds to GDP of around 10 per cent.

Real GDP (1989 = 100)



Fiscal balance and current account balance



EGYPT

HIGHLIGHTS OF THE PAST YEAR

- **Macroeconomic fundamentals have notably deteriorated during the lengthy political transition period.** The significant capital outflows and plummeting of tourist receipts have led to a precarious external position, with reserves reaching dangerously low levels. The authorities formally requested a US$ 4.8 billion loan from the IMF in August 2012.
- **Investors adopted a wait-and-see approach, especially due to continued uncertainty with regards to the political transition.** This has delayed the resumption of capital flows and FDI into the country. Following presidential elections, however, business sentiment may be turning more positive.
- **Structural reforms have not gathered much pace in light of the political transition under way.** Interim governments since the overthrow of the previous regime have not been able to implement substantial reforms, and delays are expected in the implementation of many key reforms under way.

KEY PRIORITIES FOR 2013

- **The key immediate challenges are to restore macroeconomic stability and achieve job-creating growth.** Structural skill mismatches and a lack of employment opportunities, especially among the youth, are chronic problems. A combination of restrictive labour market regulations and the lack of adequate training opportunities have led to persistent skill mismatches in the labour market.
- **Subsidies are a substantial burden on the budget and should be better targeted.** Subsidisation of many sectors – including food, energy, and utilities – constitutes more than a quarter of total public spending and distorts incentives across most sectors.
- **Strengthening the regulatory framework is required to ensure a level playing field for private business.** The state's role as regulator and competition enforcer is very weak. Egypt's judicial capacity is limited and state involvement is pervasive in many aspects of business.

MACROECONOMIC PERFORMANCE

The economy faced significant headwinds throughout the year. Real GDP growth reached 2.2 per cent at the end of the 2011-12 fiscal year (which runs from July to June), down from an average growth rate of 5 per cent in the past decade. The recent economic performance falls well below the estimated growth rate of 6-7 per cent required for Egypt to keep the unemployment rate unchanged. While tourism, mining, manufacturing and construction have somewhat recovered throughout the fiscal year, this is mostly due to favourable base effects associated with a near-stagnation of economic activity following the uprising, and they still remain significantly below levels seen in 2010. A more pronounced economic downturn was, however, avoided by buoyant private consumption. The unemployment rate has increased throughout the year, from 8.9 per cent in 2010 to 12.6 per cent by end-June 2012.

Egypt's balance of payments remains under significant pressure, mostly due to continued capital flight and falling tourist receipts. The current account deficit reached US$ 7.9 billion (3.2 per cent of GDP, up from 2.2 per cent the previous year) due to weak export growth and higher energy import costs. Tourist receipts fell by 11 per cent throughout the year. Further deterioration was, however, avoided by strong remittance inflows. In addition, the financial account remained weak, as FDI declined by 5 per cent during the year, coupled with a near doubling of portfolio outflows, especially as foreigners shed their treasury-bill holdings. Meanwhile, official foreign reserves reached US$ 15.1 billion in August covering just over three months of imports.

Weak economic activity and higher government spending on social benefits and subsidies have increased pressures on the fiscal front. The general government's fiscal deficit widened from 10 per cent of GDP in FY2010-11 to 11 per cent in FY 2011-12, surpassing the government's forecast of 8.6 per cent of GDP. Expenditures increased by 17 per cent, due to hikes in wages, social benefits and fuel subsidies, while borrowing costs continued rising. Subsidy spending rose by 23 per cent on the previous fiscal year, with petroleum subsidies constituting more than a fifth of total expenditure. In September 2012 the government provided details of a new pricing structure to reduce the burden of fuel subsidies on the budget by US$ 4.2 billion (around 2 per cent of GDP) and has been consulting with civil society to build consensus. However, the higher government spending has been to the detriment of public investment, which has fallen by 14 per cent over the fiscal year. While external debt has not increased significantly, the government has instead resorted to borrowing heavily and at a high cost from domestic banks, increasing the sector's exposure to sovereign credit risk and crowding out private credit.

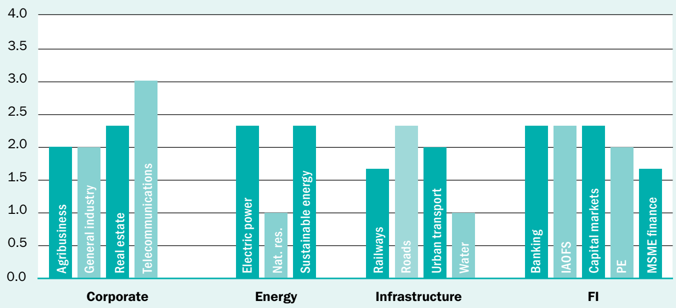
Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	4.6	5.1	1.9	2.2
Inflation (end-year)	11.5	10.5	10.1	8.0
Government balance/GDP	-7.0	-8.5	-10.1	-11.0
Current account balance/GDP	-2.5	-1.6	-2.3	-3.2
Net FDI (in million US$)	8113	6758	2189	2078
External debt/GDP	16.9	15.9	15.2	na
Gross reserves/GDP	17.5	17.2	12.0	na
Credit to private sector/GDP	7.7	7.0	1.6	na

Note: All figures are for the fiscal year July-June.

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

There are significant downside risks to the outlook associated with continued uncertainty. Egypt formally requested a US$ 4.8 billion loan from the IMF in August 2012, to financially support the government's economic reform programme, and to ease the country's deteriorating external and fiscal positions and boost investor confidence. The loan is likely to be conditional on major food and fuel subsidy reform, and will seek to attract other funds into the country. Consumer confidence has also been on a downward trend during the first half of the year, reaching lows seen during the most acute periods of the political turmoil in 2011, but business sentiment has picked up after the presidential elections in June 2012.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Egypt adopted several structural reform programmes over the past two decades with mixed results. The reforms included privatisation of state-owned enterprises, financial sector reforms, tariff reductions, capital account liberalisation, improvements in the business environment (for example, enhancing conditions for start-ups and creating a competition agency) and fiscal-structural reform (for example, income and corporate tax reforms and modernisation of tax administration). Although these reforms helped to bring about successful external liberalisation and a reduction in most trade and investment barriers, they did not manage to structurally reduce high unemployment rates or spread the reform benefits to large segments of the population.

The structural reform gaps in Egypt remain large and key market distortions persist. The state's role as regulator, guarantor of competition and enforcer of contracts has tended to be weak. In many sectors, regulatory functions are not fully separated from state operations. The Egyptian Competition Authority is not fully independent and the extent of its enforcement authority and mechanisms is unclear. In addition, Egypt's judicial capacity is weak and state involvement in many aspects of business remains heavy, leading to the lack of a level playing field for private businesses. Judicial procedures tend to be lengthy, costly and subject to political pressure and bureaucracy. Egypt ranked 110th (out of 183 countries) for ease of doing business in the 2012 World Bank *Doing Business* Report, below its SEMED peers and the regional average for the Middle East.

A number of reforms are still lagging in the agribusiness sector. Subsidies, export bans, and continued state ownership and dominance are prevalent in this sector. The agribusiness sector also lacks streamlined regulation to ease the process of owning and leasing agricultural land and reforms have yet to be developed which address the lack of alternative sources of collateral such as warehouse receipts, especially in light of severely constrained access to finance from banks.

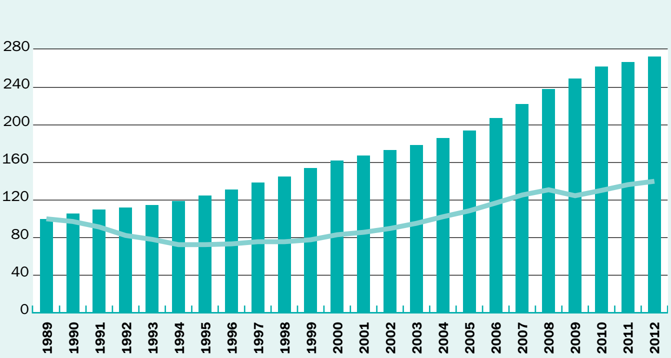
Key challenges exist in upgrading and decentralising the municipal infrastructure sector. Municipal services in Egypt are in urgent need of investment to provide better access and improved quality. Among the top priority areas are inadequate solid waste management and urban traffic management. Non-sovereign financing is limited, but decentralised financing solutions are being developed to move towards improved cost recovery and commercial discipline.

Egypt has yet to undertake substantial reforms in the energy sector. The current energy subsidy system places a heavy burden on the fiscal account and provides distorted incentives for energy use and energy efficiency. Reforms are still needed to unbundle and fully commercialise the energy sector. The authorities have expressed their intention to introduce public-private partnership (PPP) schemes that would expand private sector involvement, but concrete legislative action has yet to materialise. In addition, reforms are needed to provide incentives for investment in cleaner conventional and alternative fuels, in order for Egypt to both exploit its resources, notably in wind and solar, and alleviate pressure on domestic natural gas production.

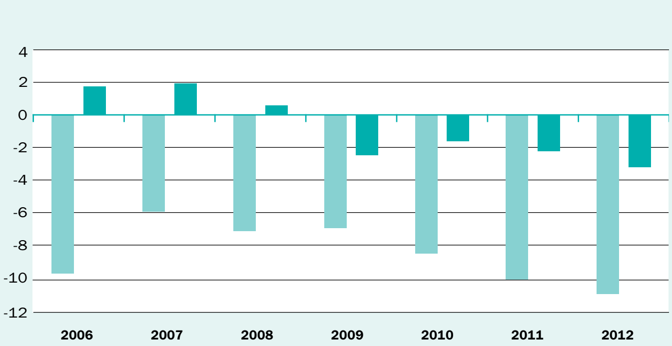
The regulatory frameworks in the transport and power sectors have not been sufficiently upgraded. These large infrastructure sectors continue to be dominated by state-owned enterprises with significant involvement and control by the central state authorities. In addition, Egypt has yet to reduce the high levels of subsidies for power, fuel and transport fares which keep prices for public services substantially below cost-recovery levels. In 2012 the Egyptian government announced plans to decrease fuel subsidies by 27 per cent. The authorities expect complete elimination of subsidies to be achieved by 2018, according to the latest announcements. Extensive regulation and the absence of market-based mechanisms for the pricing and delivery of services are also partly responsible for inefficiencies in public sector entities.

The financial sector is relatively well developed, but access to credit is limited. Improving access to finance for micro, small and medium-sized enterprises (MSMEs) is one of the key reform challenges in the financial sector. Poorly developed credit bureaus and weak contract enforcement are among the key obstacles to the further development of MSME finance. Since 2010 access to credit information has improved slightly with the addition of retailers to a private credit bureau database. However, credit to the private sector continues to be squeezed out by the government, and banks tend to favour lending to large, established companies. In addition, an unfinished privatisation agenda in the bank and non-bank financial sectors has left a number of institutions under state control.

Real GDP (1989 = 100)



Fiscal balance and current account balance



ESTONIA

HIGHLIGHTS OF THE PAST YEAR

- **Estonia showed the fastest growth of all EU countries last year.** However, the rapid expansion in exports in 2011, which currently stand at 26 per cent above pre-crisis levels, could make Estonia vulnerable to negative trends in the European economy.

- **Contributions into private pension funds are being gradually restored.** This underlines the authorities' commitment to a multi-pillar pension system and signals that a temporary crisis measure to restore fiscal balance can now be brought to an end.

- **The division of activities of the dominant energy supplier is positive for competition and market access.** The requirement for a divestment of supply activities by the current monopoly gas operator is compliant with EU directives.

KEY PRIORITIES FOR 2013

- **Capacity to generate local innovation should be expanded.** There is a continuing need to increase the growth of technology-intensive products. Education and innovation policies will need to be developed further towards this end.

- **Credit constraints for micro, small and medium-sized enterprises (MSMEs) should be relaxed and private equity and mezzanine capital developed.** Non-bank sources of finance need to be mobilised in order to facilitate the growth of innovative companies.

- **The framework for public-private partnerships (PPPs) could be developed further.** Estonia's reluctance to utilise PPPs risks going without the benefits inherent in private finance. Carefully designed projects should avert fiscal risk, and could possibly be blended with EU grant funds.

MACROECONOMIC PERFORMANCE

The economy has grown at the fastest pace of any EU country, at 8.3 per cent in 2011. Respectable growth among Estonia's main trading partners boosted exports, which rose by 27 per cent in volume terms in 2011. The main contributors to growth in industrial production (up by 16.8 per cent in 2011) were products with a higher added value, such as electronics, machinery and equipment. A clear slow-down in key export markets in the second half of 2011, and a weakening in Estonian GDP since the fourth quarter, underlined the vulnerability that stems from this export dependence. However, Estonia's ability to mobilise domestic investment and absorb the remaining EU structural funds has led to a more modest contraction in fixed capital formation during the crisis than in most other central European economies, and a more rapid recovery since then. Private sector investment has revived, growing at 26 per cent in 2011 compared with the previous year. In parallel, due to an obligation to invest revenues from the CO_2 quota trade as well as to increase the EU funds absorption before the budgeting period ends in 2013, the government remained a key driver of increasing investment activity. Unemployment has dropped from its peak in 2010 of just under 20 per cent to 10.1 per cent in mid-2012. Labour mobility with the rest of the European Union remains unusually high, and provided an important safety valve during the crisis. At the same time, this has contributed to the erosion of skilled labour available within Estonia.

Estonia's public finances stand out as the most prudently managed in the European Union. A key goal of government policy has been to keep the budget in balance, and there are no plans to issue government bonds. Gross debt currently stands at 6 per cent of GDP, and substantial fiscal reserves have been accumulated. There were small budget surpluses in both 2010 and 2011 (sales of CO_2 quotas amounted to 1.2 per cent of GDP), though the government plans to reach a deficit of about 1.5 per cent of GDP in 2012, due in part to the resumption of contributions into mandatory pension funds and in part to the environment-related investment obligations stemming from the 2011 sale of CO_2 quotas.

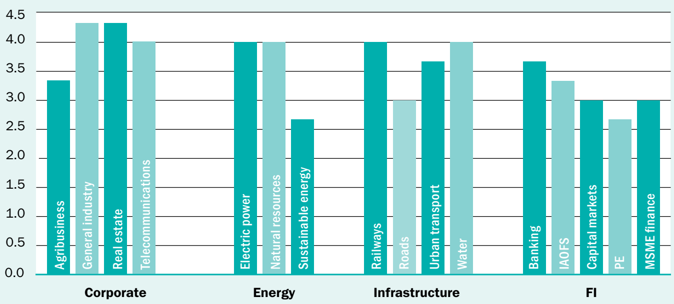
Over the next two years Estonia's growth will be substantially held back by weakness in European export markets. With nearly the entire banking sector being owned by foreign institutions, Estonia is exposed to the withdrawal of funding from foreign parents, which last year amounted to over 7 per cent of GDP, though the Nordic parent institutions are less exposed to funding constraints within the eurozone. So far, the contraction in credit to the private sector has been limited to the household sector, with corporate credit showing a modest expansion.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.1	3.3	8.3	2.3
Inflation (end-year)	-1.9	5.4	4.1	4.2
Government balance/GDP	-2.0	0.2	1.0	-1.5
Current account balance/GDP	3.4	2.9	2.1	1.0
Net FDI (in million US$)	293	1457	1715	817
External debt/GDP	125.0	115.8	98.5	na
Gross reserves/GDP	20.7	15.2	13.0	na
Credit to private sector/GDP	106.0	96.9	82.4	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Structural reforms in Estonia are well advanced. The business environment is among the soundest in the EBRD's countries of operations. A new anti-corruption law, passed in February 2012, is in line with efforts to underpin the country's role as an attractive foreign investment location. According to this law, the declaration of outside interests by public officials will be more straightforward and transparent than before. Another law was passed in parliament in March 2012 to clarify the notice period in collective labour contracts, and this further strengthens labour market flexibility and transparency of contractual rights.

The government adopted a programme aimed at further boosting the country's competitiveness. Tax revenues as a share of GDP are already well below the EU average, and a simple tax administration with extensive use of electronic submission and monitoring simplifies the system. The National Reform Programme, submitted to the European Union in April 2012, nevertheless envisages a further lowering of the tax burden to spur job creation, while preserving the current conservative fiscal approach.

Estonia remains the most knowledge-intensive economy in the transition region. High-technology goods account for about one-third of total exports to other EU countries. The country's labour force is highly skilled relative to other transition countries, and product innovation and the digital economy are encouraged through various policy initiatives, particularly in the public sector (e-government, public health system). Comprehensive programmes have been put in place to foster education at all ages and close remaining skills gaps.

The banking sector is adapting well to the withdrawal of foreign funding. Non-performing loans are the lowest of all three Baltic countries at only about 4 per cent of total loans, as of August 2012, and households continue to reduce their outstanding debt. In line with developments elsewhere in the transition region, the government has enacted reforms to enable household debt restructuring. A new law that came into effect in April 2011 allows households with debt servicing problems to restructure their debts while avoiding bankruptcy procedures. The law foresees a case-by-case restructuring of all liabilities without the use of public funds and aims to address the remaining problems among over-indebted households.

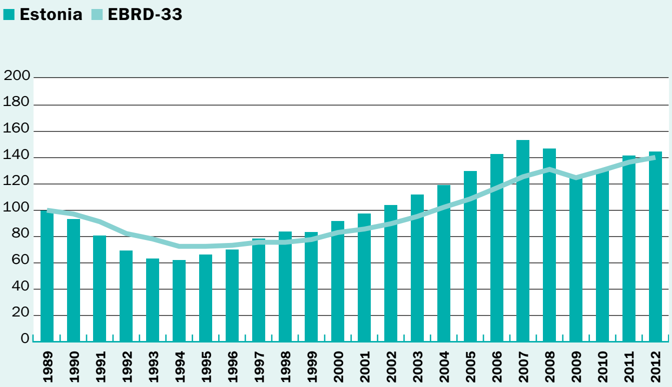
Private sector initiatives highlight a demand for non-bank sources of funding, and more risk-oriented capital. As elsewhere in the Baltic region, private equity capital remains sparse and investment strategies are limited to growth and venture capital funds. In the 2012 budget the government approved a gradual increase of contributions in private mandatory pension funds back to the level envisaged when these funds were first set up. While diversification motives and location of fund managers will still lead to the predominant part of these funds being channelled outside the country, a limited engagement within the Baltic region may now also become possible.

The government remains sceptical about the use of public-private partnerships. The authorities continue to regard EU structural funds as the principal source of funding to upgrade local infrastructure. In October 2011 the European Commission temporarily suspended fund disbursement due to irregularities in project oversight with government agencies. However, the problem was quickly rectified and funds are now being disbursed again.

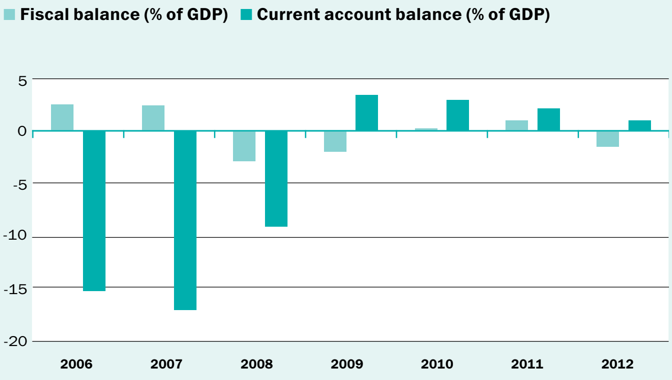
Energy intensity remains about 75 per cent higher than the EU-15 level. Several public investments in energy efficiency were advanced, though improving energy efficiency in residential properties and transport remains a government priority. In January 2012 the government published draft amendments to its energy legislation which aim at reducing the feed-in support for renewables, including for existing installations. This could retroactively lower the support for already operating renewable generators.

Energy sector restructuring progressed, in particular through the separation of activities in the gas sector. The operational separation of divisions in the monopoly supplier, AS Eesti Gaas, has already achieved somewhat greater transparency. In June 2012 parliament passed a law in accordance with an EU directive on the separation of distribution activities requiring Eesti Gaas to divest its grid network within three years. The operator, which is majority owned by German E.On. and Russian Gazprom, has threatened arbitration against this move. While the immediate acquirer may well be a state entity, in the medium term this measure could ensure greater competition by allowing access to alternative suppliers.

Real GDP (1989 = 100)



Fiscal balance and current account balance



FYR MACEDONIA

HIGHLIGHTS OF THE PAST YEAR

- **Efforts to improve the business environment and attract foreign investment have been stepped up.** FYR Macedonia's latest ranking on the 2012 World Bank's *Doing Business* scores is impressive, and some major investors are showing interest, but important business climate issues such as judicial reform and corruption remain to be fully addressed.

- **Macroeconomic stability has been preserved.** Growth in 2011 was close to 3 per cent and inflation and the government deficit were kept at low levels, but a clear slow-down is evident so far in 2012.

- **Privatisation of some of the remaining state-owned assets is proving difficult.** The failure over the past year of the state's efforts to sell some major companies highlights both the stringent tender conditions in some cases and the difficulties of offloading state-owned shares in the present climate.

KEY PRIORITIES FOR 2013

- **Reforms should be pushed forward in the context of the new high-level dialogue with the European Commission.** This dialogue offers an opportunity for the country to advance on an EU-oriented reform path even while formal accession talks cannot proceed because of the name dispute.

- **Regulatory authorities in some infrastructure sectors need to be strengthened.** In the energy sector, the regulatory authority is still subject to some intervention, and cross-subsidies are significant with household prices being kept artificially low.

- **The provision of financial services should be enhanced.** Competition in the banking sector is less vigorous than in some regional peers, and there is scope to develop a greater range of financial services than presently available.

MACROECONOMIC PERFORMANCE

The economy was less affected by the global economic and financial crisis than many regional peers but the impact of the eurozone crisis has been felt strongly in 2012. With a GDP growth rate of 2.9 per cent, FYR Macedonia was among the strongest performing SEE economies in 2011. However, the impact from the eurozone crisis began to be felt in the second half of the year and a significant slow-down has followed since. In the first half of 2012, the economy contracted on a year-on-year basis on account of the weaker export demand as well as the impact of lower foreign direct investment and reduced remittance inflows on domestic demand. Inflation stayed relatively low in 2011 and in the first half of 2012, but it accelerated recently, reaching 5.3 per cent year-on-year in September 2012. This is a temporary spike caused by rising food prices as well as increases in pensions and the introduction of a minimum wage. The currency remains pegged to the euro and international reserves are at relatively comfortable levels of 114 per cent of short-term debt and about four months of imports.

Fiscal targets have been met, but arrears are present. Given the currency peg to the euro and the limited sources of external funding, the government has implemented relatively tight fiscal policy. Over the past two years the government maintained the budget deficit within the targeted 2.5 per cent of GDP on a cash basis; this year, it is likely to reach 3.5 per cent of GDP. The government is taking measures to clear part of the accumulated budgetary arrears and delayed VAT refunds. In 2011 the government drew on the precautionary credit line (PCL) from the IMF to finance expenditures. The second review of the PCL was not completed, mainly because of IMF concerns about the arrears problem. The PCL is now dormant and will formally expire in January 2013.

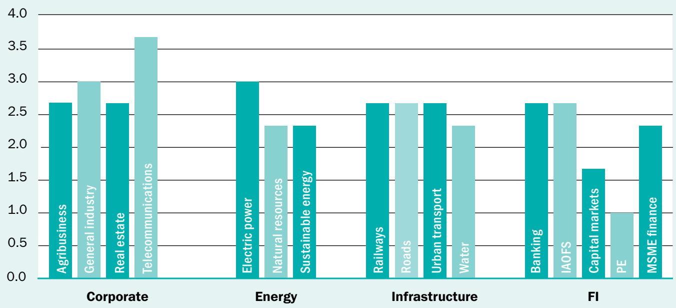
The eurozone's difficulties will continue to dampen growth prospects in 2012 and 2013. Following the contraction in the first half of the year and in light of continuing weakness in the eurozone, growth in 2012 will be minimal at best. A modest recovery is likely to occur in 2013 to around 2 per cent. A pick-up in growth is expected in the medium term, as the regional economy recovers and as FYR Macedonia reaps the benefit of sustained macroeconomic stability and investor-friendly reforms introduced in recent years.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-0.9	2.9	2.9	0.3
Inflation (end-year)	-1.6	3.0	2.8	5.9
Government balance/GDP	-2.7	-2.4	-2.5	-3.5
Current account balance/GDP	-6.8	-2.1	-2.7	-4.0
Net FDI (in million US$)	191	209	427	263
External debt/GDP	59.1	58.4	65.0	na
Gross reserves/GDP	22.1	23.4	21.5	na
Credit to private sector/GDP	43.9	45.5	46.3	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Moving to the next phase in the EU accession process remains stalled because of the name issue. Since receiving candidate status in December 2005, FYR Macedonia has made considerable progress in EU-oriented reforms. The country is on track to fulfilling the political and economic criteria for accession, but the name dispute remains a key obstacle to further advancement of the membership application. In March 2012 the government and the European Commission (EC) launched a High-Level Dialogue to boost the reform process. In its latest Progress Report, published in October 2012, the EC noted that this new Dialogue had already served as a catalyst for reforms in a number of key policy areas this year. The EC reiterated its recommendation for the opening of EU accession negotiations, stressing that this would consolidate the pace and sustainability of reforms.

Privatisation is largely complete, but efforts to sell some of the remaining state-owned enterprises have been unsuccessful. A number of attempts have been made to sell the state's 76.6 per cent stake in chemical manufacturer Ohis, but there have been no successful bids so far. Similarly, efforts to privatise the electrical engineering company EMO Ohrid, the tobacco company Tutunski Kombinat AD Prilep and the manufacturer of military kit, 11 Oktomvri Eurokompozit over the past few years have also failed. These four companies remain on top of the government's privatisation agenda. State capital remains concentrated in the energy sector (power generation and transmission companies are state-owned) and public utilities. The state also owns a significant minority stake in the country's profitable telecommunications company, Makedonski Telekom.

FYR Macedonia continues to perform well on business environment indicators. According to the 2012 World Bank's *Doing Business* Report, FYR Macedonia made the third highest improvement in ranking, moving up 12 places from 34th to 22nd (out of 183 countries) for overall ease of doing business. This places the country significantly ahead of regional peers on this business environment measure. The largest improvements were noted in dealing with construction permits, registering property and getting credit. The country still performs relatively poorly on access to electricity, cross-border trade and contract enforcement.

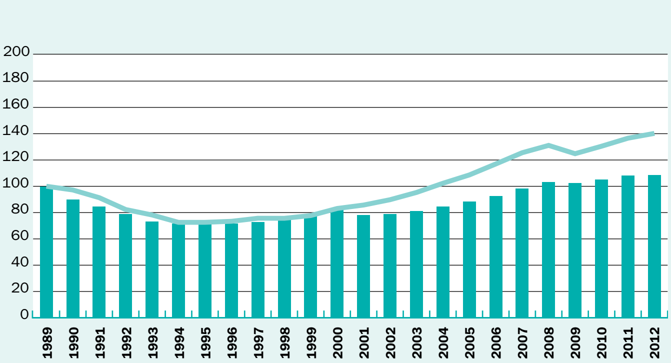
The country has attracted significant new foreign direct investments this year. The most notable is a €300 million construction project in Skopje by the Turkish company Cevahir Holding, which will include a shopping centre and four skyscrapers. In July 2012 an agreement was signed for the largest German greenfield investment in the country – a €35 million plant in the free zone of Kavadarci that will manufacture electronic installations and cables for the car industry. A week before, in the industrial zone in Bitola, construction began on another significant German investment – a €20 million plant that will also produce automotive parts. Major reinvestments by companies from the United Kingdom and United States are also under way in the car electronics and catalytic convertors industries.

Restructuring of the railways sector is ongoing. The institutional mechanisms for the introduction of public service obligation contracts and access charges are under development. Over the past year the government provided financial guarantees for an IFI-funded loan to the national rail operator, Makedonski Zeleznicki Transport. The funds will be used to modernise the freight and passenger fleet in order to improve the company's operational efficiency. Under the umbrella of the project, technical assistance will be sought for the development of a Business Segmentation Strategy, which should result in a split of the freight and passenger service into two separate legal entities by 2017. In parallel, ambitious plans for energy efficiency improvements have been envisaged with both the national rail operator and the infrastructure management company.

Overall the financial sector remains less competitive than in neighbouring countries, but pension fund assets have increased. The three largest banks (Komercijalna Banka, Stopanska Banka and NLB Tutunska Banka) still control 64 per cent of the market while the top five banks account for 77 per cent of the total market. The market is dominated by foreign banks, which account for over 90 per cent of total banking assets. However, banks have relied primarily on domestic deposits to fund lending, so they were not as exposed as those in regional peers to deleveraging pressures during the crisis. Non-performing loans have recently started to increase again, reaching 10 per cent of total loans this year, although they are more than 100 per cent provisioned. One of the three largest banks – Stopanska Banka – is a subsidiary of a Greek bank while NLB Tutunska Banka is Slovenian owned. Spillover risks are limited, however, because the bank has largely relied on domestic deposits rather than parent bank capital to finance lending.

Pension fund assets have risen sharply. Past reforms in the pension system included the setting up of a mandatory defined-contributions pillar managed by private pension funds. Along with the introduction of two voluntary funds, this has led over the past year to a substantial increase in pension fund assets, which have reached over 3 per cent of GDP (up from 1.2 per cent in 2008).

Real GDP (1989 = 100)



Fiscal balance and current account balance

GEORGIA

HIGHLIGHTS OF THE PAST YEAR

- **The government established a public fund to support private sector investment.** The Partnership Fund is endowed with equity stakes in the remaining major public enterprises and is intended to support commercially oriented private sector investment in priority areas.

- **The authorities have worked to harmonise revenue needs with a balanced and fair tax system.** The government introduced and later repealed legislation to prioritise tax payments with regard to secured lenders. The tax dispute resolution process was simplified and the tax ombudsman office was created.

- **The prominence of the country's difficult social issues increased during the parliamentary elections.** In September 2012 minimum retirement pensions were increased and mandatory health insurance for retirees was introduced. Both the outgoing and the incoming governments identified agricultural development, health and education as priority areas.

KEY PRIORITIES FOR 2013

- **Policies should support recovery of private investment.** It will be important to ensure that the newly established Partnership Fund operates on a commercial basis and foments, rather than substitutes for, foreign direct investment.

- **Complete restructuring and modernisation of the energy sector.** Despite the significant transformation of recent years, liberalisation of the energy market and the country's integration in regional energy markets remain incomplete and the sector still suffers from significant distribution losses and seasonal supply patterns inherent to Georgia's hydrology.

- **The government should continue to pursue policies to ensure that future development is more inclusive.** Policies to support retraining of the labour force, integration of the agricultural sector in the market economy and development of the labour intensive sectors should help support employment creation and higher wages over time.

MACROECONOMIC PERFORMANCE

Macroeconomic performance has been strong. Output expanded by around 7 per cent in 2011 and 8 per cent in the first half of 2012. Growth has been broad-based with manufacturing, financial services and tourism among the main contributors. As international food prices moderated, inflation declined rapidly to -0.1 per cent in September 2012. The central bank was able to loosen monetary policy by decreasing the refinancing rate from the peak of 8 per cent in June 2011 to 5.75 per cent in June 2012. Although the current account deficit rose to 12.5 per cent of GDP in 2011, rising private inflows caused appreciation pressures and enabled the central bank to replenish external reserves. The share of non-performing loans in the financial sector has declined steadily, to 4 per cent of total loans (according to the IMF's definition) at the end of July 2012. The general government deficit declined to 3.6 per cent of GDP in 2011. The authorities have been able to reduce reliance on official external financing, while maintaining a precautionary arrangement with the IMF.

The country's successful stabilisation and recent performance have been recognised by the markets. Several international rating agencies upgraded their ratings of Georgia's sovereign debt. The risk premium paid by the country narrowed to around 300 basis points as of September 2012. Georgian Railways, Georgian Oil and Gas Corporation (GOGC) and Bank of Georgia have been able to tap international markets. However, an international placement of the national railways' shares, scheduled for May 2012, had to be postponed in light of the difficult financial markets environment.

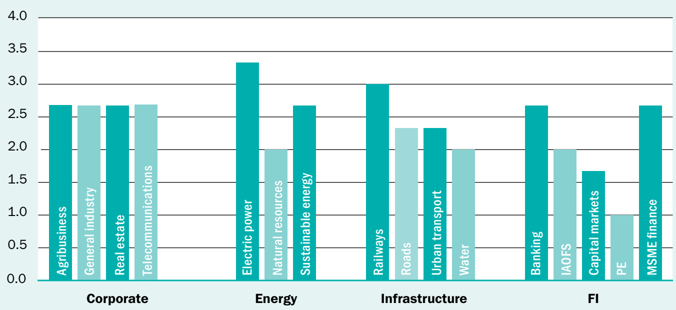
The uncertain global environment warrants continued engagement with IFIs. The short-term macroeconomic outlook is positive as broad-based growth is expected to continue at a fast pace, benefiting from credit expansion, public and private investment and remittances. However, the current account deficit remains large (at 12.5 per cent of GDP in 2011) and the level of the financial sector's dollarisation remains high although declining. The stock of external debt and overall external rollover needs are high for an emerging market economy. Replenished official international reserves and the precautionary Stand-By Arrangement with the IMF would ensure the country's high current account deficit can be financed, should private sector flows reverse, and exchange rate movements can be smoothed to avoid destabilising the financial sector. The central bank mandated commercial banks to hold additional capital as a buffer for potential exchange rate movements.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-3.8	6.3	7.0	6.5
Inflation (end-year)	3.0	11.2	2.0	3.3
Government balance/GDP	-9.2	-6.6	-3.6	-3.5
Current account balance/GDP	-10.6	-10.3	-11.8	-13.0
Net FDI (in million US$)	677	679	829	950
External debt/GDP	58.7	62.7	58.5	na
Gross reserves/GDP	19.6	19.5	19.6	na
Credit to private sector/GDP	30.9	31.8	32.8	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government established a fund to support private sector investment. The Partnership Fund (PF), endowed with equity in the country's largest state enterprises (including Georgian Railways and GOGC), was established in June 2011 and commenced operations in the spring of 2012. It is intended to support commercially oriented projects in priority sectors in the form of minority equity stakes and debt financing. To ensure that the PF is transparently managed, it was set up as a joint stock company and will be subject to IFRS reporting and rating reviews by the international rating agencies. The fund's operations will not benefit from explicit state guarantees. However, further measures will be needed to strengthen the fund's governance and limit the associated fiscal risks.

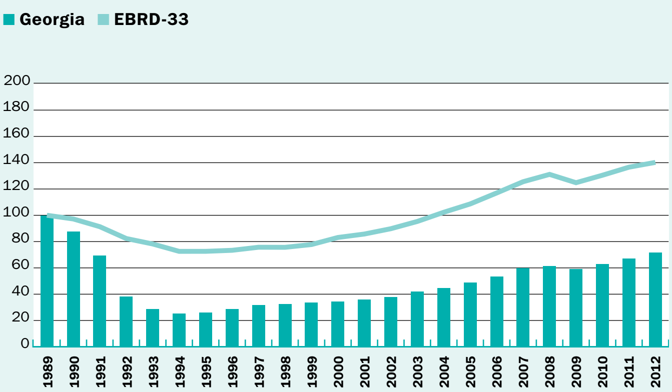
Georgia's excellent investment environment has been affected by forceful revenue collection measures. At an ease of doing business ranking of 16th (out of 183 countries), Georgia is the best-rated country in the transition region in the 2012 World Bank's *Doing Business* Report. Large-scale privatisation is very advanced, tax and customs bodies are generally well run, and tangible results have been achieved in fighting corruption. However, over the past year, the tax administration has pursued aggressive tax collection measures, raising concerns about the magnitude and fairness of various penalties. The tax code was amended in January 2012 to allow for seniority of tax liabilities over secured lenders – potentially putting in question security of mortgages and other secured loans – a measure that was later reversed. At the same time, to improve efficiency of, and confidence in, the tax system the authorities have implemented electronic tax filing, improved customs clearance procedures, introduced advanced tax ruling option binding on the tax authority and created a tax ombudsman office.

The country's social challenges were brought into sharp relief during the heavily contested parliamentary elections. Despite recent rapid growth, the rate of unemployment has remained high at around 15 per cent. Over half of the labour force is engaged in low productivity subsistence farming. About one-quarter of the population lives below the poverty line. The government has been piloting vocational training programmes, which has expanded employment opportunities for the participants. To integrate the agricultural sector into the market economy, the government is pursuing infrastructure development programmes and supporting projects to develop logistics and warehousing capacity although a fully-fledged strategy for agricultural development is yet to be articulated. The authorities continue to implement a national health care strategy for 2011-15 with the aim of improving the population's health through a reduction of disease burden and mortality by 2015. However, the recently implemented vertical integration of insurance companies and the hospital sector may lead to conflicts of interest that could negatively affect the quality of health care.

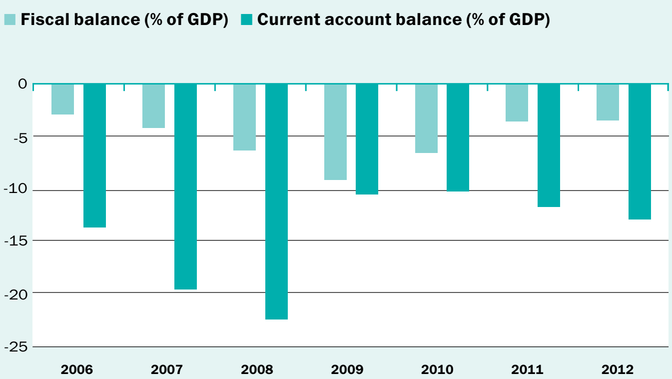
The government's plan to partially privatise several remaining public companies was shelved in the poor international market environment. The government has decided to delay the IPOs of minority stakes in several major state-owned companies due to difficult market conditions. The enterprises considered for market placement included stakes in the GOGC, Georgian Railways, and the capital electricity provider Telasi. Instead, in May 2012, GOGC successfully placed a five-year US$ 250 million Eurobond and, in June, Georgian Railways successfully placed a 10-year US$ 500 million Eurobond at the London Stock Exchange. The five-year issue, with a coupon priced at 7.125 per cent, was four times oversubscribed. The funds will be used for the construction of two hydropower plants in the Namakhvani Cascade of western Georgia. The issue should provide funds to support development of the export-oriented electricity sector and help strengthen GOGC's corporate governance and transparency.

The National Bank of Georgia (NBG) has continued to pursue the policy of inflation targeting while strengthening its financial stability frameworks. The NBG has been transitioning to an inflation targeting regime, and has set an inflation target of 6 per cent for the medium term. An EBRD technical cooperation project is helping the central bank to make more informed policy decisions and strengthen its policy credibility by enhancing its forecasting and communication capacities. As inflation declined and the exchange rate appreciated, the central bank was able to reduce the policy rate. The authorities have continued implementing measures to comply with Basel II and Basel III regulations. Financial disclosure rules are being modified in order to comply with Basel II recommendations. The central bank also developed a framework defining the need for countercyclical buffers, in line with Basel III. In response to development of the retail sector, the central bank enacted consumer protection regulations and created a consumer protection unit expected to improve financial education and transparency of retail products.

Real GDP (1989 = 100)



Fiscal balance and current account balance



HUNGARY

HIGHLIGHTS OF THE PAST YEAR

- **Fiscal discipline has been improved.** The government has made good progress in bringing headline public deficits back within the limits mandated under European treaties.
- **Overly generous social benefits have been capped.** These steps have been taken along with much-needed changes to entitlements in the state pension system.
- **The authorities have reached an agreement with the banking industry on restructuring foreign currency-denominated mortgages.** This is a significant step in finding a balanced solution to this long-running problem, though the scheme that allowed borrowers to pre-pay outstanding foreign currency mortgages at discounted exchange rates led to a considerable capital loss in the banking system.

KEY PRIORITIES FOR 2013

- **A predictable tax and regulatory regime and revived bank lending could enable corporate capital formation.** Problems in this long-running weakness have increased in the past year and constitute a key concern for long-term growth prospects.
- **Measures are needed to increase employment and participation rates.** However, it will be important not to raise the administrative burden on private enterprises or interfere in private employment contracts.
- **A speedy conclusion of the discussions on the IMF/EU programme would help to rebuild the confidence of investors.** This is important given the persistent vulnerability from external and domestic debt, and could stabilise expectations about financial regulation. A future programme would need to be backed up with comprehensive structural reforms that would limit quasi-fiscal deficits, in particular in the transport sector.

MACROECONOMIC PERFORMANCE

Hungary's growth last year remained well below the regional average and the economy has now re-entered a mild recession. Growth of 1.6 per cent in 2011 benefited from a good harvest and export-led industrial production growth until late in the year. Domestic demand remains among the weakest of all countries with household consumption stagnant over 2011 and well below pre-crisis levels. The economy re-entered a recession with two successive quarters of contraction in the first half of 2012. A particular concern is the continued erosion in the private sector capital stock. The ratio of fixed investment to GDP remains the lowest of all central European countries and, unlike in other countries, declined again in 2011.

The government made a genuine attempt to contain public debt but tax policies remain erratic. The budget recorded a sizeable surplus of over 4 per cent of GDP last year following the effective nationalisation of second pillar pension funds (accounting for about 9 per cent of GDP). Still, there has been a large deterioration in the underlying structural position. The so-called "crisis taxes" on a number of sectors, such as telecommunications, energy, retail and financial services have been widely criticised as discriminatory and punitive, and in the case of the telecommunications levy are before the European Court of Justice. Having failed to meet earlier EU demands for a fiscal correction, Hungary was briefly threatened with a suspension of about €500 million in EU cohesion funds. In its latest EU Convergence Programme in April 2012 the government presented consolidation measures of about 0.5 per cent of GDP for both this year and next. These measures would also include a new tax on the telecommunications sector and, from next year, a financial transaction tax (on top of the existing balance sheet tax). These proposals are encouraging for fiscal sustainability, though the composition of taxes and the erratic manner in which taxes are designed remain a problem for the investment climate.

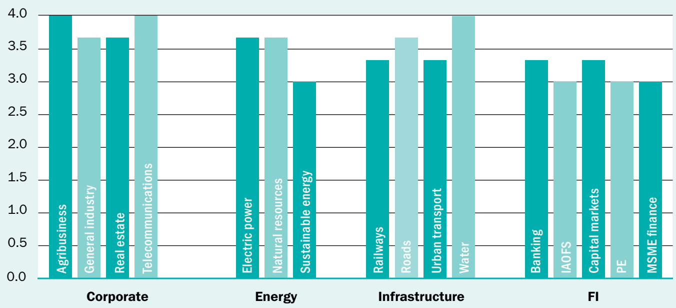
Monetary policy is restrictive, though some easing was initiated in August 2012. The restrictive monetary policy stance of the NBH has initially been motivated by high country risk premia and uncertain prospects for external financing. First reductions from the policy rate of 7 per cent were nevertheless undertaken in August and September 2012 and hinted at growing divisions within the monetary policy council. The central bank implemented a number of measures to stimulate stagnant lending in the economy, through broader collateral eligibility for central bank loans, a preferential two-year lending facility and a proposal to allow universal banks to issue mortgage bonds with support from a central bank mortgage bond purchase programme. Meanwhile, credit to the private sector contracted by 0.8 per cent of GDP in 2011 and showed a further contraction in the first half of 2012.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.8	1.3	1.6	-1.5
Inflation (end-year)	5.4	4.6	4.1	6.0
Government balance/GDP	-4.6	-4.2	4.3	-3.3
Current account balance/GDP	-0.2	1.1	0.9	1.5
Net FDI (in million US$)	131	960	-164	1035
External debt/GDP	158.1	142.0	123.5	na
Gross reserves/GDP	34.8	37.4	38.3	na
Credit to private sector/GDP	60.5	60.5	57.8	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

With the highest public debt ratio of all new EU member states, Hungary faces substantial refinancing requirements over the coming years. A second recession is likely to extend into 2013. The downgrade of Hungary's sovereign rating into speculative grade by the three main ratings agencies in late 2011 put in doubt the country's capacity to access capital markets. The government therefore requested a second financial support programme from the European Union/IMF at that time, and formal negotiations began in July 2012.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government has recognised the need to address growing competitiveness concerns and revive corporate investment. Hungary's ranking in the 2012 World Bank's *Doing Business* indicators declined in 2011. Unit labour costs have fallen since the financial crisis, though largely as a result of stagnant domestic wages. Through an extensive programme on the business environment adopted in November 2011, the government seeks to address the costs of doing business, setting out a catalogue of over 100 measures, many aimed at the micro, small and medium-sized enterprises (MSME) sector.

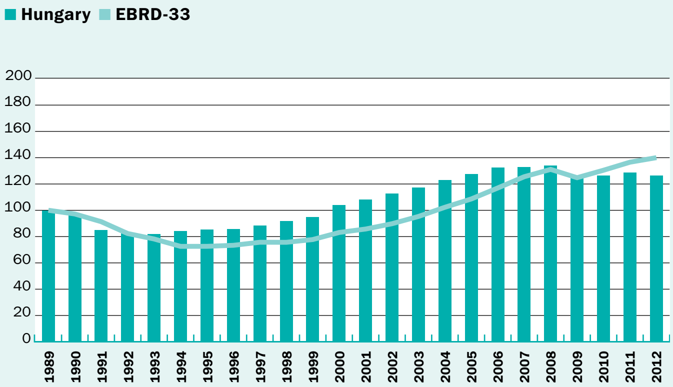
The government has adopted wide-ranging labour market reforms, though the effects on employment are as yet unclear, and the costs to private sector employers significant. Hungarian unemployment has not declined over the past year (remaining at 11 per cent according to Eurostat), with the youth unemployment rate well above the EU average. The participation rate in the labour force, while slightly increased, remains the second lowest in the EU at just under 63 per cent, well below the EU target of 75 per cent. Following a series of measures throughout 2011 the government announced a package of measures in July 2012 that included tax incentives for employers taking on workers who are marginalised due to age or lack of skills. Active labour market policies, along with these tax incentives, could in principle address the damaging effects of long-term unemployment, though there remain a number of rigidities in the social benefits system that have perpetuated the low participation rate in the Hungarian labour market. Also, a simplification of taxes for small and medium-sized enterprises (SMEs), through a lump sum payment settling a number of taxes and social security payments, is envisaged. At the same time, a reform of the personal income tax introduced in 2011, which included mandatory compensation by employers to low-wage earners, has been criticised as highly intrusive and potentially damaging to overall employment.

Financial sector taxation compounds deleveraging pressures. The financial sector as a whole has ample capital coverage, though it turned loss-making in 2011. A financial sector levy remains in place as part of the government's 2010 package of crisis taxes. The tax is the highest such tax in Europe (at about 0.8 per cent of the 2010 balance sheets of each financial institution, including non-bank institutions), though it is to be halved in 2013, and will then be revised in line with a possible European framework for such taxes.

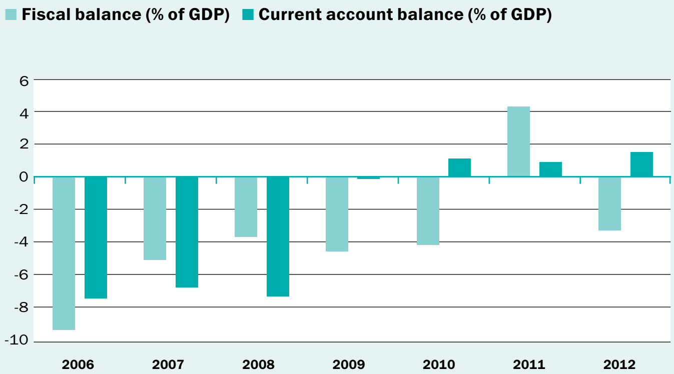
Further progress was made on the long-standing issue of foreign currency mortgages. Two measures on this issue were adopted in May and September 2011 (when early pre-payment at preferential exchange rates was permitted). This prompted several foreign banks to undertake substantial write-downs of their portfolios in Hungary and forced recapitalisations by these bank groups. The government found some reconciliation with the industry in an agreement in December 2011. This agreement allowed those banks which had booked losses through the early repayment of mortgages at preferential exchange rates (made possible through the regulation of September 2011) to credit 30 per cent of such losses against the special financial sector levy. The December agreement led to the restructuring of delinquent mortgages and the shielding of performing mortgage borrowers from excessive exchange rate fluctuations. On both aspects some burden-sharing between banks and the government was agreed.

Stability in financial sector regulation and taxation will be supportive of revived lending. The December 2011 agreement between the government and the banking industry also foresaw regular consultation on the role of the banking industry in stimulating growth, and a commitment not to impose a bank tax in 2014 higher than that in effect elsewhere in the European Union. Nevertheless, in July 2012 parliament adopted a tax that is to be levied on money transfers at a rate of 0.1 per cent up to a certain threshold per transaction, and on cash withdrawals (at 0.3 per cent), yielding an expected revenue of about 0.5 per cent of GDP in 2013 (earlier plans to also tax transactions by the central bank were dropped). While similar taxes have been prevalent in other emerging markets, transaction taxes are rare in the European Union, only used for securities, and so far there is no EU-wide transactions tax. While the government expects that this tax will be primarily borne by end-users of financial services, industry participants recalled the December 2011 agreement as specifically ruling out such additional taxes. An opinion on this tax by the ECB highlighted the risks to financial market liquidity and spillover effects in diverting financial activity into neighbouring countries.

Real GDP (1989 = 100)



Fiscal balance and current account balance



JORDAN

HIGHLIGHTS OF THE PAST YEAR

- **Jordan's economy proved vulnerable to external commodity price shocks as well as a worsening of its fiscal situation.** Both problems were likely to be amplified by regional political turmoil. The IMF has approved a request for a US$ 2 billion Stand-By Arrangement in August 2012.

- **Important progress has been made in financial sector reform.** Jordan has advanced in harmonising Basel III standards in capital, leverage and liquidity standards to strengthen banking supervision and risk management.

- **Legislation to improve the overall business environment is advancing.** A new Secured Lending Law has already been passed and a number of new draft laws have been developed on investment policy, bankruptcy and insolvency and an Islamic Sukkuk law.

PRIORITIES FOR 2013

- **Reform of the municipal infrastructure sector is urgently needed.** Significant resources are required to address water scarcity and enhance the efficiency of water usage and distribution. Private capital would help to fund upgrades of the urban transport systems through transparent public-private partnerships (PPPs).

- **Further efforts to improve energy efficiency need to be made.** A combination of a very energy intensive industrial sector coupled with persistent energy supply disruptions to the main gas pipeline from Egypt have resulted in an expensive overall energy bill. Reforms to increase the share of renewable energy are still outstanding and steps need to be taken to diversify sources of energy in the long term.

- **A key priority is addressing water scarcity and implementing reforms in the water and wastewater sectors,** in order to increase private sector participation, as well as to reform tariffs to reflect water scarcity. Improvements in water regulation and operational performance are also needed to meet increasing water demand.

MACROECONOMIC PERFORMANCE

The Jordanian economy continued to grow only moderately during the first half of 2012. Real GDP growth reached 3 per cent in the first quarter of 2012, and slowed slightly to 2.9 per cent in the second quarter, supported by a rebound in tourism and strong performance of the financial services sector, a key driver of economic growth. However, growth in the first half of the year was dragged down by a slow-down in manufacturing activity, along with contractions in agriculture, mining and construction. Policy space has been substantially reduced this year limiting the government's ability to boost economic growth. Inflation has risen throughout the year, reaching 4.8 per cent in August, up from 3.3 per cent in December, mostly due to increases in food prices, transportation and communication costs.

Fiscal and balance of payments pressures have intensified this year, prompting Jordan to seek and receive IMF assistance. The three-year, US$ 2 billion (7 per cent of GDP) Stand-By Arrangement approved by the IMF should help Jordan correct fiscal and external imbalances while maintaining the exchange rate peg. After reaching 12 per cent of GDP in 2011, the current account deficit has widened during 2012. Exports fell in the first half of 2012, but tourism and remittance flows have held up. FDI, however, remained depressed due to regional turmoil. The authorities have begun to implement a fiscal reform programme (a condition of the IMF loan) which will see increases in revenue-generating measures, such as tax increases on cars, tobacco, alcohol and airfares, along with cuts to subsidies and capital investments. The country remains dependent on foreign grants and loans, from bilateral sources (France, Japan, US and GCC) and IFIs, to secure its financing needs. Jordan also secured a US$ 250 million loan from the World Bank for budget support. In addition, the European Union has agreed to a €3 billion support package, to be disbursed over the next three years.

Risks to the economic outlook are significant. Growth will remain sluggish in 2012 and, with the conflict in neighbouring Syria likely to stay protracted, the negative repercussions on tourism and on investors' perceptions of the region are likely to be felt. Remittances are likely to remain strong especially since Gulf Cooperation Council economies are expected to perform well in 2012-13, but increasing energy prices and possibly unstable gas supply from Egypt could pose further problems.

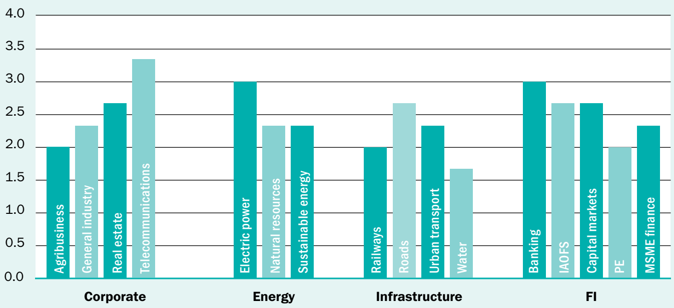
Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	5.5	2.3	2.6	2.6
Inflation (end-year)	-0.7	5.0	4.4	5.0
Government balance/GDP	-10.9	-7.5	-12.7	-10.5
Current account balance/GDP	-5.2	-7.1	-12.0	-14.0
Net FDI (in million US$)	1713	1172	1046	800
External debt/GDP	61.2	63.1	59.9	na
Gross reserves/GDP	48.1	48.6	39.0	na
Credit to private sector/GDP	4.7	7.8	9.0	na

Note: Government balance excludes grants.

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Economic reforms progressed cautiously throughout the year, with several important laws introduced since the beginning of 2011. These fall under the purview of the country's action plan, which is based on the Executive Development Programme of 2011-13. The programme is not only very comprehensive, addressing both regulatory and investment bottlenecks, but also demonstrates a clear focus on private sector involvement and support from the international community. Reforms in some key areas have already been undertaken, but they are lagging behind in others.

Jordan has made substantial progress in financial sector reforms. The appropriate regulatory framework and supervision mechanisms have been adopted through the completion of Basel II implementation in 2009, and the implementation of Basel III is ongoing in 2012. An automated data collection system was introduced in June 2010 and cross-border bank regulation has been enhanced. In 2010 the law establishing Private Credit Bureaux was adopted, but the first bureau is yet to be established. The low effectiveness of enforcement of bankruptcy procedures among borrowers, however, remains a significant impediment to increasing lending to both consumers and corporate borrowers.

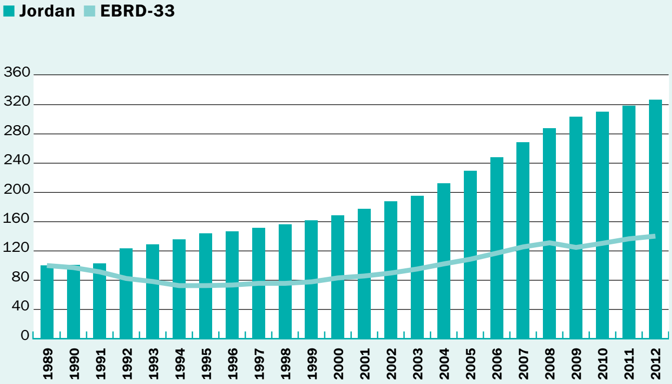
While the government recognises the large challenges of the energy sector as one of its main priorities, it has only made limited progress so far on the reform side. The industrial sector remains very energy intensive, and significant reforms have not yet been enacted to increase the share of renewable energy in total generation. On the other hand, energy subsidies have expanded substantially in 2011. However, increasing fiscal pressures, associated partly with the rise of gas prices due to persistent disruptions to the pipeline from Egypt, have forced the government to modify some of those subsidies. As a result, subsidies on premium fuels were decreased in May 2012, while electricity tariffs for major industrial firms were raised.

Some reforms have been enacted to enhance competitiveness, investment, and private sector development along with labour market reforms. The legislative frameworks for both foreign and local investments have been improved. A new Secured Lending Law is now in place, in addition to a new draft Investment Law. Other laws that are in the pipeline for 2012 include a new Insolvency and Bankruptcy Law and an Islamic Sukkuk Law. Some structural issues with the labour market have been addressed, through a law easing the hiring and firing of workers. The government has also launched a US$ 211 million fund, running in partnership with the private sector and civil society, to promote inclusive growth and job creation. A US$ 1.41 million loan guarantee fund for SMEs was launched in August 2012 to facilitate SME access to credit.

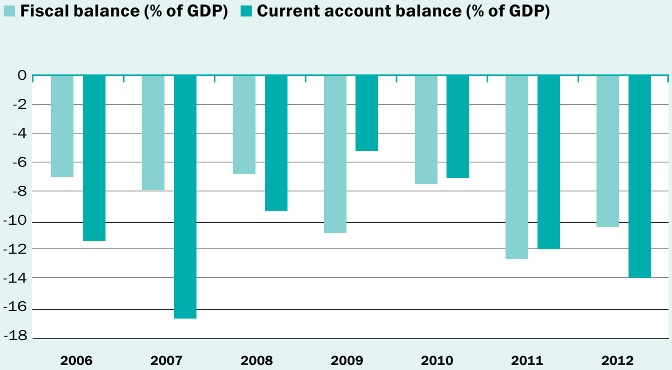
Reforms are being enacted to ease conditions for local and foreign direct investment, especially in large infrastructure projects and in the municipal sector. Jordan has established public-private partnership-specific central government institutions and is in the process of enacting a PPP law (as opposed to the existing Privatisation Law, which is broader in focus). The government is also planning to launch a number of large infrastructure and renewable energy projects, which will require some sort of PPP formulation to attract the private sector.

Despite considerable structural reform, the sustainable energy sector still faces substantial challenges. Jordan has made considerable progress in unbundling and corporatising its power sector, including drawing in substantial private sector involvement. However, the regulated tariff system, which is not cost-reflective, along with persistent energy subsidies, has limited competition in the sector and is in need of reform. On the renewable energy side (which accounts for less than one per cent of production despite Jordan's massive solar energy potential), the government published a framework in May 2012 to support and promote investment in the sector. However, due to limited fiscal space and constrained lending conditions in the banking sector, financing renewable energy projects remains a challenge. In this regard, a renewable Jordan Energy and Energy Efficiency Fund (JREEF) is in the process of being set up with the aim of providing some support for renewables and energy efficiency projects.

Real GDP (1989 = 100)



Fiscal balance and current account balance



KAZAKHSTAN

HIGHLIGHTS OF THE PAST YEAR

- **Gross domestic product (GDP) growth is strong but slowing down in 2012.** The deceleration of growth, to 5.6 per cent year-on-year in the first half of 2012, is largely explained by the poor performance in mining and construction, in part because of the unusually cold winter.
- **The banking sector remains weak.** Non-performing loans (NPLs) now exceed 30 per cent of total loans, while provisioning for NPLs remains sufficient according to official data. The third largest bank, BTA, started negotiations on a second debt restructuring in January 2012.
- **Further progress was made with regional economic integration.** Following the establishment of a customs union between Kazakhstan, Russia and Belarus in 2010, the three countries launched the next stage of economic integration – towards a common economic space – in January 2012.

KEY PRIORITIES FOR 2013

- **Restoring the health of the banking system is a key priority.** To reduce the high level of NPLs, the authorities need to conduct a thorough assessment of asset quality and ensure proper valuation and accounting of restructured loans.
- **State interference in business processes needs to be reduced.** This will help to balance public and private investments, with private businesses playing a greater role. The remaining price controls need to be phased out and corporate governance in state-owned enterprises should be strengthened further.
- **Energy sector reform is needed to address high energy intensity.** To enable investment in renewable energy, a comprehensive legislative and regulatory framework should be developed that includes feed-in tariffs and connection charges.

MACROECONOMIC PERFORMANCE

The economy grew strongly by 7.5 per cent in 2011 but growth has started to slow in 2012. The extraction and construction sectors experienced a contraction during the first quarter of 2012, in part because of unusually cold weather but also because of lower commodity prices. According to preliminary estimates, the economy rebounded in the second quarter but overall growth slowed to 5.6 per cent (year-on-year) in the first half of 2012. Lower global commodity prices have also caused inflation to fall to around 5 per cent during the first half of 2012.

The country's fiscal and external positions remain strong. The general government balance remained positive while the authorities have also managed to reduce the country's non-oil fiscal balance. The current account surplus rose to over 7 per cent of GDP in 2011, the highest level on record.

Bank credit growth recovered to over 17 per cent year-on-year in May, partly driven by subsidised state loan programmes. Several banking sector indicators remain weak: non-performing loans (NPLs) still exceed 30 per cent of total loans, provisioning for NPLs remains insufficient, and the third largest bank, BTA, is seeking a second debt restructuring less than two years after the first one. However, in April 2012 Fitch ratings agency upgraded the ratings of two of the largest banks, Halyk Bank and Kazkommertsbank, and confirmed the ratings of four other banks. Fitch characterised the sector overall as weak but stable.

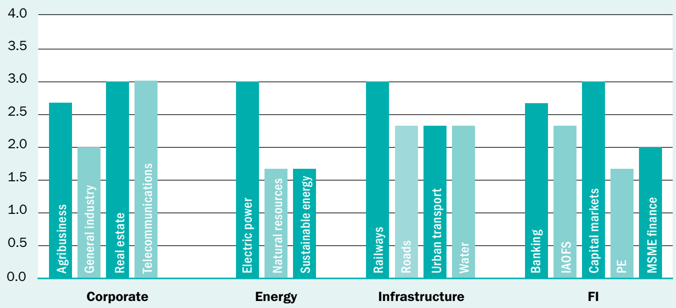
On current trends, GDP growth is expected to slow to around 5.5 per cent in 2012. However, there are further downside risks arising from the impact of the eurozone crisis and prolonged global slow-down, which are likely to affect the country's main economic partners with spillovers to trade, finance and investment. Furthermore, the failure to restore the health of the banking sector could increase these downside risks.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	1.2	7.3	7.5	5.5
Inflation (end-year)	6.2	7.8	7.4	6.5
Government balance/GDP	-1.2	1.5	5.9	3.6
Current account balance/GDP	-3.6	1.6	7.6	6.2
Net FDI (in million US$)	10083	2931	9129	8979
External debt/GDP	97.9	79.9	66.5	na
Gross reserves/GDP	18.1	19.1	15.8	na
Credit to private sector/GDP	49.0	34.8	32.2	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The role of the state has increased in a number of key sectors. In June 2012 the parliament approved amendments to legislation regulating state monopolies, limiting them to cases related to national security, defence, protection of public order and health. However, no concrete reduction in state monopolies has thus far been made; instead, the role of the state has increased in the natural resources and mining sectors. Following a long dispute with existing private shareholders, a 10 per cent stake in the Karachaganak Petroleum Operating (KPO) consortium was transferred to Kazakhstan in June 2012. In January 2012 the state also acquired the pre-emptive right to purchase raw and commercial gas, while the National Bank of Kazakhstan (NBK) obtained the pre-emptive right to purchase refined gold "in order to protect the national interest." Furthermore, there are proposals for new legislation that would require a mandatory 50 per cent state stake in any new oil or gas pipeline projects.

The implementation of the strategy to resolve problems in the banking sector has been slow. The new mechanism to deal with impaired loans launched by the authorities in April 2012 combined a centralised problem loans fund, established and funded by the NBK and other investors, and bank-run Special Purpose Vehicles (SPVs). In late-2011, parliament approved legislation to remove some of the tax disincentives for NPL write-offs and to create a second Distressed Asset Fund, effective from 2012, but the latter is expected to begin operating only towards the end of 2012.

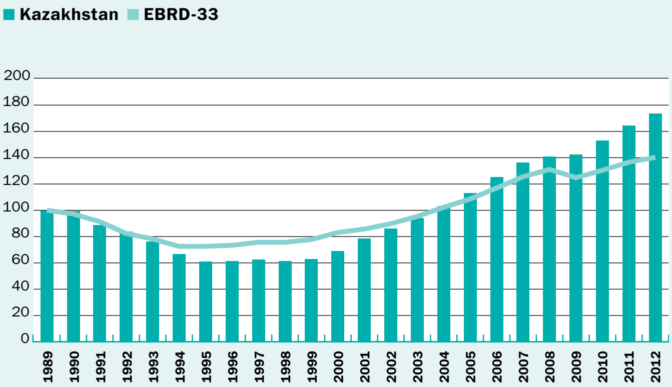
Kazakhstan has improved its ease of doing business ranking. According to the 2012 World Bank *Doing Business* Report, Kazakhstan improved its ease of doing business ranking from 58th to 47th position among 183 countries. Major improvements were made in the area of investor protection with adoption of stricter regulation on transactions between interested parties. At the same time, the country still ranks poorly in trading across borders and dealing with construction permits.

Railway sector reform has been slow, but there has been some recent progress. Kazakhstan Temir Zholy (KTZ), the main railway carrier, proceeded with the implementation of the restructuring plan adopted in November. In March 2012 KTZ completed implementation of an anti-corruption programme, which included specialised training for KTZ staff, adoption of a corporate ethics code, and a campaign for zero-tolerance towards corruption. In the power sector, new legislation adopted in July 2012 introduces a long-term capacity payment system, which represents a step away from a market-based system. In addition, the development of competition in the sector in the medium term may be constrained by the use of a single buyer system to award contracts for new generation capacity.

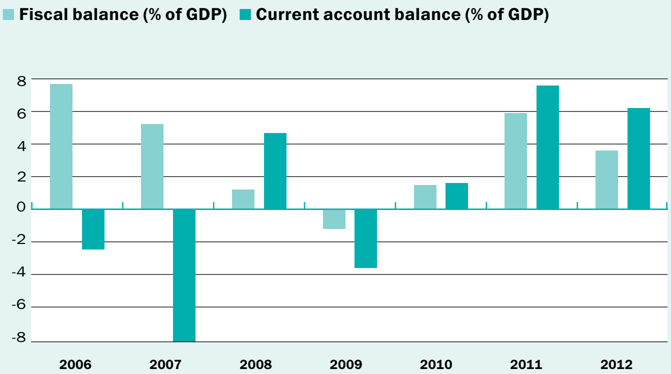
Further progress has been made with regional economic integration. Following the establishment of a customs union between Kazakhstan, Russia and Belarus in 2010, the three countries launched the next stage of economic integration in January 2012. This stage envisages the creation of a common economic space within the Eurasian Economic Community. The stated ultimate goal of the community is free movement of goods, capital and people, as well as harmonisation of macroeconomic and structural policies. The Eurasian Economic Commission, a newly established supranational body of the community, is expected to gradually take over a number of responsibilities from the national authorities in areas such as competition policy, technical regulations and environmental standards. Key decisions will be taken by the Council of country representatives based on the "one country, one vote" principle. Thus far there is not much evidence that the integration process under the Russia-Kazakhstan-Belarus Customs Union (CU) has increased trade between the CU countries, but larger benefits are likely to come from gradually liberalising services sectors and market access within the economic union.

Bilateral World Trade Organization (WTO) accession talks are expected to be concluded by the end of 2012, in which case Kazakhstan could join WTO around mid-2013. The remaining discussions focus on support for agriculture, export duties on natural resources and local content requirements in the hydrocarbon industry.

Real GDP (1989 = 100)



Fiscal balance and current account balance



KYRGYZ REPUBLIC

HIGHLIGHTS OF THE PAST YEAR

- **The authorities have embarked on an ambitious reform programme.** It includes major cuts in the number of licences and inspections, as well as plans for radical reforms in public administration, fiscal policy, mining and energy.
- **The economy grew strongly in 2011 but contracted in the first half of 2012.** Real GDP grew by 5.7 per cent in 2011 after a decline in 2010, but problems at the biggest mining site in February 2012 caused a temporary economic contraction in the first half of the year.
- **The fiscal framework has been strengthened.** Key measures included the establishment of a public financial management committee, extension of treasury coverage of general government operations and adoption of a medium-term debt management strategy.

KEY PRIORITIES FOR 2013

- **The new government should continue its ambitious plans to improve the business climate.** Key priorities for the country are strengthening governance and transparency, protecting private property rights and lowering the cost of doing business by radically simplifying regulation, inspections and licences.
- **The role of the state in the banking system should be reduced.** The main challenge is to increase confidence in the banking system, including through a successful and transparent privatisation of two large banks.
- **The energy sector is in need of modernisation and structural reform.** A recently adopted medium-term strategy for sector development needs to be implemented, with a focus on improved public administration over the sector, improved corporate governance and transparency and increased operational efficiency.

MACROECONOMIC PERFORMANCE

The economy has recovered well from the 2010 socio-political crisis. Political stability improved following the presidential elections in October 2011 and the successful formation of a new four-party government. Macroeconomic stability returned as well, with GDP growth recovering to 5.7 per cent in 2011 on the back of strong growth in manufacturing, transport and telecoms, combined with higher gold prices and a rebound in neighbouring countries. The general government deficit was kept below 5 per cent of GDP in 2011, reflecting higher tax revenues and lower than planned expenditures. Inflation decelerated sharply from above 20 per cent in early 2011 to below zero in April 2012 and remained around that level until June, mostly reflecting international commodity price developments. A combination of industrial action and difficult weather conditions in the high-altitude pit at the Kumtor gold mine in early 2012 caused gold production to decline by 65 per cent year-on-year in the first quarter of the year and hence a GDP contraction of almost 6 per cent during the first half of the year. Nevertheless, non-gold GDP has continued to grow by nearly 4 per cent during the same period.

The external position is expected to deteriorate in 2012. The current account balance deficit narrowed in the first half of 2011 due to strong export demand, favourable gold prices and a rapid recovery of remittance inflows, mostly from Russia but remained around 6 per cent of GDP at the end of 2011. The early indications of a slow-down in Russia and Kazakhstan are likely to have a negative impact on exports and remittances in 2012. The situation is not helped by the fact that Kazakhstan introduced various barriers for Kyrgyz food exporters in late 2011. Meanwhile, financial stability has improved and further banking system restructuring is under way. Private sector credit increased by 21 per cent in 2011 and non-performing loans declined from 16 per cent at the end of 2010 to 10 per cent in December 2011. The microfinance sector remains very vibrant and helps to ensure that credit continues to flow to small and medium-sized enterprises.

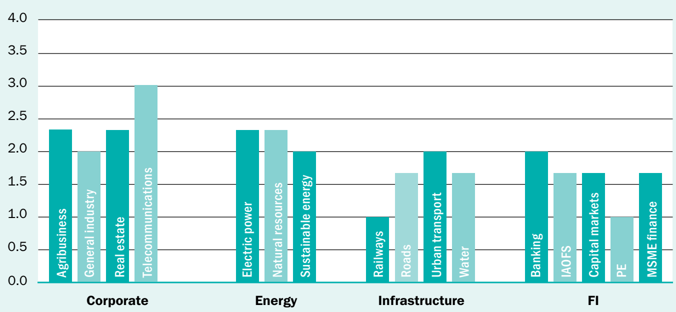
GDP growth in 2012 will likely be negative. This is a result of the temporary mining sector contraction and unfavourable weather conditions affecting agriculture. The outlook for GDP will depend to a large extent on eurozone developments, which will affect the gold price, as well as economic developments in Russia and Kazakhstan, which will influence remittances and exports.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	2.9	-0.5	5.7	-1.1
Inflation (end-year)	0.0	18.9	5.7	7.5
Government balance/GDP	-8.0	-5.6	-4.9	-6.0
Current account balance/GDP	-2.5	-6.4	-6.3	-12.8
Net FDI (in million US$)	190	438	694	432
External debt/GDP	91.6	87.7	76.9	na
Gross reserves/GDP	32.0	33.6	31.0	na
Credit to private sector/GDP	12.5	12.4	11.4	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The new government has embarked on a radical reform programme to improve public administration and boost the business environment. The first presidential election under a new form of republic governance took place in October 2011. Following the elections, the new government has made major progress with their 100-day action plan focusing on anti-corruption measures. The financial police was liquidated, 72 types of licences were abolished in early 2012 and the number of activities subject to licensing requirements is expected to be reduced further, from 500 before the start of reforms to 220. The level of civil service staff was cut by 15 per cent as a result of restructuring and consolidation of various agencies and a substantial reduction in the number of agencies conducting regular inspections of businesses. Various services provided by the state had been reviewed and their total number was drastically reduced, from around 20,000 to 386. The authorities also adopted a plan for fighting corruption in 2012-14. Related measures include a moratorium on checks and inspections of businesses and implementation of a form of performance-based budgeting which takes into account progress in terms of reforms in various areas as measured by national polls and international rankings of the quality of business environment.

Banking sector reform is proceeding slowly. The banking sector continues to be characterised by a large state presence, but there are plans to privatise two of the largest banks, Zalkar Bank and the Savings and Settlements Company (SSC). The privatisation of Zalkar Bank is expected to be concluded by the end of 2012, while plans for the privatisation of SSC remain uncertain. At present, the authorities use SSC to implement the lending support programme to farmers. The legal framework for the resolution of banking sector problems is weak and impedes restructuring of the four banks currently under conservatorship. The authorities have also progressed in establishing a State Development Bank (SDB) to support economic activity, mainly in agriculture. However, there is no agreement so far on the source of funds for the SDB.

There has been good progress in the area of public finance management (PFM) and the achievements in this area remain on track. Establishment of a high level PFM committee, which became operational in 2012, was a major step forward in this area. The authorities also adopted a decree to extend treasury coverage to the remaining extra-budgetary funds, including the Social Fund. A medium-term debt management strategy was developed and adopted. Further steps are however necessary to strengthen the fiscal framework through better organisation of the Ministry of Finance, and upgrading standards of public procurement.

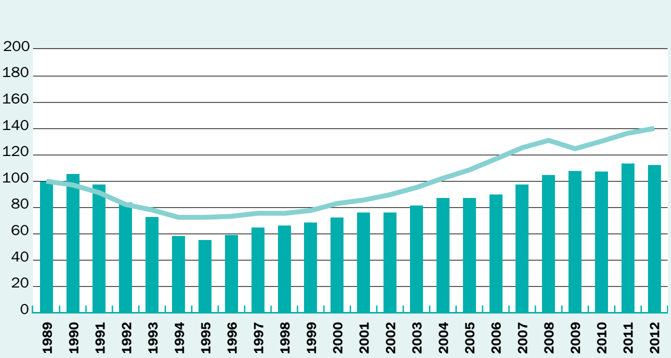
The authorities have drafted a new law on natural resources and new regulations on licensing in the natural resources sector. These plans were included in the "100 days" reform programme. In April 2012 the government adopted amendments to the regulations on mining licences that would force some holders of a mining licence to establish a business entity and transfer a 20 per cent share of this entity to the state. This was, however, cancelled in June after consultation with investors and representatives of the mining sector. Recently, the parliament has ordered a review of the agreements between Kumtor and the country with a possible increase in the participating rights of the Kyrgyz Republic state. These developments could have a negative impact on the investment climate as they may increase state influence in the sector and create uncertainty among foreign investors regarding the protection of private property rights.

The energy sector remains largely unreformed but the authorities have adopted a medium-term energy sector strategy for 2012-17. The strategy, adopted in July 2012, was prepared in cooperation with the World Bank, the Asian Development Bank and USAID. The priorities identified in the medium-term are improvement of the public administration over the sector, a better management of the energy companies, including improved corporate governance and transparency, and increasing energy efficiency and output.

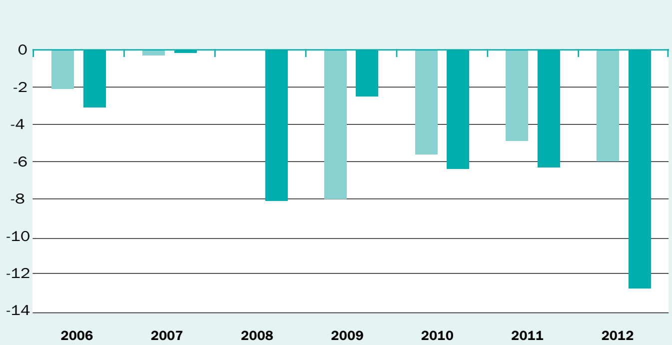
A new law on public-private partnerships (PPPs) was enacted in February 2012. The law defines a concept of PPPs and provides for private sector participation in the design, financing, construction, restoration and reconstruction of infrastructure facilities under concessions for up to 50 years.

The Kyrgyz Republic became the sixth full member of the Eurasian Development Bank. Membership occurred in September 2011, with the country joining Armenia, Belarus, Kazakhstan, Russia and Tajikistan. Potential accession of the Kyrgyz Republic to the customs union of Belarus, Kazakhstan and Russia remains under negotiation.

Real GDP (1989 = 100)



Fiscal balance and current account balance



LATVIA

HIGHLIGHTS OF THE PAST YEAR

- **The EU/IMF programme was successfully concluded at the end of 2011.** This paves the way for compliance with key Maastricht criteria for public finances, and the government remains committed to euro adoption in 2014.
- **The authorities have delivered a strong policy performance.** As a result, Latvia has regained its investment grade sovereign credit rating and managed to return to international capital markets with substantial issues at manageable yields.
- **The restructuring of the financial sector has progressed well.** This applies particularly with regard to the successor institution to Parex, formerly the second largest bank in the country. The restructuring of Mortgage and Land Bank (MLB) is also under way.

KEY PRIORITIES FOR 2013

- **The government should continue to pursue its competitiveness agenda.** Skill mismatches are an increasingly prominent constraint on growth. Poor indicators for private research and development (R&D) and vocational training in comparison with European partners underline the need for improvements in these areas.
- **The government should implement plans to improve the management and transparency of state-owned companies.** Important proposals include moving to partially centralised ownership of state-owned enterprises, and regular publication of financial accounts.
- **The gradual reinstatement of contributions to private pension funds should continue.** The substantial assets accumulated in this process could begin to feed local needs for long-term funds, with prudent portfolio diversification remaining the key priority.

MACROECONOMIC PERFORMANCE

Latvia has seen a consistent recovery since early 2010, following a dramatic 20 per cent drop in GDP in 2008-09. The year 2011 saw one of the highest growth rates in the European Union (at 5.5 per cent) despite the implementation of further fiscal austerity measures. Exports remained on a steady expansion path in spite of the slow-down in the core eurozone economies in the second half of 2011, with capital and consumption goods performing particularly strongly. Industrial production weakened from the second half of last year, though still showed growth of about 7 per cent in annual terms in the first months of 2012. Despite this weakening in the external environment the economy showed one of the strongest quarterly growth rates of all EU countries in the second quarter, with a 1 per cent expansion compared with the previous quarter. Unemployment continues on a steady downward trend to currently almost 16 per cent.

Latvia concluded its three-year financial programme with the European Union and IMF in December 2011, and the balance-of-payments position (with a very small current account deficit in 2011) had adjusted to the point where the government did not need to draw on a substantial share of the available programme funds. The government remains, in principle, committed to eurozone accession in 2014, on which a decision will be taken by mid-2013. Euro membership could further reduce the cost of major refinancing needs in the coming years.

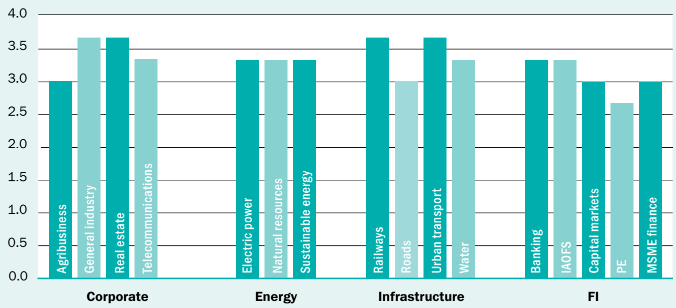
Further fiscal measures have already brought the fiscal deficit down to a much better than expected 3.5 per cent of GDP in 2011, and in the first half of 2012 the budget has similarly outperformed plans. External assessments by the European Commission (EC) and the IMF therefore expect that ambitious fiscal targets this year can be met. The target for inflation (which in July 2012 stood at only 1.7 per cent compared with a year ago) is similarly likely to be met, and reductions in indirect taxes have helped in this regard. The positive policy performance has been reflected in a number of sovereign rating upgrades, which paved the way for Latvia's return to the capital markets in summer 2011 and again in February 2012. Overall credit to the private sector contracted by 8 per cent in 2011, though in the face of emerging capacity constraints corporate lending has expanded modestly. As in the other Baltic economies, foreign-owned bank subsidiaries continue to reduce their liabilities to their parents.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-17.7	-0.9	5.5	4.2
Inflation (end-year)	-1.4	2.4	3.9	1.9
Government balance/GDP	-9.8	-8.2	-3.5	-2.0
Current account balance/GDP	8.7	3.0	-2.2	-2.0
Net FDI (in million US$)	157	359	1457	1024
External debt/GDP	164.3	165.0	137.2	na
Gross reserves/GDP	25.7	31.7	22.5	na
Credit to private sector/GDP	108.8	104.2	93.9	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

The short-term outlook is for a substantial weakening in growth as the eurozone stagnates. Continuing tight fiscal policy, wage adjustments in the face of still considerable unemployment and the contraction in credit remain key impediments to Latvia's growth in the next two years. There is also an ongoing risk to bank asset quality, with the share of non-performing loans still remaining at around 12.5 per cent.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government has focused on strengthening competitiveness and the investment regime. An action plan of 645 measures in such areas as human capital, innovation and investment promotion was adopted by parliament in February 2012. Strengthening education is a key priority; for instance, enrolment in vocational education in Latvia remains one of the lowest in the European Union. The action plan comprises measures on higher education, where infrastructure and equipment are to be modernised, and legislative changes aimed at enhancing flexibility and focusing on study fields more in line with demand expressed by industry. Private R&D spending remains the lowest in the European Union, though the government is seeking to take steps to accelerate the commercialisation of scientific research, for example, by establishing competence centres and stimulating knowledge transfer.

Latvia remains an attractive location for foreign direct investment. Inflows accounted for about 5 per cent of GDP in 2011, in line with the other Baltic economies. A recent initiative by the president is to give greater autonomy to regional governments in giving incentives for investment in production facilities. The government remains committed to strengthening attractiveness to FDI investors in priority sectors, such as export-oriented manufacturing or energy efficiency investments.

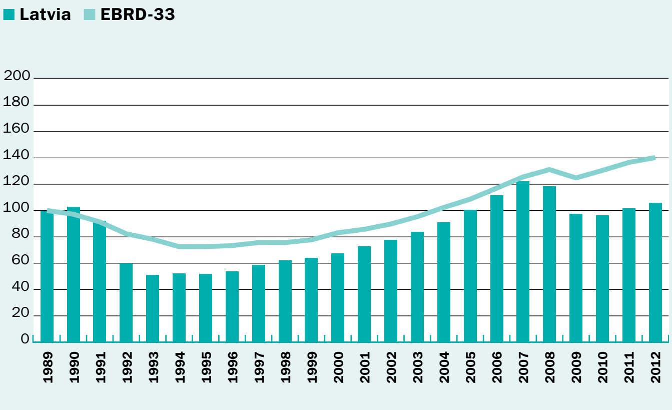
The governance and anti-competitive conduct of state-owned companies remains a concern for private investors, though the government is pursuing measures to address these issues. The government's intention is to partially centralise ownership of state-owned enterprises, and to enhance transparency through regular publication of financial accounts. The decision by Latvenergo to have its long-term bonds quoted on the local exchange and to comply with the resulting listing requirements is a step in this direction. The nationalisation of the remaining shares in the state airline, Air Baltic, became necessary following the failure of Lithuanian Bank Snoras, and of its Latvian subsidiary. However, the airline remains loss-making and required a substantial cash injection by the government in October 2011. This may give rise to a state-aid investigation by the EC.

Integration in the regional energy markets remains a priority. In August 2012 the government announced measures that mandate large enterprises to contract their electricity in the open market (as opposed to transacting at regulated prices). This is expected to enhance competition, ultimately also benefiting households. The planned nuclear power plant and LNG terminal in Lithuania could also help to reduce energy costs in Latvia.

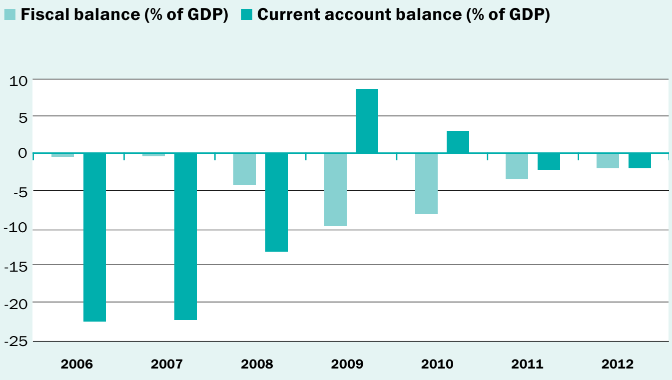
The financial sector continues to return to health. The liquidation in November 2011 of Krajbanka, the subsidiary of Lithuanian Bank Snoras, was due to an isolated case of fraud at the parent bank. The supervisor has since confirmed through more in-depth on-site inspections that no similar problems exist in other banks. This bank failure did, however, highlight some remaining inefficiencies in the coordination of supervisory intervention with other countries in the region, even though this coordination is in principle very close, given the contacts built up through the Nordic-Baltic Memorandum of Understanding (MoU). Elsewhere, Citadele Bank, the "good bank" successor to Parex Bank following its nationalisation in late 2008, is continuing its restructuring programme, including through the sale of various foreign participations in agreement with the competition directorate of the EC. This should facilitate the ultimate objective of transferring the bank back into private ownership and reviving growth in credit in the domestic credit market. The remaining institution – also named Parex Bank – that took over delinquent assets ceased commercial banking operations in March 2012. Renamed Reverta, it continues to manage delinquent assets with a view to maximising recoveries. The sale of Mortgage and Land Bank (MLB), Latvia's eighth largest bank and the remaining state participation in the sector, is progressing and, according to the government, should be concluded by the end of 2012.

The government is committed to gradually reinstating contributions to private pension funds. During the severe 2009 recession, Latvia reduced contributions to mandatory (second pillar) pension funds from 8 to 2 per cent of gross salaries, similar to measures also adopted by several other countries in central Europe and the Baltics.
In July 2012 the government approved a gradual increase of contributions from 2013 to ultimately 6 per cent in 2016, underlining a commitment to the three-pillar model. These funds, which currently hold assets of about €1.5 billion, could be an important source of local long-term capital, which is increasingly sought by large domestic enterprises. The decision to gradually increase the retirement age to 65 years, from the current 62 years, along with several other changes in entitlements, should also help to put the finances of the state system on a more sustainable footing.

Real GDP (1989 = 100)



Fiscal balance and current account balance



LITHUANIA

HIGHLIGHTS OF THE PAST YEAR

- **Lithuania recorded the EU's second highest growth in 2011.** The country benefited from good diversification in exports across markets and products. Relatively low household debt and a reviving labour market have supported private consumption, underpinning a balanced recovery.

- **A mid-sized, locally owned bank was closed in late-2011.** This was due to an isolated case of fraud and the bank's closure and safeguarding of deposits was handled well by the authorities. This incident has nevertheless prompted greater attention to bank governance.

- **The government has adopted an ambitious programme on raising skills and competitiveness.** Among other measures, the programme aims to make improvements in the governance and transparency of state-owned enterprises.

KEY PRIORITIES FOR 2013

- **More technology-intensive sectors that are oriented towards export markets should be developed.** Knowledge absorption could be raised not just through policies aimed at domestic innovation but also through facilitating Lithuanian firms to establish a foothold in foreign markets.

- **There is a need to further develop sources of equity capital outside the banking sector, such as private equity and venture capital.** Risk-oriented and long term capital are sparse within a banking sector that continues to adopt tight credit standards and reduce foreign liabilities.

- **Energy intensity of the Lithuanian economy remains one of the highest in the European Union and diversifying sources of energy supplies remains a key objective of the government.** Energy efficiency investments will need to be stepped up, in particular in public buildings, and a wider set of regional electricity connections should be established.

MACROECONOMIC PERFORMANCE

In 2011 Lithuania experienced the second fastest expansion in the EU, as gross domestic product (GDP) grew by 5.9 per cent. This recovery from the deep recession of 2008-09 has been balanced between external demand and domestic private consumption and now enters its third year. Along with other countries in the region Lithuania showed a clear weakening in growth towards the end of 2011 following the renewed instability in the euro area. Growth figures for the first half of 2012 showed a reduced pace of about 3.5 per cent growth compared with a year earlier. Robust export growth is underpinned by much-improved competitiveness indicators. In early 2012 exports stood at 24 per cent above the level of 2008. With nominal wage reductions in the face of the financial crisis, real unit labour costs have fallen by about 7 per cent since early 2008, in contrast to several other central European countries. On the back of recovering corporate profits and regaining flows in credit to the corporate sector fixed capital investment has also recovered, showing a growth of 18.5 per cent in 2011. Unemployment, which peaked at over 18 per cent in mid-2010, has since dropped markedly (though it was still at 13.2 per cent in mid-2012). The labour market nevertheless remains a concern as youth unemployment stands at 24.8 per cent and the employment rate at only 60.7 per cent is significantly below the EU-wide target of 75 per cent.

Lithuania's general government deficit remained precariously high in both 2010 and 2011. The country hence witnessed a rapid deterioration in its public debt indicators, with public debt now projected to continue climbing to a peak next year at just over 40 per cent of GDP. The authorities seek to comply with Maastricht deficit criteria already in 2012, notwithstanding the government's somewhat lower growth expectations. These plans were backed up in 2011 through a four per cent across-the-board spending cut. Given excessive pre-crisis foreign funding, banks in Lithuania continue to reduce external liabilities, last year at a rate of about 3 per cent of GDP.

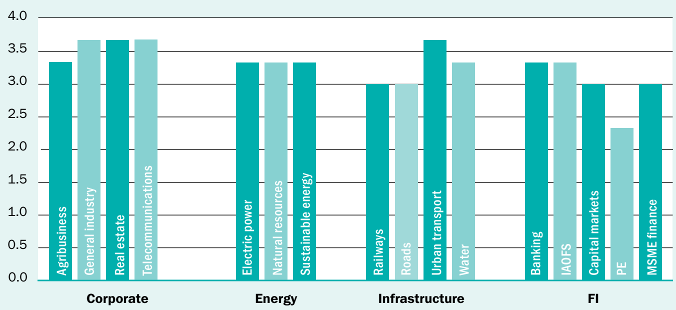
Short-term growth prospects are constrained by internal and external factors. As in the other Baltic economies the constraints in credit availability coupled with weakness in export markets will likely keep growth below 3 per cent this year and next. While the government is committed to a timeline for accession to the European Monetary Union (EMU) in 2014, it remains opposed to using indirect taxes and administered prices towards that end.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.8	1.4	5.9	2.7
Inflation (end-year)	1.2	3.6	3.5	3.5
Government balance/GDP	-9.4	-7.2	-5.5	-3.0
Current account balance/GDP	3.7	0.1	-3.7	-2.5
Net FDI (in million US$)	-184	666	1081	1005
External debt/GDP	91.5	85.8	76.1	na
Gross reserves/GDP	17.4	19.6	19.1	na
Credit to private sector/GDP	66.7	59.4	50.1	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Lithuania has revived its efforts in structural reforms. Most of its policy ambitions have been articulated under the National Reform Programme which was updated in April 2012, and assessed by the EU Council, based on a proposal by the European Commission. The updated programme identifies some well-known obstacles to growth – principally, imbalances in the public finances, still insufficient competitiveness and productivity, problems in the business environment, underdeveloped infrastructure and high unemployment.

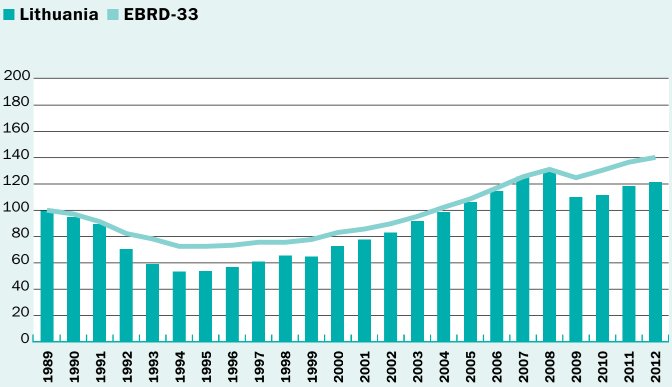
The government is taking steps to level the playing field for investors. These measures are taken in light of the ongoing concerns of private investors over governance issues and competition from the informal sector. The government continues to hold numerous stakes in state-owned companies, importantly in the energy, transportation and postal services sectors. For these companies there has been some progress in improving transparency and strategic planning. The Reform Programme underlines the fact that this sector has shown good revenue growth and has returned to profit in 2011. A full separation of regulatory functions from the ministries which also manage the ownership stakes in these enterprises remains the government's ambition.

The national reform programme emphasises the need to raise competitiveness. The programme targets technology-intensive production through stimulating research and development. Private equity, which could be instrumental in providing seed capital for young and innovative firms, remains underdeveloped. The government's programme recognises the long-term nature of many of these plans, for instance in raising participation in the labour market, improving standards in education and training or in the development of clusters of innovative technologies. Education expenditure in Lithuania is already among the highest in the CEB region. However, the European Commission's 2012 Ageing Report suggests that over the next 50 years Lithuania's total population will decrease by 19.6 per cent with a parallel drop in the total workforce of almost 36 per cent. As a result, the dependency ratio (population aged 0-14 plus 65 and over relative to the workforce aged 15-64) is expected to increase from 45 to 82 per cent over that period.

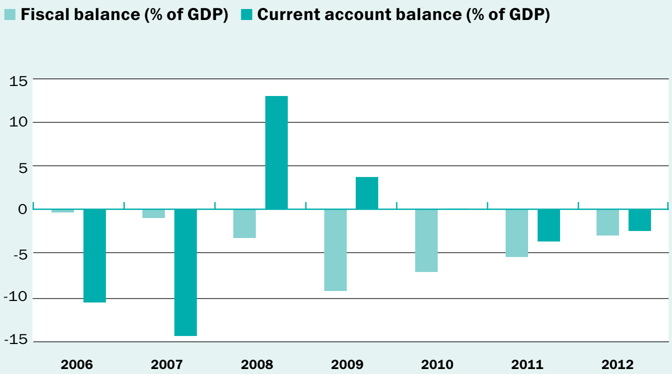
The energy sector remains a focus of the government's work. In 2010 the government adopted the Energy Independence Strategy, which is aimed at expanding generation capacity, raising energy efficiency and securing supplies through the connection to markets in continental Europe. In line with these plans some consolidation in the domestic electricity operators was implemented in 2011. The need to diversify sources of energy supply and enhance energy security has emerged as a major challenge following the closure of the Ignalina nuclear power plant and the uncertainty over the reliability of gas supplies from Russia, from where all gas is imported. In May 2012 the government gained full control over the gas distribution network within the country and in July an agreement on the construction of a floating LNG terminal in the port of Klaipeda was reached, which bodes well for the government's energy independence strategy. Plans for a new nuclear power plant have progressed but were subject to a referendum in October 2012.

In the financial sector, the authorities are keen to put in place a regulatory framework that will prevent the excesses of the previous lending boom. The personal bankruptcy law was streamlined, and in September 2011 a regulation for responsible lending was adopted that aims to prevent the re-emergence of unsustainable credit and house price developments. The failure of a mid-sized local bank (Bank Snoras) in November 2011 motivated greater government attention to the governance and business models of locally owned banks. The bank's failure was due to an isolated case of fraud, but it briefly eroded depositor confidence in the viability of the few remaining locally owned banks, as was evident in deposit flight from such institutions immediately following this incident. This bank closure was handled expeditiously and all retail deposits of Snoras were honoured, though as a result of the closure of the bank the public sector has assumed a liability of at least 2.5 per cent of GDP in excess of the assets in the deposit insurance fund.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MOLDOVA

HIGHLIGHTS OF THE PAST YEAR

- **The authorities are pursuing ambitious reforms to improve the business environment and public sector governance.** The government is implementing a second round of the "Regulatory Guillotine" to further reduce the regulatory burden on the economy. A law on state inspections reduced the frequency of inspections and set limits on inspectors' discretion.

- **The rules on ownership and governance of banks have been improved.** The central bank and the government now require prior authorisation of the transfer of banks' shares, and parliament has approved legislation requiring greater transparency of banks' ownership.

- **The ban on privatisation of a number of large enterprises was lifted.** Privatisation of national railway, airline companies, Banca de Economii and the telecommunications incumbent is now permitted.

KEY PRIORITIES FOR 2013

- **New policies on governance of locally owned banks should be implemented.** Implementation of new rules on disclosure of beneficial owners and enforcement of the central bank's fit and proper policies will likely test the government's commitment to reform and the country's weak judicial system. However, there is strong potential to significantly improve the business environment and depoliticise the sector.

- **The role of the state in the economy should be further reduced.** The authorities should proceed with privatisation of the landline incumbent and the national airline and consider divesting the railways.

- **Moldova's dependence on energy imports highlights the need to focus on energy security.** Implementation of the country's commitments to the European Energy Community should help diversify energy sources over time.

MACROECONOMIC PERFORMANCE

After growing rapidly in 2011, the economy slowed down in 2012. GDP expanded by 6.4 per cent in 2011 as manufacturing, wholesale and retail trade benefited from the favourable external environment and the agricultural sector recovered from the 2010 drought. However, the pace of output growth declined to 0.8 per cent in the first half of 2012 as industrial output suffered from the contracting external demand and lower agricultural production following a harsh winter. Remittances have also fallen although remain significantly higher than during the 2008-09 crisis. Consumer price inflation peaked at 9.2 per cent in August 2011, declining to below 4 per cent in June 2012 as global food prices decelerated and base effects of last year's large increase wore off. After tightening monetary policy in 2011 to contain inflation, the central bank reduced policy interest rates significantly as inflation subsided.

The authorities' reform programme continues to benefit from significant international assistance. The fiscal adjustment programme is progressing, although corrective measures were needed in early 2012 to address revenue shortfall, unbudgeted revenue commitments and external assistance delays. The central bank continues to pursue inflation targeting. The banking sector remains generally stable, and the risk of spillover from the eurozone crisis limited. However, in February 2012 the central bank put a small bank into liquidation. This measure had only a limited impact on the stability of the overall banking system. However, the state-owned Banca de Economii has seen its financial situation deteriorate further. The current account deficit widened in 2011 to around 12 per cent of GDP.

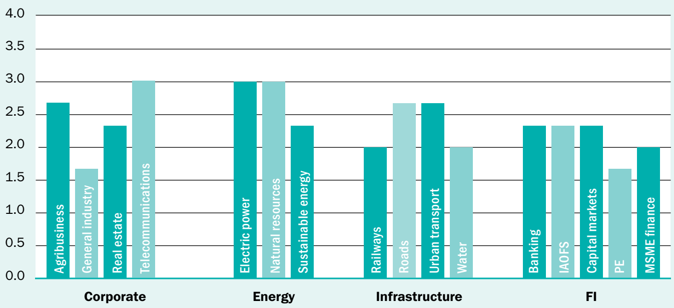
The country's longer term prospects depend on the government's ability to create a conducive environment for private sector development. In the immediate future, the economy will continue to be affected by the developments in the European Union and Russia. With output per capita very low, Moldova has strong potential to increase labour productivity and maintain a fast pace of growth over time. However, as the public sector balance sheet is relatively stretched and the country requires fiscal adjustment to be able to graduate from dependence on international financial support, growth would have to come from the private sector. Reforms to improve the functioning of the judiciary, reduce public sector corruption and strengthen tax administration and customs and gain greater access to the CIS and EU markets should help attract significant foreign and domestic investment in the export-oriented sectors.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.0	7.1	6.4	1.0
Inflation (end-year)	0.5	8.2	6.1	6.6
Government balance/GDP	-6.3	-2.5	-2.4	-1.5
Current account balance/GDP	-8.6	-7.9	-11.5	-12.0
Net FDI (in million US$)	139	194	253	260
External debt/GDP	65.5	67.3	64.4	na
Gross reserves/GDP	27.2	30.5	29.5	na
Credit to private sector/GDP	35.6	33.4	35.9	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The authorities have made strides to improve the country's business environment. Reforms to cut red tape, improve competitiveness, and stimulate trade are ongoing. In the 2012 World Bank's *Doing Business* Report, Moldova advanced by 18 positions to rank 81st (out of 183 countries) on ease of doing business and came second in the top reformers list. The report highlighted that Moldova improved conditions for starting a business and its credit information system, made enforcements of court judgments more efficient, and amended the insolvency law to grant priority to secured creditors. The authorities have been implementing a "Regulatory Guillotine 2" programme to systematically reduce unnecessary regulations and improve legislation. The government is also pursuing a strategy of justice system reform. The main objective of the medium-term reform programme is to establish an independent and accessible justice system, consistent with EU standards. If implemented, the announced reforms should help make the judicial system more effective, decrease corruption and ensure citizens' equality before the law.

A draft law on state control over business has been passed. The law, passed by the parliament at its first reading in March 2012, is aimed at improving the business climate in the country by reducing the number of state bodies controlling business from 64 to 33, as well as decreasing the number of state control measures over businesses. A single system of audit and inspection activities will be introduced, and no inspecting agency will benefit from revenues generated from penalties levied on inspected enterprises. If implemented, the law could help to significantly improve the business environment by further limiting red tape, which is an important constraint to doing business in Moldova.

Legislation was amended to strengthen governance of financial institutions and increase transparency of banks' ownership. In January 2012 the parliament approved amendments to Laws on Financial Institutions and Securities Markets, mandating that equity interest in the capital of a commercial bank may be transferred from one entity to another only with the prior written consent of the National Bank of Moldova, and requiring more transparency of shareholders. The amendments, adopted in response to several high profile illicit transfers of banks' equity in the summer of 2011, should help improve corporate governance and the stability of Moldova's financial sector. In July 2012 parliament adopted legal amendments to increase the transparency of banks' beneficiary owners.

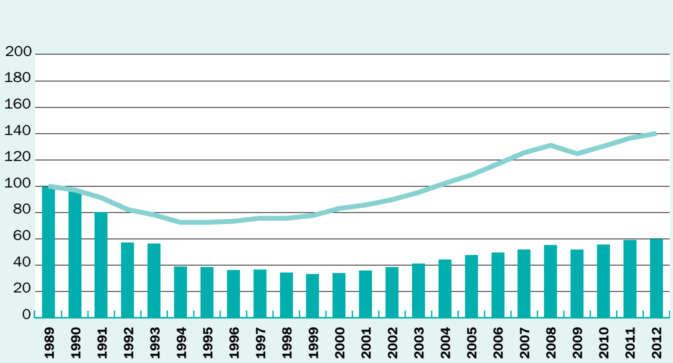
The government is pursuing privatisation of medium companies and expanding the privatisation list to include several large companies. In February 2012 the government auctioned the Chisinau jewellery factory raising US$ 5 million. In July 2012 the list of companies excluded from possible privatisation was amended to allow privatisation of Banca de Economii, the national airline and railways companies, and the landline telephone incumbent Moldtelecom. Privatisation of the majority state-owned Banca de Economii, if it goes ahead, should help modernise the banking system. However, the bank will need significant pre-privatisation restructuring and its governance problems will need to be addressed to attract a reputable international bidder at a time when bank equity is very difficult to raise. Other large-scale privatisations would also be expected to increase competition and address the fundamental conflict of interest whereby the government is both a regulator and owner of dominant enterprises in the sector.

Competition policy has been strengthened. The government has started to apply the new law on competition, approved in September 2011, which intends to emulate best EU practices and strengthen procedures for identifying, investigating and eliminating anti-competition practices. A council on competition will be established as a legal successor of the National Agency for Protection of Competition. The law was developed with assistance from the European Union, in the context of the country's ongoing negotiations on a deep and comprehensive free trade area with the European Union. The legislation on competition will be supported by a legal framework for state aid, aimed at creating a fair competitive environment in the economy.

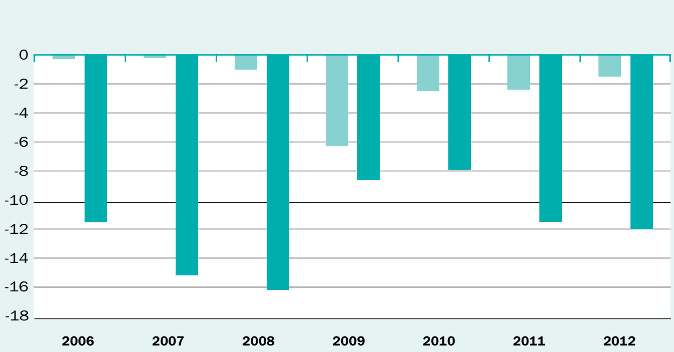
Reforms to facilitate debt resolution should increase financial intermediation over time. The financial sector in Moldova had suffered from complicated procedures for debt restructuring and execution of loan collateral. The procedures could last for years, thus making collateral effectively worthless. Amendments to the relevant laws, passed in June 2012, will simplify the procedures for debt collection and restructuring by clarifying instances when rights on collateral property can be exercised automatically and specifying the procedures for transfer of the collateral property to a claimer.

Monetary policy tools to fight inflation are being enhanced. The National Bank of Moldova switched to explicit inflation targeting in 2010, setting the medium-term target at 5 per cent, and has been following forward-looking policies, thus contributing to economic stability. An EBRD technical cooperation project is helping the central bank to make more informed policy decisions and strengthen its policy credibility by enhancing its forecasting and communication capacities.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MONGOLIA

HIGHLIGHTS OF THE PAST YEAR

- **The mining boom in Mongolia continues.** Economic growth accelerated from 6.4 per cent in 2010 to 17.5 per cent in 2011 and foreign direct investment (FDI), predominantly mining-related, reached 44 per cent of gross domestic product (GDP) in 2011, up from 26 per cent in the previous year.

- **The government has further strengthened the fiscal framework.** The Integrated Budget Law (IBL) will improve the reporting of government contingent liabilities and strengthen public investment planning.

- **A new foreign investment law imposes new restrictions on foreign investment in mining, banking and other strategic industries**. Significant foreign investments in these industries will now be subject to government or parliamentary approval.

KEY PRIORITIES FOR 2013

- **The fiscal stability law (FSL) needs to be adhered to.** The FSL passed in 2010 is the cornerstone of Mongolia's fiscal framework for managing commodity revenues. It comes into force in 2013 and needs to be adhered to fully to ensure credibility of the overall framework.

- **The system of cash transfers to the population needs to become fiscally sustainable.** The unconditional monthly cash payment to each individual out of the Human Development Fund (HDF) imposes a high fiscal burden and is difficult to accommodate within the existing macroeconomic framework.

- **Sustained financial development calls for further strengthening of the legal framework for financial markets.** Improvements are needed, in particular, in the areas of deposit insurance, collateralised lending and securities trading.

MACROECONOMIC PERFORMANCE

The mining boom in Mongolia continues. Real GDP growth accelerated from 6.4 per cent in 2010 to 17.5 per cent in 2011 and remained strong in the first half of 2012 (13.2 per cent year-on-year). Growth has been supported by sustained high prices of copper and other commodities and record levels of FDI, which reached over 50 per cent of GDP in 2011. Expansionary fiscal policy also played a role: despite high growth, the general government recorded a deficit in excess of 3 per cent of GDP, largely due to increases in social transfers and public sector wages. This trend continued in the first half of 2012 in the run-up to the parliamentary elections held in June 2012. As a result, a larger fiscal deficit may be recorded in 2012 even as high commodity prices continue to boost government revenues.

In this context, stricter fiscal discipline would help Mongolia to better manage risks and avoid overheating. Against the backdrop of procyclical fiscal policy, inflation accelerated sharply, from 4 per cent year-on-year at end-May 2011 to 16 per cent at end-April 2012. The 2010 FSL, which introduces various measures aimed at improving fiscal discipline, will come into full force in 2013-14. Full adherence to the conditions of the FSL would require fiscal consolidation efforts as the law caps the structural fiscal deficit at 2 per cent of GDP (the structural fiscal deficit is calculated based on revenues estimated using historical average commodity prices).

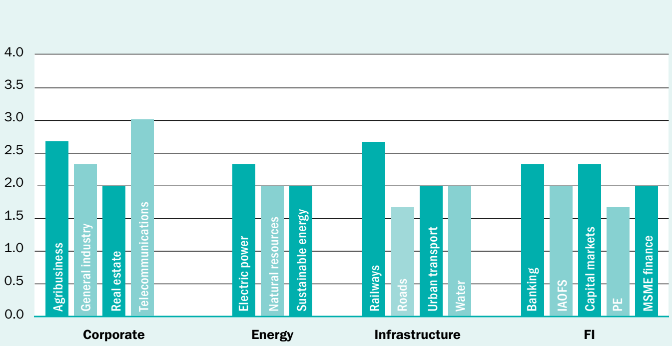
The banking sector also experienced a boom. The mining boom led to a rapid credit growth (at the rates of 50 to 75 per cent year-on-year and even faster in the consumer segment). Consequently the non-performing loans ratio declined rapidly, to below 5 per cent, excluding the two banks in receivership, although the true quality of new assets is yet to be tested. Higher commodity revenues enabled the central bank to build up reserves of around US$ 2.5 billion (around four months of imports). The Bank of Mongolia also extended its swap line with China to US$ 1.6 billion equivalent. The economic boom also led to a sharp drop in the headline poverty rate, from 39 per cent in 2010 to 30 per cent in 2011, according to official estimates.

The economic outlook remains strong. Output growth is expected to reach 11.5 per cent in 2012, and perhaps accelerate further as new mining developments come on stream. The Oyu Tolgoi mine, one of the largest copper and gold deposits in the world, is on track to start operations in 2013 under the management of Ivanhoe Mines and Rio Tinto. Various options for development of Tavan Tolgoi, a multi-billion coal mining project, are currently being considered. At the same time, a downturn in global commodity prices may substantially weaken investment and economic activity given Mongolia's high, and growing, dependence on mining.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-1.3	6.4	17.5	11.5
Inflation (end-year)	4.1	13.0	10.3	15.0
Government balance/GDP	-5.0	1.2	-3.5	-9.5
Current account balance/GDP	-9.0	-14.9	-31.8	-31.4
Net FDI (in million US$)	496	1574	4620	2003
External debt/GDP	46.0	49.2	45.0	na
Gross reserves/GDP	28.2	36.6	28.1	na
Credit to private sector/GDP	43.9	44.0	47.0	na

2012 sector transition indicators



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The fiscal framework has been further strengthened with an Integrated Budget Law (IBL) and a revised Procurement Law. The IBL was passed in December 2011 to complement the existing FSL. The law further improves reporting of government contingent liabilities, strengthens public investment planning, and lays the foundation for fiscal decentralisation whereby more responsibilities may over time be devolved to the local governments. A move towards an inflation targeting framework by the central bank is currently being considered.

In January 2012 the parliament also passed a Social Welfare Law, which provides for a means-tested poverty benefit. The benefit is expected to reach around one-fifth of households and include an additional child allowance. Over time, it may partially or fully replace unconditional cash transfers disbursed out of the Human Development Fund (HDF). At the same time, in the first half of 2012 the monthly payments out of HDF (MNT 21,000 per citizen, or US$ 17) continued and were complemented with larger disbursements to the elderly and the disabled (with the first tranche of MNT 330,000, [US$ 250]).

The government further announced distribution of a portion of shares of the state-owned coal company, Erdenes Tavan Tolgoi (ETT), to the population. Under the scheme, each member of public is entitled to a certain number of shares of ETT. Overall, up to 20 per cent of ETT shares have been earmarked for this scheme, while additional minority stakes may be sold later via an initial public offering (IPO) in the local and international markets. Prior to the June 2012 elections the government made an offer to members of the public to exchange their ETT ownership entitlement for a single cash payment in 2013 set at MNT 1 million (approximately US$ 775). The majority of the population opted for a cash payment and the authorities are expected to clarify further modalities of this scheme. In particular, some shares in ETT may be sold to local companies prior to the IPO in order to raise financing for cash transfers.

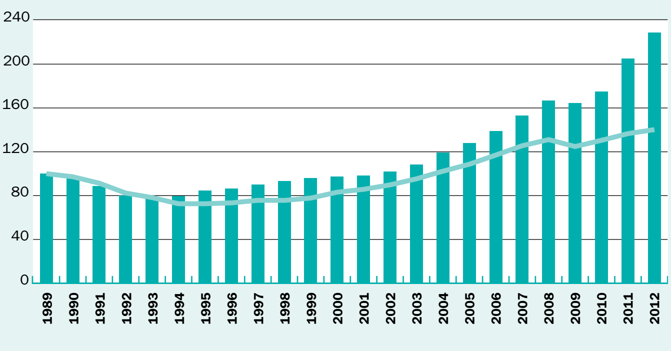
The recently established Development Bank of Mongolia (DBM) broadened its funding base. DBM, a state-owned development agency inaugurated in the middle of last year, managed to place US$ 600 million (around 8 per cent of GDP) in government-guaranteed five-year bonds at a 5.75 per cent yield. This yield is relatively favourable and suggests there is sustained investor interest in Mongolia. The use of proceeds is likely to include a combination of infrastructure and social housing projects, in line with the mandate of DBM.

In May 2012 Mongolia passed a law on foreign investment. The new law requires government approval for all investments by state-owned foreign entities. It also requires parliamentary approval of foreign ownership in excess of 49 per cent in companies operating in industries designated as "strategic", namely, mining, finance, media and telecommunications. Large transactions involving minority foreign stakes in these sectors will be subject to government approval (within a 45-day period). The law aims to strike a delicate balance between the interests of the Mongolian people and the need to attract foreign expertise in key sectors, including mining. The parliamentary discussions of the law could have been in part influenced by the change of ownership of a major coal mining license in April 2012 when Ivanhoe Mines sold its majority stake in South Gobi Resources to China Aluminium Corporation (Chalco), majority owned by the Chinese state. The deal aimed to raise additional funds for development of Oyu Tolgoi, the core asset of Ivanhoe Mines and Mongolia's largest mining development to date.

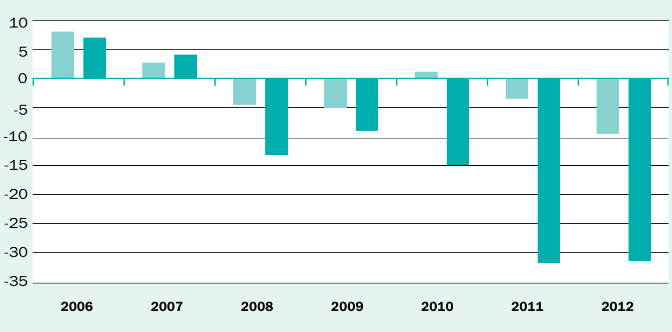
A number of legislative act governing the financial sector are being considered. The blanket deposit guarantee is set to expire in November 2012 and is expected to be extended and gradually replaced with a comprehensive deposit insurance scheme. A new securities law is a precondition for the planned dual listing of ETT shares.

Mongolia has adopted a law on gender equality. The law, adopted in February 2011, explicitly prohibits gender discrimination and introduces a 20 per cent quota for female candidates nominated by parties to stand in parliamentary elections. This provision was applied for the first time in the context of the June 2012 general elections.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MONTENEGRO

HIGHLIGHTS OF THE PAST YEAR

- **Montenegro has begun EU accession negotiations.** The decision of the European Council in June 2012 to endorse the European Commission's recommendation reflects substantial and sustained progress in reforms in both the political and the economic spheres.
- **Montenegro became a member of the World Trade Organization.** This marks n important milestone in the country's trade integration agenda, and is likely to boost the country's growth potential in the medium to long run.
- **Important steps have been taken to develop Montenegro's energy potential.** Tariff reforms have progressed in the power sector, and plans are advancing in the development of an underwater interconnection cable between Montenegro and Italy.

KEY PRIORITIES FOR 2013

- **The fate of the main industrial enterprise needs to be resolved.** The future viability of the aluminium company KAP is highly uncertain. The government needs to come up with a clear action plan for either major restructuring or closure of this company, which still employs a significant portion of the labour force and accounts for a large share of exports.
- **Further strengthening of the financial system and maintaining adequate access to financing for the private sector, especially small and medium-sized enterprises (SMEs), is vital for economic recovery.** The state's involvement in this sector should be designed to ensure a level playing field and transparent regulation, rather than focused on support for selected troubled banks.
- **Moving ahead with the restructuring of the power sector is a priority to improving electricity supply and efficiency.** The government has adopted an ambitious Energy Development Strategy, but concrete programmes and implementation instruments to promote renewable energy and energy efficiency have yet to be established.

MACROECONOMIC DEVELOPMENTS

Economic performance has weakened substantially. After the severe economic contraction in 2009, Montenegro was on its way to a modest but steady recovery, growing at 2.5 per cent in 2010 and 3.2 per cent in 2011. Exports and tourism were the main drivers of growth in 2011, countering the drop in FDI inflows and an ongoing credit crunch. However, external demand has weakened substantially this year as a result of the impact of the eurozone crisis and, combined with weak domestic demand, this has resulted in a slight fall in GDP in the first half of the year. The weak external environment affected the aluminium producer KAP, Montenegro's largest enterprise and exporter, which was reflected in very volatile industrial production figures. In December 2011 industrial production marked the largest fall in two years, plunging 37.5 per cent year-on-year. In January 2012 it was down 24.5 per cent year-on-year. The current account deficit, which narrowed to 19.4 per cent of GDP in 2011, remains the highest in the region. Inflation has been on a generally upward trend this year. It stood at 4.4 per cent year-on-year in July 2012.

The fiscal position has been weakened by KAP nationalisation and weaker than expected growth. On the fiscal side, policies have become more prudent in the past couple of years, but the deteriorating economic situation and the activation of state loan guarantees related to KAP have prompted revisions of the 2012 budget. Public debt was close to 50 per cent of GDP as of August 2012. Following its country mission in February 2012, the IMF has expressed readiness to start negotiations for a credit arrangement with Montenegro.

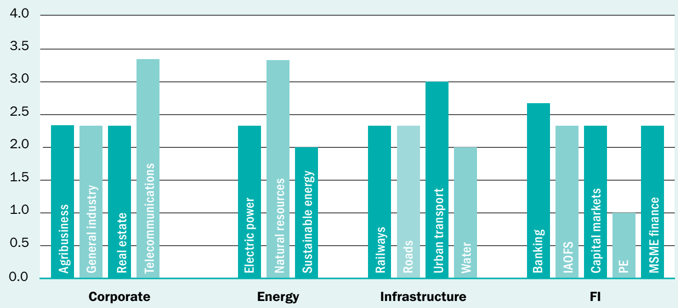
Negligible growth is expected in the short term. The eurozone crisis will continue to negatively impact Montenegro's economy and growth is forecast at negligible levels in 2012, with only a small rise in this figure expected in 2013. Diversification of the economy remains a challenge for building sustainable growth in the medium term, but the visible progress in the EU approximation process should help to attract further FDI and ultimately boost the country's growth prospects.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-5.7	2.5	3.2	0.3
Inflation (end-year)	1.7	0.7	2.8	3.5
Government balance/GDP	-5.7	-4.9	-6.5	-5.1
Current account balance/GDP	-29.6	-24.6	-19.5	-20.0
Net FDI (in million US$)	1485	733	541	474
External debt/GDP	98.0	96.0	94.6	na
Gross reserves/GDP	13.8	14.4	11.0	na
Credit to private sector/GDP	76.5	66.9	55.2	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Montengero's EU membership aspirations have received a significant boost. In June 2012 Montenegro received official approval from the European Council to proceed to the next stage of the EU accession process. The Council endorsed the European Commission's assessment that Montenegro was sufficiently compliant with the membership criteria to be able to start accession negotiations. The Council also highlighted that the government needs to make further efforts in addressing important remaining challenges, particularly the strengthening of judicial independence, tackling corruption and fighting against organised crime.

Montenegro has become a member of the World Trade Organization. Accession to the WTO finally took place in December 2011. Montenegro had started WTO membership negotiations in December 2004, but its accession was delayed due to disagreements on the bilateral treaty with a member of the WTO. When an agreement was finally reached and the bilateral treaty was signed in November 2011, the path was clear for Montenegro's accession in December. WTO accession may help boost trade and economic growth in the medium to long term.

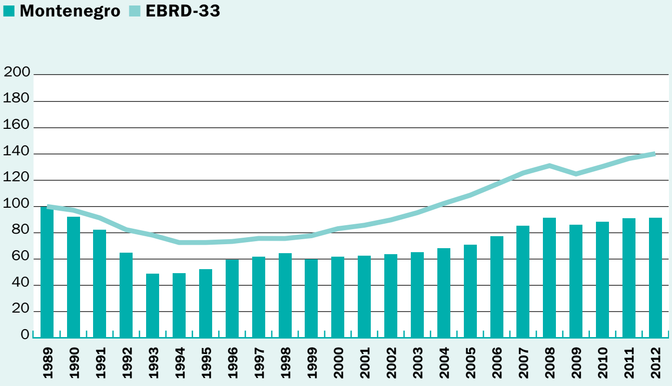
The state has repaid a major loan of KAP, for which it had provided a sovereign guarantee. In April 2012 the government paid from the budget €23.4 million (€22 million principal and €1.4 million interest and other expenses) to Deutsche Bank. Substantial payments to the Hungarian bank, OTP, are also overdue and are being negotiated. Although there have been some disagreements with the other major shareholder of KAP, that is, Russian EN+ Group, over how to manage the company's debt, the government has decided not to cancel the privatisation contract with EN+. KAP's financial situation is difficult and the company made a net loss of €21 million in the first half of 2012. Meanwhile, the government had a success in April 2012 when it managed to sell the steel company, Zeljezara Niksic, to a Turkish investor for €15 million. Two previous tenders for the sale of the company had failed to attract any bids.

Electricity tariffs are rising towards more cost-reflective levels. In December 2011 the energy regulatory agency of Montenegro approved an increase in electricity prices to compensate the electricity generation company, EPCG, for its rising production and import costs. The regulator approved an average increase in tariffs of 6.13 per cent. The highest increases of on average 6.7 per cent were applied to households. This represents a partial reversal of moves by the energy regulator last year to lower consumer tariffs.

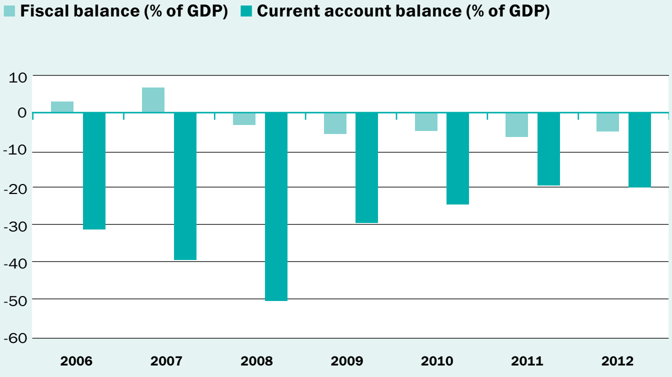
Plans are advancing for a major underwater cable with Italy. The construction of the Italy-Montenegro interconnection cable is expected to start by the end of 2015. The agreement on the establishment of a submarine interconnection between Montenegro and Italy was signed in November 2010. The interconnection cable will be 415 km long (of which 390 km will be under the sea). The Italian company, Terna, will begin the construction of the electricity transmission infrastructure. The company announced completion of the authorisation process on its side but this process is still ongoing on the Montenegrin side as the expropriation and public land (including maritime property) rights acquisition processes have not yet been completed. The detailed spatial plan has been approved by the Montenegrin government.

Deleveraging continued in the financial sector in the past year. Prior to the crisis between 2006 and early 2008, Montenegro reported annual credit growth rates of over 100 per cent. Since the crisis, however, significant deleveraging has taken place and this trend has continued at a vigorous pace over the past year. Private sector credit as a percentage of GDP fell from 69 per cent at the end of 2010 to 55 per cent of GDP at the end of 2011. The banking sector is also characterised by a high level of non-performing loans (NPLs). NPLs declined from about 21 per cent of total loans in 2010 to 15.5 per cent in mid-2012, but this figure is still at the higher end of the spectrum in the SEE region as well as the transition region more broadly.

Real GDP (1989 = 100)



Fiscal balance and current account balance



MOROCCO

HIGHLIGHTS OF THE PAST YEAR

- **Following robust economic growth in 2011, economic activities slowed down in 2012.** A weak agricultural harvest due to drought along with persistant weaknesses in the eurozone, the major source of external demand for Morocco, continue to dampen growth prospects.
- **The widening of both the current account and fiscal deficits pose significant risks to the outlook.** In response to the crisis last year, the government raised wages and increased subsidies and spending. The IMF programme agreed in August provides both confidence and a buffer against future shocks.
- **Notwithstanding major progress, some crucial reforms are still incomplete.** These are needed to enhance competitiveness in major sectors in the economy, as well as to improve the general business environment.

KEY PRIORITIES FOR 2013

- **Significant reforms are required in the energy, power, and natural resource sectors.** A combination of state-owned monopolies within a single-buyer market and considerable energy subsidies has created substantial market distortions. Subsidy expenditures can be reduced in conjunction with policies to replace open-ended commitments with targeted support for the poor.
- **There are urgent reform needs in the infrastructure sector, especially at the municipal level.** The challenge is to build municipal capacity to manage, run and efficiently operate large infrastructure projects including transparent participation of the private sector through PPPs.
- **The renewable energy sector is growing, and the ambitious green energy plan requires resources and investment.** To make use of wind and solar energy to generate power in Morocco, it is necessary to overhaul the transmission systems and introduce a competitive market for electricity.

MACROECONOMIC PERFORMANCE

Although the overall macroeconomic position held up well in 2011, the resilience of the Moroccan economy has weakened in 2012. While real GDP growth reached 5.0 per cent in 2011, the economy slowed considerably to 2.8 per cent year-on-year in the first quarter of 2012, and to 2.3 per cent in the second quarter, on the back of a sharp decline in agricultural production (around 15 per cent of GDP) due to droughts, and moderating domestic demand. Manufacturing and mining activity declined throughout the first six months of the year, and capacity utilisation rates in the third quarter point to continued weakness. In addition, construction (which was a driver of growth in the first quarter) slowed down, dragged down by diminished business confidence and a slow-down in the real estate sector. FDI, however, increased by 6 per cent year-on-year in H1 2012, reflecting improved prospects of large-scale projects materialising in the short to medium term.

The fiscal and current account deficits have widened over the year, and pressures have persisted in the first half of 2012. This has prompted the Moroccan authorities to seek and receive a US$ 6.2 billion Precautionary and Liquidity Line from the IMF to help cushion the economy against any further external shocks. Morocco's trade deficit rose in the first quarter of 2012, after reaching 20 per cent of GDP in 2011, but improved slightly in the second quarter, on the back of reduced energy prices per volume. The external current account deficit reached 8 per cent of GDP in 2011, and widened further in H1 2012, on the back of faltering exports and a pickup in imports associated with higher energy prices, but is expected to narrow throughout the year as oil prices moderate. However, continued weakness in the eurozone (Morocco's main trading partner) contributed to lower tourist receipts, exports and remittances. On the other hand, the general government deficit in 2011 rose to 7 per cent of GDP (excluding privatisation receipts), its highest level in 20 years. Much of it reflects subsidies for basic food staples and energy products, which amounted to six per cent of GDP (with fuel subsidies alone amounting to 17 per cent of spending), and wage increases to alleviate political and social unrest.

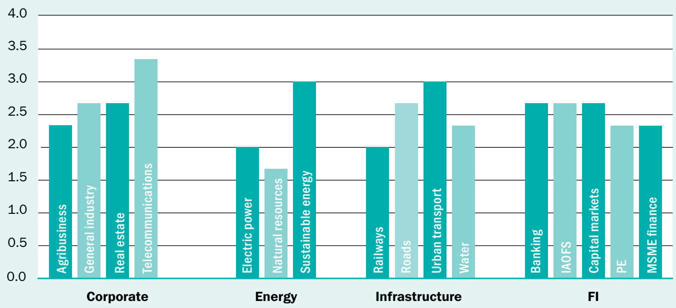
Several factors pose a risk to a strong economic recovery in Morocco. First, a further deterioration in the eurozone would negatively impact Morocco's growth prospects substantially, given the close external trade and financial links. External shocks could further widen the current account deficit, while a growing budget balance could reduce the government's fiscal space. Lastly, the failure so far by the authorities to enhance Morocco's competitiveness through improvements in human capital and in the business environment poses further downside risks to the medium-term outlook of the country.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	4.8	3.6	5.0	2.3
Inflation (end-year)	-1.6	2.2	0.9	1.9
Government balance/GDP	-2.2	-4.4	-6.9	-6.1
Current account balance/GDP	-5.4	-4.3	-8.0	-7.4
Net FDI (in million US$)	3212	3868	2988	1800
External debt/GDP	27.1	29.6	31.5	na
Gross reserves/GDP	23.5	23.8	20.1	na
Credit to private sector/GDP	8.8	10.7	10.0	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Reforms that have been enacted in Morocco have been largely successful. Substantial progress has been made in the privatisation agenda since the beginning of the last decade, resulting in a boost to competitiveness in a number of sectors, including telecommunications and other service sectors. As a result the privatisation agenda, with the exception of utilities and natural resources, is by now almost complete. These efforts were coupled with structural reforms in the transport, energy and telecommunications sectors. Average import tariffs were substantially reduced even though non-tariff barriers, in particular in the agricultural sector, still remain substantial. However some capital account restrictions on residents remain, including surrender requirements for export proceeds and limits on foreign investments by local institutional investors such as pension funds.

There remains a significant unfinished reform agenda. Reforms are needed to improve the business environment in general, as regulatory capture has had an adverse impact on entry and competition across a number of industrial sectors. Barriers to entry, cross-ownership in some sectors and low levels of corporate governance have contributed to lower levels of competitiveness. In addition, labour market rigidities have contributed to the high unemployment rates in the country.

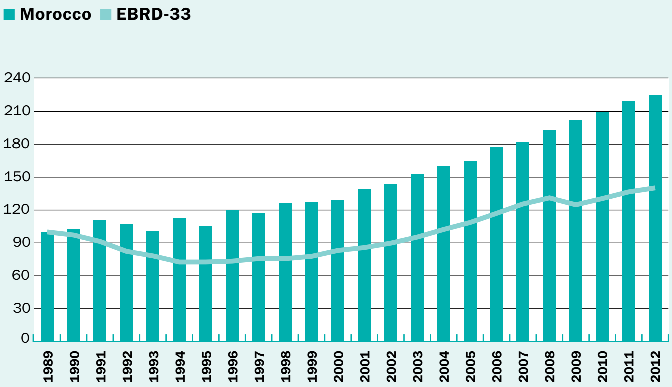
In response to its deteriorating fiscal position, the government raised the prices of key subsidised items in 2012. In June energy prices were hiked by 16 per cent, while subsidies on soft wheat imports were reduced by 15 per cent in September. The government is considering plans to further reform the subsidy system, including measures such as adjustments of administered prices, conditional cash transfers and targeted programmes.

Reforms are crucially lacking in the energy and infrastructure sectors, and tariff reform is needed across the board to improve cost recovery. Delivery of municipal services faces large reform challenges and is constrained by poor local capacity. After many years of delay, regulatory agencies in some sectors, including energy, insurance and securities, have recently moved to become more independent. Reforms are needed in the energy sector to ensure unbundling of the sector, gradual liberalisation of prices, creation of a competitive wholesale market, independence of regulatory agencies, and improvement in energy efficiency. In this regard, the Ministry of Energy has recently decided to move ahead with the unbundling of the vertically integrated energy utility ONE and corporatising its units, with EU assistance.

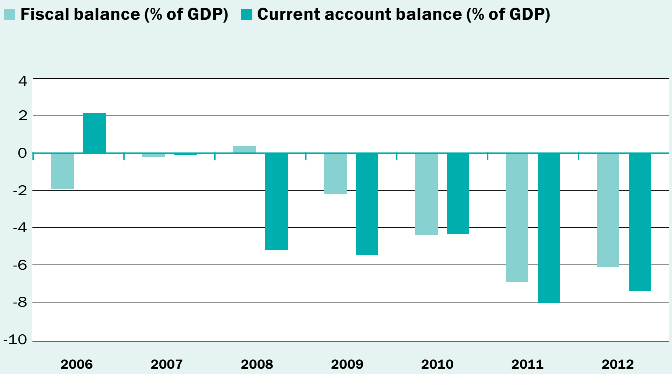
Measures have been put in place to exploit Morocco's potential in the sustainable energy sector. The use and development of renewable energy technologies has been a priority for the government, but has only recently become a major policy objective. Ambitious programmes exist, such as the Green Energy plan, to increase the share of renewables in the country's total energy demand. Morocco has started to develop the legal and regulatory framework in order to achieve these targets. The government passed four laws dealing with renewables and energy efficiency in early 2010. Under these laws, a renewable energy agency as well as an agency (ANDEREE) to promote solar technology, were established. The laws provide financial incentives and government guarantees for renewable energy producers, including long-term off-take agreements with ONE at pre-determined prices.

Reforms in the financial sector have been successful, but some additional measures are needed to increase the sector's robustness. Regulatory frameworks are reasonably advanced in both the banking and non-banking sectors, with further improvements in the pipeline, including independence of regulatory agencies for the insurance and securities markets. While the money and government bond markets are well developed, securities markets are small and lack liquidity and the regulatory and tax frameworks for more advanced products (such as securitisations and derivatives) are yet to be developed.

Real GDP (1989 = 100)



Fiscal balance and current account balance



POLAND

HIGHLIGHTS OF THE PAST YEAR

- **Poland has continued to record strong growth.** A soundly supervised banking system and fiscal consolidation have further improved investor risk perceptions and attracted capital inflows into local equity and government bond markets. Weaker indicators in early 2012 have nevertheless led to a significant downward revision in growth expectations.

- **The government has initiated important fiscal reforms.** These include measures to improve the state pensions system and prevent a further increase in public debt.

- **Privatisation volumes have been substantial.** The four-year programme to 2011 was met in terms of revenue targets, and a new programme for another 300 companies has been announced. The state's stake in the country's largest bank, PKO, has been reduced to a minority one, though the state continues to exercise management control.

KEY PRIORITIES FOR 2013

- **A long-standing challenge is to develop more sustainable private financing mechanisms in infrastructure, adopting best practice on public-private partnerships (PPPs).** EU structural funds will be more focused and more constrained in future years, in particular given the budget constraints of local governments.

- **Links with European parent banks – and close coordination with their supervisors – should be preserved.** These links will be increasingly important in light of the current risks to European financial integration, and new institutional mechanisms on bank supervision within the eurozone.

- **Local long-term debt funding should be developed further, in particular for banks.** Bond market development will require a number of changes in legislation and prudential supervision, for example, in transferring titles for covered bond issuance, and should be supported through the emergence of well-diversified local institutional investors such as pension funds.

MACROECONOMIC PERFORMANCE

Growth in Poland remained buoyant in 2011 and, although it has slowed in 2012, it remains well above the regional average. Against the headwinds of fiscal consolidation and a slowing EU economy, the Polish economy registered 4.3 per cent growth in 2011. Over the past two years, household consumption and capital investment continued to be the main drivers of growth. The accelerated absorption of EU grant funds and increased infrastructure spending ahead of the 2012 European Championships were key factors behind this success. Since early 2012 exports and industrial production have been slowing markedly, though private consumption, accounting for 61 per cent of GDP, continued to grow at 1.8 per cent in the first half of the year relative to a year earlier. Public investment is expected to fall sharply from the second half of 2012 as fiscal consolidation will significantly weigh on local governments' capital expenditure, and their capacity to co-finance EU grants, which are about to come to an end under the current budgeting period.

Poland has benefited from strong capital inflows though portfolio investment in the domestic bond markets remained volatile. In 2011 capital inflows were primarily directed into the domestic government bond market, and substantial grant inflows from EU structural funds financed a still sizeable current account deficit (4.9 per cent of GDP last year). In contrast, bank funding showed considerable outflows over the second half of last year, though direct investment within Poland has remained unaffected so far, and the gross FDI inflows of about 3.7 per cent of GDP are relatively high compared with other countries in the region.

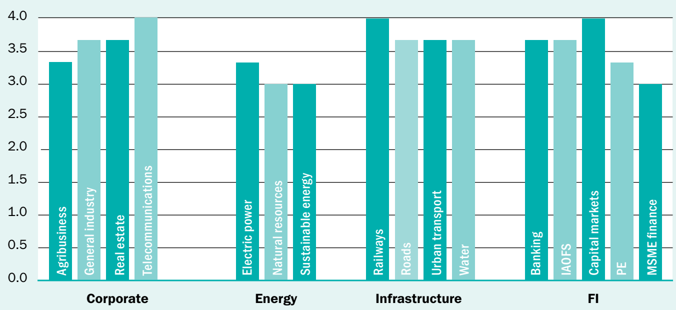
The government embarked on a long-delayed fiscal deficit and public debt reduction programme. During the financial crisis of 2009 Poland allowed its fiscal deficit to widen, which mitigated the effects of the crisis. The reduction in the deficit last year stemmed in good measure from the reduction in the contributions into mandatory pension funds, but also from a freeze in the public sector wage bill, and cuts in certain social security expenditures. Following the election in October 2011, the Prime Minister announced a plan to reduce the general government deficit to the Maastricht-compliant level of 3 per cent of GDP in 2012, and then gradually to 1 per cent in 2015, although the 2012 target will be missed given recent growth weaknesses. According to the government's strategy, public debt is set to stay well clear of the legal limit of 55 per cent of GDP, and should be cut to 47 per cent towards the end of the government's term in 2015. A more rigorous fiscal rule that will constrain expenditure more tightly from 2015 is under discussion.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	1.6	3.9	4.3	2.5
Inflation (end-year)	3.8	2.9	4.5	3.8
Government balance/GDP	-7.4	-7.8	-5.1	-3.5
Current account balance/GDP	-3.8	-5.1	-4.9	-3.5
Net FDI (in million US$)	8460	3574	9120	9527
External debt/GDP	65.0	67.1	64.8	na
Gross reserves/GDP	17.7	19.4	19.0	na
Credit to private sector/GDP	46.6	48.1	50.7	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government initiated a number of fiscal reforms that will have profound implications for public investment. As part of a strengthened legal framework for public finances announced in early 2012, the Finance Ministry set limits on local government deficits. The rule envisages a gradual reduction in the total deficit of local authorities to 0.4 per cent of GDP (from 0.8 per cent last year). Local authorities have been central to the government's relatively good record in the absorption of EU structural funds, which according to government estimates boosted GDP growth by 0.8 per cent of GDP in 2011. EU structural funds in total represented a net transfer of 2.4 per cent of GDP in 2011, increasing from 0.9 per cent three years previously. A cap on local government deficits may be desirable from the perspective of overall fiscal governance, though it may constrain the co-financing normally mobilised by local authorities, and hence local investment overall.

There has been only limited progress in mobilising private finance for infrastructure through PPPs. In the roads sector two attempts to launch tenders for motorways under the PPP framework were unsuccessful and were cancelled. PPPs encountered major difficulties in relation to open and transparent tendering and during implementation (for example, with regard to land acquisition, cost overruns and lower than expected traffic) which explained a lack of interest from private investors.

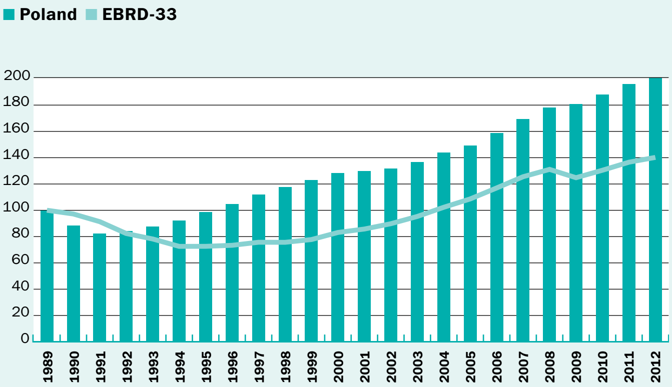
The government has begun to tackle the long-outstanding reform of the public pensions system. Following months of difficult public dialogue, in May 2012 parliament adopted an increase in the retirement age. Under this law, starting in 2013, the retirement age will be gradually raised to 67, from the current 60 for women and 65 for men. Labour force participation remains one of the lowest in the EU. Early pension rights for uniformed personnel, a key beneficiary group in the public pension system, will also be restricted. This reform package will begin to address the chronic deficit in ZUS, the state pensions provider, though the longer term demographic challenges are likely to necessitate further reform. The 2011 budget benefited from a considerable reduction in the contributions going into private mandatory pension funds, which will again rise gradually in the period to 2017. In April 2012 the Finance Ministry prepared a plan to partially liberalise the investment allocation restrictions of these private funds and allow the investment of larger shares of portfolios abroad. Also, guarantee requirements that incentivised defensive portfolio allocations have been lifted.

The government, the National Bank, and the financial regulator, KNF, have jointly taken on an agenda to further strengthen the resilience of the financial sector. This includes strengthened macro prudential supervision, following European recommendations in that area, the establishment of a bank resolution regime, and stepped-up bank supervision, in particular with regard to foreign currency mortgages. Given the still dysfunctional inter-bank market, dividend payments, including to these foreign parent banks, have been curtailed. In this area the authorities actively collaborate with other European supervisors, including under the Vienna Initiative. KNF has initiated a number of working groups to develop long-term bond issuance, through the issuance of covered mortgage bonds.

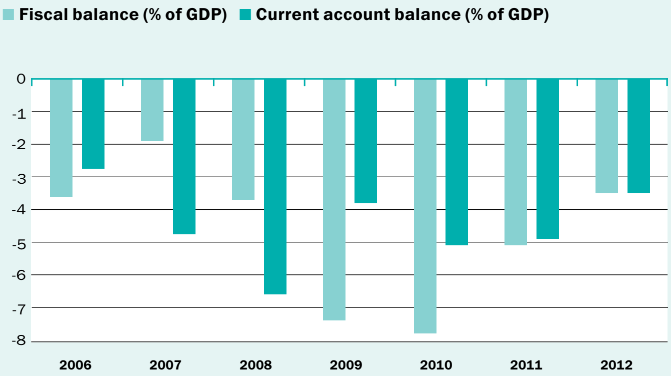
The government announced a new privatisation plan for 2012-13. Sales of state-owned entities accelerated under the previous programme in the four years to 2011, over which about PLN 50 billion or 3.3 per cent of 2011 GDP in privatisation revenues has been raised. Nevertheless, these were primarily small stakes, and key sectors such as petrochemicals, other energy, and chemicals remain state-dominated. Further ownership transformation is now targeted for 300 companies, though in about 45 important companies (mainly in the energy, finance and defence sectors) majority stakes will be retained. According to this plan, the government will seek to raise innovation the potential and competiveness, exercise more active supervision, and attract more innovative financing. Privatisation revenues may partly be directed to a reserve fund for the public pensions system and into the Fund for Polish Science and Technology. The programme also mentions potential benefits of the development of local capital markets, and of Warsaw as a regional financial centre, given the likely higher stock exchange capitalisation and market turnover. The sale in July 2012 of a 7.8 per cent state stake in PKO BP, the country's largest bank, was a notable step in this agenda and reduced the state's share to less than an outright majority. The management of the bank, however, continues to be appointed by the state as the largest shareholder.

The government seeks to further reduce administrative barriers to enterprises. The 2012 World Bank's *Doing Business* Report showed a slight decline in Poland's relative ease of doing business ranking (to 62nd place out of 183 countries worldwide), and the low score (relative to most EU countries) is, in a large part, due to barriers to starting a business and tax administration. According to the Polish Confederation of Private Employers, the main obstacle for business growth is the overregulated labour code that makes it difficult to increase employment. Following re-election, the government re-launched a programme that aims to gradually reduce regulations on more than 200 professions. A number of measures were also adopted in 2011 with a view to reduce red tape for business, for instance, through greater scope for self-certification.

Real GDP (1989 = 100)



Fiscal balance and current account balance



ROMANIA

HIGHLIGHTS OF THE PAST YEAR

- **Growth has resumed and macroeconomic stability has been preserved.** The growth rate in 2011 was influenced by an exceptional performance in agriculture, and inflation fell to historically low levels, but economic performance in 2012 is being adversely affected by the eurozone crisis.

- **Problems persist in the energy sector but are being addressed.** Romania has faced infringement action by the European Commission over the persistence of regulated prices, but the government has committed to phase these out over time.

- **Financial sector contingency planning has been stepped up.** The banking sector has coped well with the crisis but vulnerabilities remain; the authorities have taken steps to strengthen coordination and bank resolution powers.

KEY PRIORITIES FOR 2013

- **The key overall reform priority is to make further improvements to the investment climate.** Heightened efforts are needed to remove red tape and licensing problems, which are cited as problems by enterprises in business climate surveys.

- **Important privatisations in key sectors should be advanced.** The government has expressed its commitment to proceed with the sale of important assets, but implementation has been slow and should be accelerated if sales are to be achieved next year.

- **The quality of the transport network needs significant improvements.** Now that the appropriate legislation for private sector involvement is in place, the authorities should step up efforts to attract private investment and know-how to key transport projects.

MACROECONOMIC PERFORMANCE

Economic growth is weakening. Romania continues to be highly exposed to negative developments in the eurozone and the summer 2012 political crisis has also had a negative impact on the economy. Growth in 2011 reached an estimated 2.5 per cent, aided by an exceptional performance in the agriculture sector in the third quarter. However the economy slowed down significantly towards the end of 2011, contracting on a quarter-over-quarter basis in real terms in the fourth quarter, and growth has been minimal in the first half of 2012. Inflation fell to a historic low of 1.9 per cent year-on-year in April 2012, but it is on the rise again, reaching 5.3 per cent year-on-year in September as a result of higher agricultural and fuel prices, as well as increases in some administered prices.

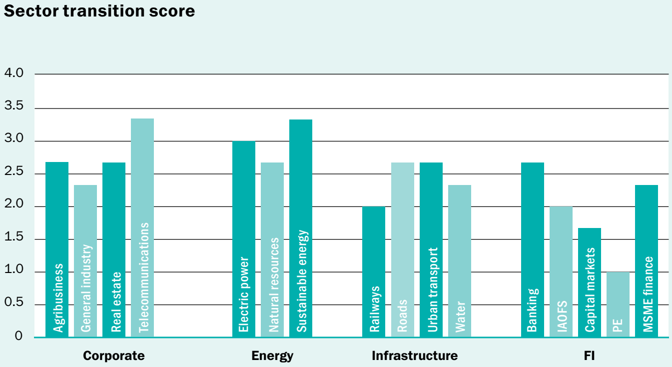
Significant risks continue to lie in the fiscal sector. The budget deficit target was revised from 1.9 per cent to 2.2 per cent of GDP in 2012. The IMF approved an increase in the deficit target this year to account for an increase in public wages (8 per cent in June; to bring up to a total of 15 per cent increase by the end of the year) and the repayment to pensioners of illegally collected tax revenues. The fact that the IMF programme – a 24-month precautionary Stand-By Arrangement of €3.4 billion signed in March 2011 – is on track provides some comfort. Further comfort comes from the relatively low level of public debt and strong foreign reserve coverage.

Growth projections for this year have been revised downwards. The revisions reflect both base effects (agriculture this year is unlikely to repeat the strong performance of last year), the worsening outlook in major export markets and possible turbulence in credit markets. GDP growth is expected to fall below 1 per cent in 2012 with only a modest rise in 2013. However, medium-term prospects remain favourable, reflecting the diversified economy and strong catch-up potential in a country where GDP per capita (adjusted for purchasing power standards) is less than half the EU average, according to Eurostat estimates.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-6.6	-1.7	2.5	0.5
Inflation (end-year)	4.7	8.0	3.1	5.5
Government balance/GDP	-7.3	-6.4	-4.1	-2.2
Current account balance/GDP	-4.2	-4.5	-4.4	-3.7
Net FDI (in million US$)	4950	2970	2645	1542
External debt/GDP	72.1	74.3	68.4	na
Gross reserves/GDP	24.9	27.7	20.5	na
Credit to private sector/GDP	39.5	46.1	38.0	na

2012 sector transition indicators



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The European Commission (EC) has expressed concerns over Romania's commitment to the rule of law and judicial independence. In its annual report under the Cooperation and Verification Mechanism (CVM), published in July 2012, the EC noted that the country has taken important steps over the previous five years in judicial reform and the fight against corruption. However, events in July 2012, particularly the perceived undermining of the constitutional court, pose a serious threat to the progress achieved to date by Romania, according to the EC. The government has promised to address these concerns. The EC will monitor progress closely and will adopt another report under the CVM before the end of 2012.

Absorption of EU funds has increased but remains at a low level. In September 2011 a new Ministry for European Affairs was established, with the primary aim of accelerating the absorption rate of EU structural and cohesion funds, which at the time was below 5 per cent of the allocated amount of around €20 billion for the period 2007-13. Although the situation has improved since then, absorption rates remain low at around 8.5 per cent as of July 2012. The government is targeting a rate of 20 per cent by year-end.

Several important privatisations have been delayed. Under its standby arrangement with the IMF, Romania has committed to a significant privatisation agenda in several key sectors, including electric power, gas, railways and chemicals. One achievement was the sale in March 2012 of an additional 15 per cent stake in the electricity transmission company, Transelectrica, on the stock exchange. However, the privatisation of other companies, including the chemical company Oltchim (in which the state has a majority stake) and the copper mine Cuprumin, is behind schedule. The government has committed to move forward this year with the sale of shares in several energy and gas companies, as well as a majority sale of the railway company, CFR Marfa. The planned partial privatisation of the hydro-electric company, Hidroelectrica, has been delayed by the company's filing for insolvency in July 2012. The company had entered into bilateral contracts that meant it was selling energy at below production cost.

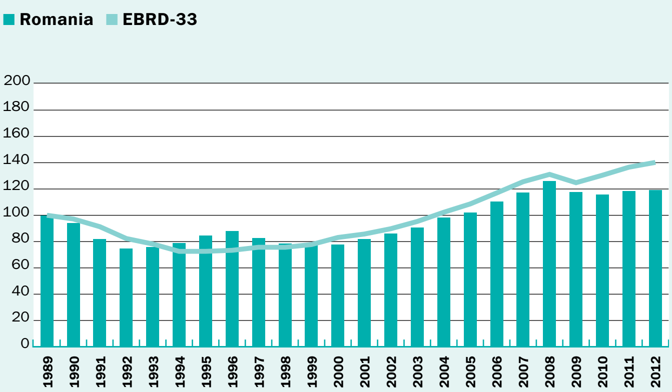
A new electricity and natural gas law is aimed at liberalising the market. The law was endorsed by parliament in June 2012 and is in line with the EU's Third Energy Package adopted in 2009. The objectives include the granting of financial and operational independence for the energy regulator. In addition, the government has committed to start phasing out regulated electricity prices from September 2012, with the process to be completed by end-2017. In the gas market, full liberalisation is envisaged by end-2018.

These measures, if implemented, should address various problems that have arisen in recent years in the power sector, notably, the continuing failure of institutions and policies to deliver competition and new private sector entrants to the market, as well as ongoing infringement action by the EC over the persistence of regulated prices.

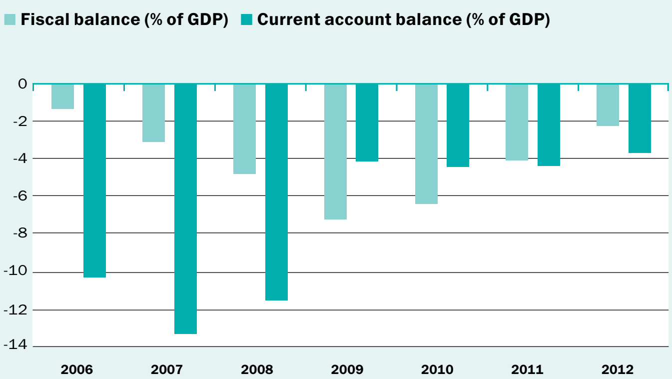
Important amendments have been made to the public-private partnership (PPP) law. These amendments were introduced in October 2011, following feedback from the EC on the law enacted in 2010 and amended in April 2011. The aim is to make the procedures for awarding a PPP contract consistent with EU directives on public procurement. While the legal framework is now broad enough to allow the implementation of different types of PPPs, including concessions, it remains the case that no major projects in the roads sector have yet been carried out through concessions or other types of PPPs. Progress is also lagging behind in reforms to the railways, as well as in urban transport, where public service contracts are rarely in line with international standards and responsibilities and payment mechanisms are often unclear.

Contingency planning in the financial sector has been strengthened. The Romanian banking system remains liquid and well capitalised, but significant vulnerabilities remain, especially in light of the eurozone crisis. Credit institutions as a whole became loss-making again in the period March-June 2012. The authorities have taken significant steps in the past year to strengthen the degree of preparedness for possible future stresses. The National Bank of Romania and the Deposit Guarantee Fund (DGF) have signed a Memorandum of Understanding (MoU) that outlines measures to ensure a greater flow of information to the DGF and, along with the Ministry of Public Finance, stronger coordination on the implementation of new bank resolution powers, including the power to establish a "bridge bank" in cases where a large bank falls into serious difficulties. Since 2009, Romania has been an active participant in the Vienna Initiative, which now aims to improve coordination between home and host country authorities in order to manage cross-border deleveraging.

Real GDP (1989 = 100)



Fiscal balance and current account balance



RUSSIA

HIGHLIGHTS OF THE PAST YEAR

- **The Russian economy has not been immune to the impact of the eurozone crisis.** Both external and domestic demand growth slowed down in 2012, driven by the weaker global environment and lower investor and consumer confidence.
- **Price stability has become a top priority.** Inflation started rising again after reaching a record historical low rate of 3.6 per cent in early 2012, but the authorities have confirmed commitments to inflation targeting and a floating rouble.
- **Russia joined the World Trade Organization (WTO) in August 2012.** After 18 years of negotiations, the terms of accession were agreed at a Ministerial Conference in Geneva in December 2011 and ratified by the Russian parliament in July 2012.

KEY PRIORITIES FOR 2013

- **The key long-term priority for Russia is diversification of the economy away from its strong dependence on oil and gas exports.** This requires modernisation of the economy, and serious improvements in productivity and the investment climate.
- **The benefits of economic growth and development need to be shared more equally across regions.** In addition to fiscal transfers, this requires major improvements in the regional business environments, so as to attract more private investment.
- **The role of the state in the economy needs to be further reduced.** Faster progress with privatisation can help to increase the country's productivity and competitiveness (particularly important following WTO accession) provided that the privatisation process is transparent and increases competition.

MACROECONOMIC PERFORMANCE

The Russian economy is beginning to be affected by the global economic slow-down through falling export demand and weaker investor and consumer confidence. Output grew by 4.3 per cent in both 2010 and 2011, aided by expansionary fiscal policies, high oil prices and associated services sector growth. However, as eurozone developments started to affect the Russian economy from the end of 2011, industrial production and retail sales growth slowed down, while agricultural output fell due to adverse weather conditions. Net capital outflows have continued and reached US$ 57 billion during the first three quarters of 2012. The official unemployment rate declined to the pre-crisis level of around 5.5 per cent by mid-2012 but does not capture unofficial unemployment and differs widely between Russia's 83 regions. On current trends, GDP growth is expected to slow down to 3.2 per cent in 2012 and record a similar level in 2013.

The Central Bank of Russia (CBR) has started to put more emphasis on price stability as a priority and has already significantly increased exchange rate flexibility. In part as a result of, but also helped by, falling global food prices and delayed administered price increases, inflation declined to a record low of 3.6 per cent year-on-year in April-May 2012, from 8.4 per cent in 2011. However, inflation has picked up since then to 6.6 per cent in September and is expected to be close to 7 per cent by the end of the year – well above the 5-6 per cent inflation target. The CBR aims to keep its end-year inflation target at 5-6 per cent for 2013 and to reduce it to 4-5 per cent for 2014-15. It plans to complete the transition to inflation targeting and a free floating rouble by 2015, which should help to improve the economy's resilience to shocks.

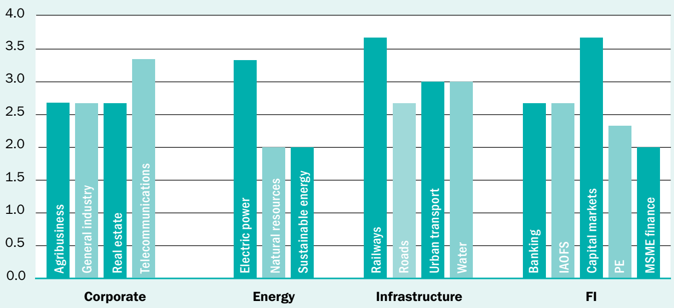
Russia's outlook for growth remains highly dependent on commodity prices, particularly oil and gas. Other vulnerabilities stem from significant private external debt of around US$ 500 billion, or over 25 per cent of GDP, and the high sensitivity of the fiscal balance to the oil price. General government gross debt was around 12 per cent of GDP at the end of 2011. The non-oil deficit now exceeds 10 per cent and the budget-balancing oil price has increased to around US$ 115 per barrel. A sustained drop in the oil price would thus threaten fiscal sustainability and could lead to additional capital outflows, further pressure on the rouble and a credit freeze. In late June 2012 the government approved the use of an additional RB 200 billion from the Reserve Fund for real and financial sector support in case global market conditions deteriorate further. However, fiscal space is more limited now than during the 2008-9 crisis, when similar anti-crisis measures amounted to RB 1.2 trillion.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-7.8	4.3	4.3	3.2
Inflation (end-year)	8.8	8.8	6.1	6.8
Government balance/GDP	-5.9	-4.0	0.8	0.1
Current account balance/GDP	4.0	4.7	5.3	5.2
Net FDI (in million US$)	-8125	-8599	-14342	-16857
External debt/GDP	38.2	32.9	27.6	na
Gross reserves/GDP	32.6	29.8	26.9	na
Credit to private sector/GDP	42.4	41.8	42.9	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

To improve fiscal sustainability, the authorities plan to limit government spending and make fiscal policy more countercyclical. In the autumn of 2012 a new fiscal rule was adopted, according to which future budgets will be based on the long-term average oil price rather than on the expected oil price during the budget year. However, implementation of this fiscal rule is likely to be delayed as it would only be gradually phased in, and the 2013 budget will still be based on a higher oil price than that implied by the new rule. Nevertheless, the draft medium-term budget framework aims to reduce spending growth and targets a balanced budget by 2015.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Russia joined the WTO in August 2012. The terms of accession were agreed at a Ministerial Conference in Geneva in December 2011. The Russian parliament ratified the agreement in July 2012 thus completing a long accession process that started back in 1993. Under the terms of the accession, Russia has made a number of commitments. These include: gradually lowering a number of import duties in agriculture and manufacturing (by around 2-3 percentage points on average); relaxing restrictions on foreign entry in the services sectors such as insurance and telecommunications; limiting future agricultural subsidies; and introducing non-discriminatory tariffs for trans-shipment of goods through the country. Many provisions include transition periods of up to nine years, depending on the sector. Work on Russia's accession to the Organisation for Economic Co-operation and Development (OECD) is ongoing.

In January 2012, Belarus, Kazakhstan and Russia launched the next stage of economic integration. This stage envisages the creation of a common economic space within the Eurasian Economic Community, building on the Customs Union between Belarus, Kazakhstan and Russia launched in 2010. The stated ultimate goal of the Community is free movement of goods, capital and people, as well as harmonisation of macroeconomic and structural policies. The Eurasian Economic Commission, a newly established supranational body of the community with nine members (three from each country), is expected to gradually take over some responsibilities from the national authorities in areas such as competition policy, technical regulations and environmental standards. Key decisions will be taken by the Council of country representatives based on the "one country, one vote" principle. The exact modalities and timetable for the next steps of integration are yet to be fully clarified.

Despite delays, some progress was made with privatisation. The revised privatisation programme announced in June 2012 is broadly in line with the previous versions. It foresees the sale or initial public offerings of shares in state-controlled companies in various sectors including transport, power generation, agribusiness, banking and insurance. Implementation of the previous privatisation programme was slower than initially envisaged but recent noteworthy sales have included a majority stake in Freight One, a former cargo subsidiary of Russian Railways, and minority stakes in United Grain Company and Sberbank. Other sales anticipated in the near future include minority stakes in Novorossiysk Commercial Seaport and Sovkomflot, a maritime company specialising in oil and gas shipping. Further selected majority privatisations are envisaged in the coming years.

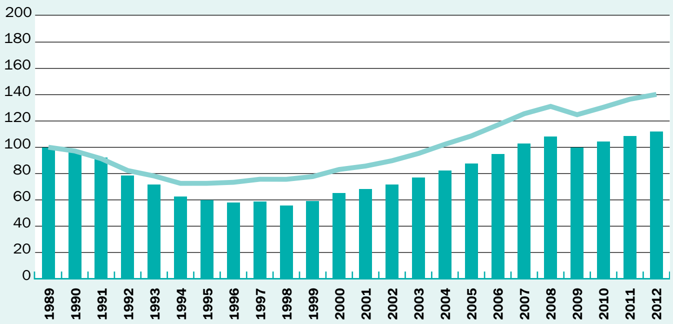
Two major oil companies have established a strategic alliance. The landmark deal, signed in September 2011 between Rosneft, a leading state-owned oil company, and ExxonMobil, a major international oil company, envisages the establishment of joint ventures to explore oil and gas in the Russian Arctic where Rosneft will hold two thirds of shares and ExxonMobil the rest. Rosneft in turn is expected to get stakes in at least six projects of ExxonMobil. Estimates of long-term investment needs for exploration in the Arctic range within US$ 200-500 billion and the strategic alliance is expected to give a major boost to the development of new oil and gas fields.

The Direct Investment Fund (DIF) has started operations. The fund was set up in 2011 with the objective of promoting innovation and modernisation of the economy through leveraging private co-investment by foreign companies. It is managed by a fully owned subsidiary of VEB, the state development bank. In April 2012 DIF and China Investment Corporation (CIC) agreed to each contribute US$ 1 billion to a joint investment fund, with further contributions from Chinese institutions expected in the future. The fund's management company will be owned 60 per cent by the Russian state (via VEB) and 40 per cent by the Chinese state (via CIC). The fund will target investments in Russia and the CIS as well as Chinese companies actively dealing with Russia.

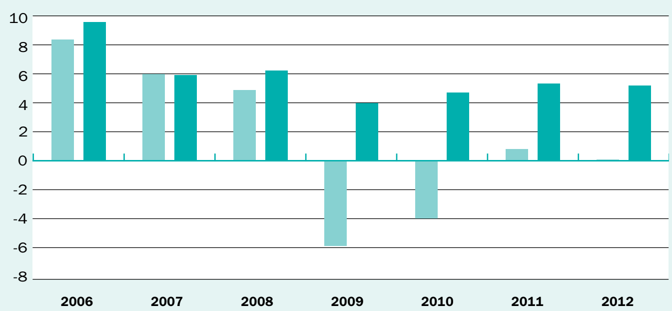
The work on development of local capital markets continued. In December 2011 the parliament passed a law on Central Depository. As part of the agenda of transforming Moscow into an international financial centre, a number of measures have been adopted to liberalise the domestic sovereign rouble bond market and make it easier for non-residents to trade in Russian securities through international clearing systems such as Euroclear.

Amendments to the competition law have made rules of competition enforcement clearer. Under these amendments, collusion and cartel behaviour have become more explicitly defined while a number of other offenses have been decriminalised, contributing to a better, more predictable business environment.

Real GDP (1989 = 100)



Fiscal balance and current account balance



SERBIA

HIGHLIGHTS OF THE PAST YEAR

- **Serbia has become an EU candidate country.** The decision by the European Council in March 2012 is in recognition of Serbia's cumulative reform efforts. However, no date has yet been set for beginning the accession talks.

- **Reforms have advanced in several infrastructure sectors.** In telecommunications, the market has now become fully liberalised and competition is increasing, while in railways, further steps have been made towards the separation of infrastructure from transport.

- **Macroeconomic discipline has been weakened.** The fiscal deficit increased substantially in the first half of the year above 7 per cent of gross domestic product (GDP), and the level of public and publicly guaranteed debt is now above the 45 per cent ceiling set by the Budget System Law.

KEY PRIORITIES FOR 2013

- **Restoring fiscal prudence is essential for overall macroeconomic stability.** Given the weak short-term growth outlook, the new government will have to implement some difficult measures in order to reduce the size of the fiscal deficit to more manageable levels.

- **Regulatory independence in the energy sector should be strengthened.** The removal of government interference in tariff-setting should help in improving energy efficiency and investor confidence.

- **Efforts to strengthen local capital markets should be intensified.** Measures to promote "dinarisation" by the central bank are bearing fruit and further progress in this area would help in the development of a more sustainable financial sector.

MACROECONOMIC PERFORMANCE

The economy contracted in the first half of 2012. In 2011 the Serbian economy grew by a meagre 1.6 per cent, one of the lowest growth levels recorded in the SEE region, and growth has significantly weakened further this year. In the first and second quarters of 2012, GDP fell by a real 2.5 and 0.8 per cent respectively year-on-year due to a combination of weak external and domestic demand. Industrial production and exports have continued to decline in the second quarter of 2012, and, more recently, a summer drought has badly affected agricultural output.

After a year of decline, inflation is on the rise again. Inflation dropped from a peak of 14.7 per cent in April 2011 to 3.2 per cent in March 2012 before beginning to climb again. In September 2012 inflation stood at 10.3 per cent year-on-year. The National Bank of Serbia (NBS) expects inflationary pressure to persist due to a combination of higher agricultural prices, a recent VAT increase (see below) and an expected increase in some regulated prices, and as a result, it anticipates that inflation will temporarily remain well above the upper limit on the target band of 4 ± 1.5 per cent. In response, NBS raised the key repo rate to 10.5 per cent in three consecutive months (June, July and August 2012), and to 10.75 per cent in October 2012. It also tightened reserve requirements. The dinar has weakened in nominal terms by about 7 per cent relative to the euro between January and August, alongside significant central bank intervention to prevent further depreciation (the NBS has sold €1.35 billion on the intrabank foreign exchange market so far this year to support the dinar).

Substantial fiscal adjustment is needed in the short term. The budget deficit, currently estimated at over 7 per cent of GDP, significantly exceeds the target of 4.25 per cent of GDP that had been agreed with the IMF under the Stand-By Arrangement. At an estimated 55 per cent of GDP, public debt exceeds the administrative limit of 45 per cent of GDP. In light of these figures and the weakening economic performance, there is a need for urgent fiscal adjustments (according to the Fiscal Council, an estimated €1 billion in savings needs to be implemented in 2012 and 2013 to avoid a debt crisis). In September 2012, the government adopted a revised budget for 2012 which aims to bring down the deficit to 6.7 per cent of GDP this year. New measures include an increase in the VAT rate (from 18 to 20 per cent) and limits on salary and pension indexation. However, spending has been raised in some areas and it is unclear if even this new target will be reached.

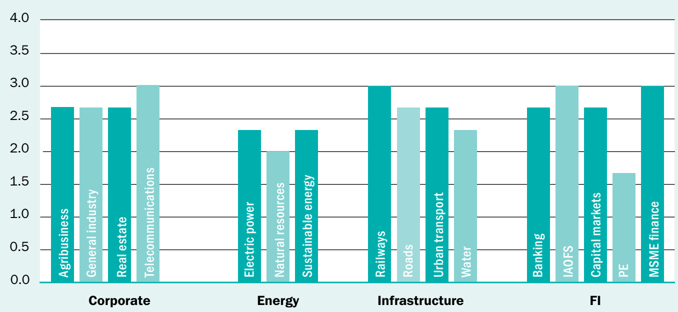
Further output reductions are likely in the short term. The combination of weak domestic demand and the ongoing crisis in the eurozone is having a major dampening effect on the economy. The necessary fiscal retrenchment expected in the

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-3.5	1.0	1.6	-0.7
Inflation (end-year)	6.6	10.3	7.0	12.0
Government balance/GDP	-3.7	-3.7	-4.2	-6.7
Current account balance/GDP	-7.1	-7.4	-9.5	-11.5
Net FDI (in million US$)	1904	1133	2531	633
External debt/GDP	78.9	85.2	84.9	na
Gross reserves/GDP	36.9	34.5	27.0	na
Credit to private sector/GDP	45.2	51.3	52.1	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

coming year will also weigh heavily on growth prospects. However, medium-term prospects remain favourable once confidence returns to the domestic and foreign investor community.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Serbia has become an EU candidate country. Candidate status was granted by the European Council at its meeting on 1 March 2012. No date has yet been set for starting accession talks. In its latest progress report, published in October 2012, the European Commission (EC) stated that Serbia is broadly on track in fulfilling the criteria under the Stabilisation and Association process. However, in light of recent rulings by the Constitutional Court, the EC also noted that Serbia should focus more on the rule of law, in particular ensuring the independence and impartiality of the judiciary. The EC also indicated that recent developments call for increased attention on the rights of vulnerable groups as well as the independence of key institutions such as the central bank.

A major steel company has been renationalised. In January 2012 the government repurchased the local unit of US Steel, which was privatised in 2003, for a nominal price of one US dollar. US Steel decided to exit the Serbian market as a result of increasing losses and the global downturn in the steel market. The unit was subsequently shut down on 10 July because of the depressed market conditions and, as of late-September, had not yet reopened. The government issued a tender, which was subsequently cancelled, and is continuing to search for a strategic partner.

The fixed-line telecommunications market has been liberalised. The final steps to achieve full liberalisation occurred in 2012. Companies that wish to compete in the market now only need a permit, rather than an operating licence as previously required. However, implementation of a number of competitive safeguards, such as local loop unbundling or fixed number portability, is lagging behind. In addition, the fixed line market remains dominated by Telekom Srbija, which is still state-owned following a failed privatisation attempt in 2011. At the end of 2011, Telekom Srbija agreed to buy back a 20 per cent share from the Greek-owned company, OTE.

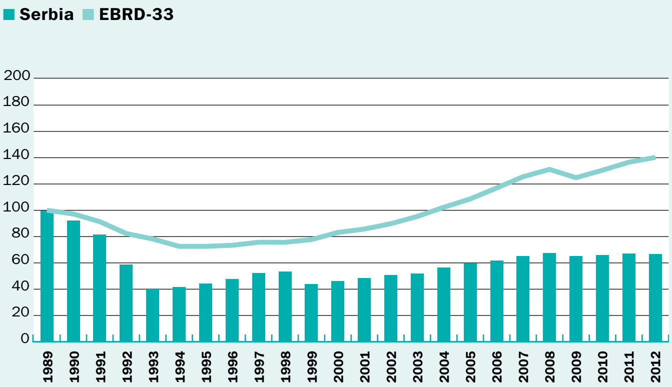
Regulatory independence remains limited in the power sector. For example, the regulatory agency still does not have the power to determine the final tariff levels (though they set tariff methodologies), which rests with the Serbian government. Proposed changes to the Energy Law to give the regulator full control over tariffs have yet to be passed by the government or the parliament. The new government has announced that it has no plans to privatise the state-owned power company, EPS. However, EPS intends to open up tenders this year for the construction of eight small hydropower plants, as well as for the rehabilitation of 15 existing plants.

Significant reform efforts are ongoing in the railways sector. A new law that allows for important institutional restructuring was adopted in August 2011. Under this law, the operating and policy-setting functions have been separated, and core railway businesses are also financially and operationally separated. The aim is to enable greater competition and improved services. Another development in 2011 was the conversion of the state-owned railways company into a joint-stock company. The new structure is intended to lead to the complete separation of infrastructure from transport, in line with EU directives. Notwithstanding these efforts, however, the pace of reforms remains slow and the sector is still a significant burden on the budget.

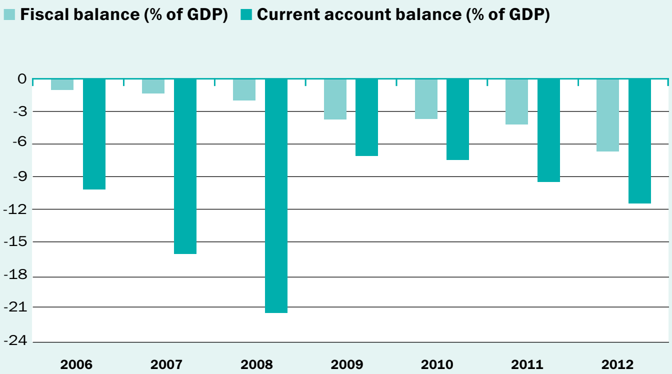
Non-performing loans are rising, but the institutional framework for small business finance has improved. The banking sector has coped well with the crises of the past few years and the capital adequacy ratio remains strong at 19.7 per cent as at the end of 2011. However, the level of NPLs has continued to rise and stands above 20 per cent as of mid-2012. In May 2012 the National Bank of Serbia (NBS) removed the licence of Agrobanka, which had been under administration for five months, and licenced instead a new, state-owned bank, Nova Agrobanka. Meanwhile, some of the architecture for financing SMEs has been strengthened in the past year. The credit information system has increased in effectiveness, with coverage increasing to cover 100 per cent of adults. The cadastre system has also been improved in 2011 as the registration process accelerated.

Efforts to promote local currency use have been strengthened. The National Bank of Serbia's "dinarisation" strategy rests on three pillars: strengthening the macroeconomic environment; promoting dinar-denominated instruments and markets and developing hedging instruments for foreign currency risk in the non-bank sector. Several measures were introduced in late-2011 to advance these objectives, including a new law (applicable in December 2011) on the protection of financial services consumers, under which the first offer of a loan must be made in dinars and, if a subsequent quote is made in foreign currency, the bank must inform the customer of the risks associated with exchange rate movements. In April 2012 the NBS and the then government signed a Memorandum of Understanding (MoU) on the promotion of the dinar in financial transactions. Since 2009, Serbia has been an active participant in the Vienna Initiative, which now aims to improve coordination between home and host country authorities in order to manage cross-border deleveraging.

Real GDP (1989 = 100)



Fiscal balance and current account balance



SLOVAK REPUBLIC

HIGHLIGHTS OF THE PAST YEAR

- **Growth in the Slovak Republic remains well above the regional average.** The continued expansion of a number of foreign owned manufacturing plants underlines the success of the country's growth model.
- **Banks remain relatively sheltered from the European banking crisis, and continue to show growth in credit to the private sector.** Traditionally prudent funding models have underpinned this success.
- **The government has made a promising start with a fiscal consolidation strategy.** However, certain tax measures risk distorting private sector incentives.

KEY PRIORITIES FOR 2013

- **An education policy focused on addressing skills shortages and efforts to facilitate investment in the country's eastern regions are needed.** Despite a relatively strong recovery since the 2009 recession, there has not been a significant dent in long term unemployment and social exclusion.
- **The framework for private pension funds should be made more predictable.** European Monetary Union (EMU) membership does not obviate the need to build local sources of funding for longer-term assets, of which pension funds could be a valuable source. While the banking sector remains well capitalised, taxation of the sector could be a risk and should hence be limited to the revenue target announced.
- **Private finance of road infrastructure should play a stronger role.** While EU structural funds will remain the principal source of such finance, the private sector's capacity to design and partially complement such funding is as yet under-utilised.

MACROECONOMIC PERFORMANCE

The Slovak Republic has shown a very rapid recovery from the severe 2009 recession. Growth in 2010 stood at over 4 per cent and at 3.3 per cent in 2011, well above the regional average. Growth remains closely correlated with, and hence vulnerable to, the cycle in German industrial production. Exports account for 80 per cent of gross domestic product (GDP) and value added in manufacturing for about 35 per cent of GDP, and this sector is in turn concentrated in a few products, mainly vehicles and electrical equipment. After a brief weakening, indicators for exports and industrial production in early 2012 again showed signs of a surprisingly strong revival, primarily driven by automotive related industrial production, confirming this pattern. However, unemployment rates have increased notably over the last few years, peaking at just under 15 per cent in early 2010 and still at 14 per cent in mid-2012, with youth unemployment at 32 per cent, the highest in the CEB region.

Banks have been comparatively unaffected by problems of its peers elsewhere in the euro area. Capital ratios are generally sound with aggregate non-performing loans (NPLs) at 5.5 per cent of total loans. Prudent funding practices are evident in the very low loan-to-deposit ratio of about 90 per cent. The stock of domestic credit to the private sector remains relatively low (at about 46 per cent of GDP at end-2011), and both corporate and household credit have shown some increases.

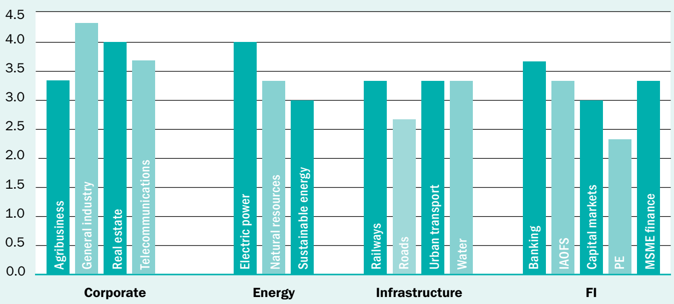
The new government has strongly committed itself to further fiscal consolidation. As the budget deficit and public debt had risen sharply following the 2009 recession the previous government already implemented a significant consolidation, reducing the deficit from 7.7 per cent of GDP in 2010 to 4.8 per cent in 2011. Public sector pay cuts and an increase in the VAT rate over the course of 2011 led to a renewed fall in net disposable income. The new government adopted a mixture of further expenditure cuts and a wide-ranging reform of the tax system. Through these new measures the budget balance could reach the EU-mandated target of 3 per cent by 2013. In December 2011 the then outgoing government adopted a Fiscal Responsibility Law under which public debt will be limited and gradually brought down to 50 per cent of GDP. Fiscal performance will now be monitored by an independent fiscal council.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-4.9	4.2	3.3	2.7
Inflation (end-year)	0.0	1.3	4.6	4.0
Government balance/GDP	-8.0	-7.7	-4.8	-3.3
Current account balance/GDP	-2.6	-2.5	0.1	1.0
Net FDI (in million US$)	-913	198	1654	2119
External debt/GDP	74.5	75.4	77.3	na
Gross reserves/GDP	0.9	0.9	0.8	na
Credit to private sector/GDP	44.1	44.6	46.2	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Deficit reduction remains a key guiding principle in the programme of the new government. Strengthened tax collection and administration is a central theme of the government's efforts in this area. In a significant departure from the long-standing model of a flat personal tax (which has been at 19 per cent since 2004) the new government announced that a second tax band for high earners will be introduced.

The new government announced major revisions to the corporate tax system. The corporate income tax is to be raised from 19 to 23 per cent, and a one-off levy on regulated enterprises (telecommunications, utilities and banks) may be introduced. A bank tax was introduced in 2011 at a relatively high rate of 0.4 per cent of liabilities net of insured deposits and equity, which was particularly burdensome for banks relying on corporate deposits. This tax is to be broadened from 2013 to include retail deposits, though discounting the insurance premium paid to the deposit guarantee fund. The government has also indicated that the tax will be time-bound, and be phased out once a certain revenue target has been reached.

The direction on the outstanding privatisations remains unclear. The previous government's privatisation programme remained controversial and did not make progress. The new government's manifesto envisages a review of this programme (which was, in particular, aimed at heating companies).

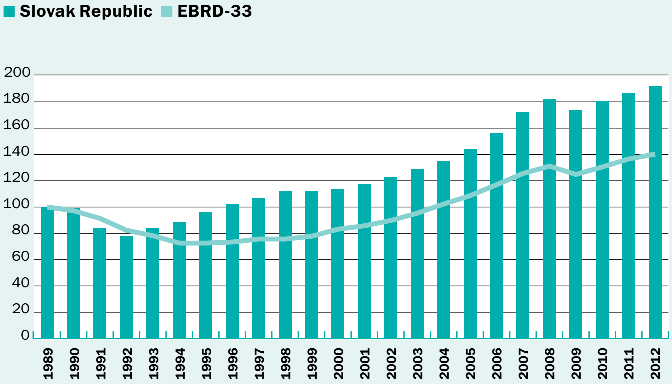
The government will seek to primarily use EU structural funds to finance infrastructure projects, importantly for the unfinished parts of the highway to the eastern part of the country, though it remains open to the use of public-private partnerships (PPP) schemes, possibly in combination with structural funds.

The banking sector is well regulated, though the central bank announced some prudential tightening in inter-bank exposures. The central bank in January 2012 announced new measures to raise mandatory capital standards, limit dividend payments within a certain range of capital ratios, and enforce a cap on loan-to-deposit ratios. While these prudential measures are not binding on most banks, they have underlined the central bank's determination to resist any deleveraging pressures through banking linkages to the rest of the euro area.

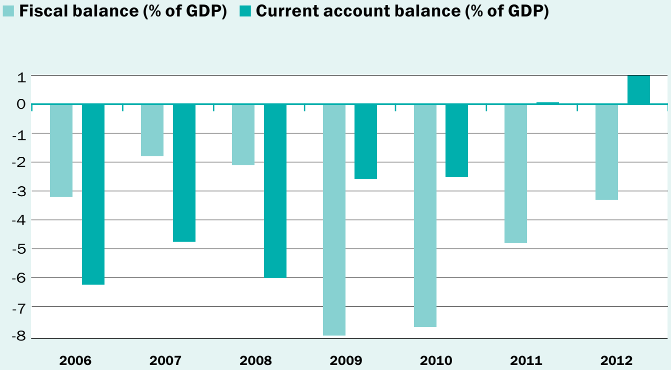
The regulation of private pension funds has again been revisited. A reduction of the employer contributions into the funds from nine to around four per cent of gross salaries became effective in September 2012. The industry is particularly opposed to the guarantee requirements, which have skewed portfolios into defensive allocations, though some more growth-oriented fund allocations with long-term guarantee requirements may now emerge. The European Commission's 2012 Ageing Report suggests that over the next 50 years the total population is foreseen to decrease by 6.1 per cent with a parallel drop in the total workforce of almost 30 per cent. As a result of these trends the dependency ratio (population aged 65 and over relative to the workforce 15-64) is expected to increase from 19 to 68 per cent between 2010 and 2060. This will considerably heighten pressure on the sustainability of the public pension system.

Stimulating the knowledge economy remains a key objective for the new government. The new administration will seek to encourage the growth of technology-intensive local enterprises and other SMEs, in particular those focused on job creation in the more remote parts of the country. A strategy for the knowledge economy ('Minerva 2.0') was drawn up by the previous government and listed 26 measures in the areas of human resources, support of scientific and innovative research and the reform of the institutional and legal framework. A close collaboration in this area was envisaged between government, educational institutions and business.

Real GDP (1989 = 100)



Fiscal balance and current account balance



SLOVENIA

HIGHLIGHTS OF THE PAST YEAR

- **The economy entered a second recession in 2011.** As yet the fallout in terms of further increases in unemployment remains contained although estimates of loan delinquencies are rising.

- **The new government is committed to fiscal consolidation and has initiated pension reform and other expenditure measures.** It has reached agreement on key changes with important trade unions, which should make parliamentary Acts less exposed to popular votes.

- **The government has signalled its support for the substantial Šoštanj Thermal Power Plant (TES).** It has announced that it intends to provide a state guarantee for part of a loan.

KEY PRIORITIES FOR 2013

- **A key challenge remains to secure adequate and lasting capital support in the banking system, particularly for the largest bank, state-owned Nova Ljubljanska Banka.** Clearing the banking system of non-performing loans (NPLs) will ultimately require restructuring delinquent loans while outside strategic investors will likely seek full operational control of the remaining banking institutions.

- **The corporate sector is similarly in need of fresh external capital and governance reform.** The proposed new holding for state assets should be adequately empowered to implement privatisation of all non-strategic assets and the withdrawal of indirect state ownership. Reducing the state's involvement in the economy would be appropriate given Slovenia's state of development.

- **Securing fiscal stability is a key priority.** In light of long-term fiscal challenges due to rapid ageing and the renewed recession, further fiscal reforms, including adjustments to the pension system, will be needed.

MACROECONOMIC PERFORMANCE

Slovenia was the first new EU member to enter a double-dip recession. Initially, the country experienced a weak recovery after the deep recession in 2009, though in 2011 GDP again contracted throughout the year. In mid-2012 all indicators of economic activity remained well below pre-crisis levels, for instance, fixed investment was over 40 per cent below the levels in 2008. Private and government consumption have remained stagnant. Competitiveness indicators also remain poor. In the central Europe region, Slovenia shows the highest relative increase in real unit labour costs, in contrast to most new EU member states which have shown declines. Following a temporary acceleration in exports and industrial production between mid-2010 and late-2011, export growth has again been very slow since early 2012, in particular given weak demand in Italy to where 12 per cent of exports are directed. Nevertheless, given the depressed domestic demand, over the past three years Slovenia has shown no more than modest trade deficits, and overall roughly balanced current accounts.

This absence of a meaningful recovery has been reflected in mounting fiscal deficits. The general government deficit has been above 6 per cent of GDP in each of the past three years, leading to a rapid deterioration in public debt levels to about 50 per cent of GDP in mid-2012, from only 22 per cent in 2008. Soon after taking office in April 2012, the new government therefore adopted a comprehensive restructuring of public expenditure to meet a deficit target that is mandated at 3 per cent of GDP for 2013 under the EU Excessive Deficit Procedure. These measures could be adopted after the government had reached some reconciliation with the unions, preventing a recurrence of the large-scale strikes that had disrupted the public sector earlier in the year. Nevertheless, the small share of public debt that is publicly traded showed a significant deterioration in yield spreads early in the year. The public sector has very limited refinancing requirements until a Eurobond falls due in 2013. A fiscal rule, limiting public expenditures as the country approaches critical debt levels, has not yet been adopted.

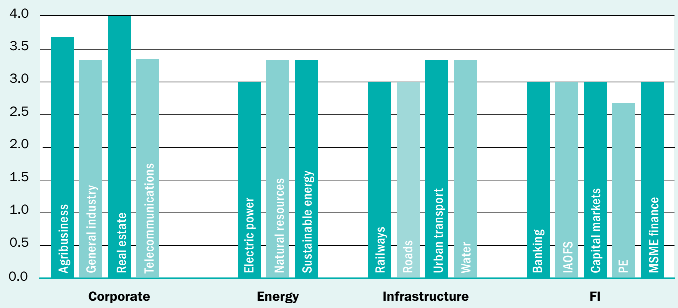
Prospects for a return to growth are dim given weak trading partner growth, further credit contraction and continued fiscal consolidation. Slovenia remains exposed to weaknesses in other countries of the eurozone periphery, especially the recession in Italy, Slovenia's largest trading partner. With no impetus in sight to domestic demand, and given the stagnation in the rest of the eurozone and fiscal consolidation under the new government, a consensus has developed that there will be a continued GDP contraction in 2012.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-7.8	1.2	0.6	-2.5
Inflation (end-year)	2.1	2.2	2.1	3.0
Government balance/GDP	-6.1	-6.0	-6.4	-4.0
Current account balance/GDP	-0.7	-0.6	0.0	1.0
Net FDI (in million US$)	-915	571	888	659
External debt/GDP	133.5	134.6	131.3	na
Gross reserves/GDP	2.0	2.0	1.7	na
Credit to private sector/GDP	82.2	84.6	81.7	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Progress with structural reforms has been slow over the past year. Weak support for the previous coalition government undermined three reform bills that were voted down in referenda last year, including a crucial pension reforms bill. This stalemate and the ensuing fiscal risks resulted in a number of downgrades in sovereign credit ratings (which all envisage further deterioration in risks). Following early elections in December 2011, a five-party coalition came to office in February 2012 and announced a swift reform to pension entitlements, a number of immediate expenditure cuts, and the privatisation of key banks (while retaining control through minority ownership stakes). Success will depend on preventing fresh referenda from blocking such initiatives, as has been the case repeatedly. An agreement with the trade unions on austerity measures in the public sector, reached in May 2012, is somewhat encouraging in this respect.

The financial sector remains essentially unreformed, with state banks in an increasingly entrenched position. Economic weakness has further weighed on the quality of bank assets, with non-performing loans rising to 13.1 per cent of total loans in July 2012, according to the central bank. Rating agency assessments, based on independent loan reclassifications, suggest an even higher level of loan delinquencies. Unlike other central European economies, the capital coverage of the banking sector overall is relatively low at only 9 per cent of core tier one capital, underlining the need to raise capital amid a second recession, vulnerable collateral values, and ongoing losses within the sector. Funding levels nevertheless remain secure, and the banking system as a whole has drawn down about €2.5 billion through the long-term refinancing operations (LTROs) with the ECB. Overall, the sector remains a drag on economic activity with the corporate sector repaying outstanding credit of about 3 per cent of GDP in the year to mid-2012.

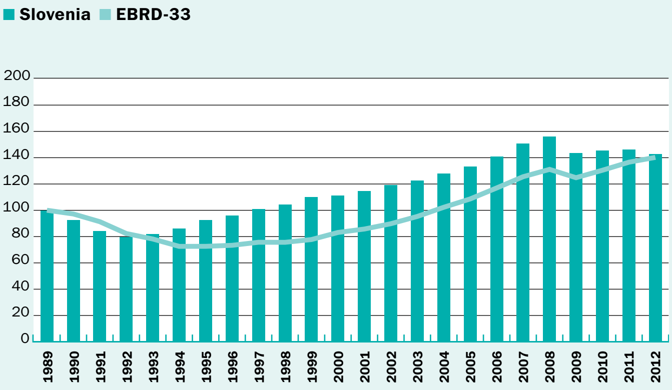
Slovenia's largest and state-owned bank, Nova Ljubljanska Banka (NLB), remains in need of an adequate and durable capital basis. As the bank failed to meet capital standards in the EU-wide stress tests in October 2011 a further capital injection was made by the state. The most significant foreign investor in Slovenia's banking sector, Belgian bank KBC, will have to withdraw from its participation in NLB by year end, and did not participate in this capital increase. The government currently contemplates separating out poorly performing assets to make the bank more attractive for possible outside investors.

The enterprise sector continues to suffer from a high level of direct and indirect government involvement, excessive leverage and generally poor corporate governance standards. In advance of accession to the OECD in July 2010 Slovenia adopted legislation to improve the corporate governance framework for state-owned enterprises, minority shareholder protection and securities regulation though an independent agency for state-assets is now being closed down. The government has introduced in parliament a plan for a more comprehensive state holding agency, though there are concerns over the independence of its supervisory board, and to include delinquent banking sector assets.

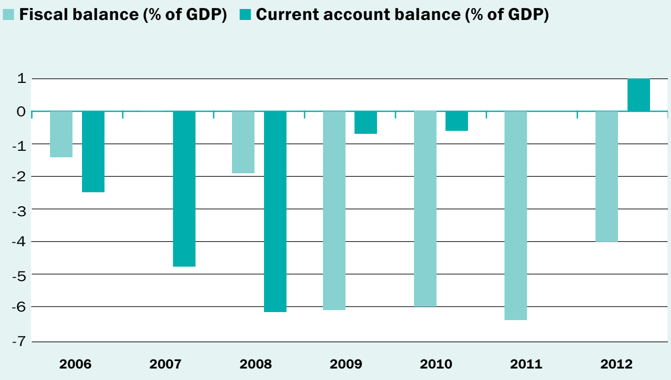
Given a rapidly ageing population over the coming years, Slovenia will experience a rapid increase in its age-related expenditures, in particular pension payments, a factor that already weighs on sovereign credit assessments. According to projections by the European Commission, the old-age dependency ratio is expected to double within the next 30 years. The new government introduced to parliament some limited changes to the state insurance system in May 2012, though a more comprehensive reform the retirement age and of the privileges of specific groups is still outstanding. Low labour force participation rates also continue to weigh on the sustainability of finances. The government has announced plans to establish a three-pillar pension system which would require reforming the holdings of the state pension company, KAD.

Slovenia's access to inward direct investment remains limited. Since the crisis began, inward flows have almost halved. Restrictive labour practices, regulatory impediments, and pervasive direct and indirect participations with no prospect of a comprehensive privatisation strategy continue to discourage greater access by foreign investors. The bid by a Croatian investor for Slovenia's largest retail chain, Mercator, was put on hold, given resistance by its largest shareholder, NLB.

Real GDP (1989 = 100)



Fiscal balance and current account balance



TAJIKISTAN

HIGHLIGHTS OF THE PAST YEAR

- **Economic growth has remained stronger than expected.** Official estimates suggest that gross domestic product (GDP) growth reached 7.4 per cent in 2011 and continued at the same rate during the first half of 2012, driven mainly by services, construction and agriculture. The services sector was boosted by robust growth of remittance inflows, mostly from Russia.

- **The authorities adopted a comprehensive restructuring plan for Barqi Tojik, the integrated national power sector company.** The plan covers the period 2011-18 and envisages operational and financial restructuring of the company, divestment of its non-core assets, as well as unbundling and privatisation during later stages.

- **Vulnerabilities in the banking sector remain.** Banking sector liquidity has improved due to significant government and central bank support, but heavy state interference through directed lending and other non-market practices persists.

KEY PRIORITIES FOR 2013

- **Confidence and transparency in the banking system need to be increased.** Capital and liquidity injections should be conducted in a transparent way and any support to the real sector should be done through the government budget rather than through state-directed lending. Banking supervision should be strengthened further as well.

- **Further steps are necessary to complete the Agrarian Reform and the implementation of the new Land Code.** In particular, land rights will need to become transferable, which would increase access to finance for farmers.

- **Energy reform needs to continue.** This will help to ensure long-term sustainability of the power supply and gradual improvement in operational efficiency in generation, transmission and distribution.

MACROECONOMIC PERFORMANCE

GDP growth has remained stronger than expected at 7.4 per cent in both 2011 and the first half of 2012. The data suggest that this strong economic performance was driven to an important extent by increasing aluminium prices in 2011, continued high remittance growth and the largest-ever cotton harvest. The fiscal deficit was better than expected at around 2.1 per cent of GDP in 2011, while the current account moved from a slight deficit in 2010 to a surplus in 2011 of 0.6 per cent of GDP.

Inflation fell to less than five per cent year-on-year by mid-2012 following the global trend of decreasing commodity prices. However, given the recent development in the world wheat market and internal energy price hikes, inflation could rise again in the second half of 2012.

The situation in the banking sector has continued to deteriorate. State-led lending practices continued during 2011 and 2012 and overdue loans remained relatively high at around 15 per cent of total loans. Capitalisation and liquidity have improved due to significant government and central bank injections of capital and liquidity, but some banks remain undercapitalised and largely dependent on the liquidity loans from the NBT. At the beginning of 2012 the interest rate for government securities issued to compensate for the write-off of directed cotton sector loans was increased. However it remains below the refinancing rate of the NBT and the average inflation rate in the past two years.

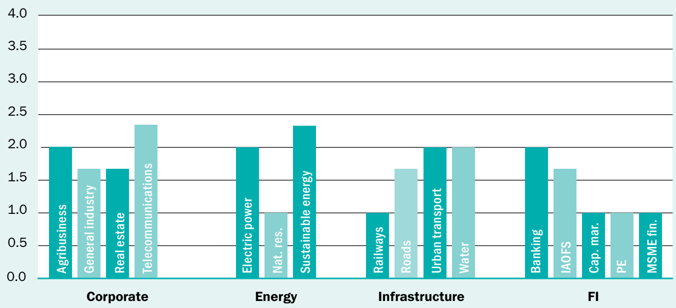
Economic growth is expected to slow down in the short term. Eurozone developments and their impact on Russia are bound to affect Tajikistan through lower exports and remittance inflows. Moreover, recent measures to reduce railway traffic through Uzbekistan will also negatively affect trade and economic activity in Tajikistan.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	3.9	6.5	7.4	6.0
Inflation (end-year)	5.0	9.8	9.3	9.5
Government balance/GDP	-5.2	-3.0	-2.1	-2.9
Current account balance/GDP	-5.9	-0.3	0.6	-4.0
Net FDI (in million US$)	16	16	11	160
External debt/GDP	51.7	50.5	48.1	na
Gross reserves/GDP	3.4	5.8	4.6	na
Credit to private sector/GDP	25.0	23.6	13.7	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Progress with agricultural sector reform has been slow. Several initiatives are ongoing but little progress has been made with none brought to completion. The sector employs around 70 per cent of the population and remains heavily controlled by the state. Development of the sector is held back by the limited access to finance, insufficient protection of property rights and the lack of the necessary infrastructure for non-cotton agriculture. The new Land Code was adopted on 19 July 2012 and the working plan on the agrarian reform process has been adopted.

There have been positive reform developments in the energy sector. The comprehensive restructuring plan of the Barqi Tojik, the integrated national power sector company, was adopted in August 2011. The plan covers the period 2011-18 and envisages operational and financial restructuring of the company, divestment of its non-core assets, unbundling and, potentially, privatisation towards the end of the period. Four working groups have been created to support implementation of the plan. Tajiktransgas's restructuring has been underway since 2009, with the public unitary enterprise Tajikgas transformed into a joint stock company and its functions divided into transportation and distribution. The privatisation of the company is planned for late 2012.

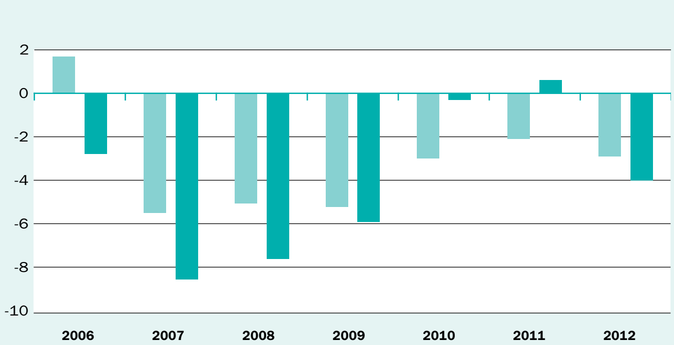
The business environment remains weak but important improvements are underway. In the 2012 World Bank *Doing Business* Report, Tajikistan's ease of doing business ranking improved slightly from 152th to 147th position. Major improvements were made in the area of starting a business where the country went up by 67 positions. This follows a decision in 2011 to allow entrepreneurs to pay in their capital up to one year after the start of operations, thereby eliminating the requirements related to opening a bank account. Tajikistan has also acceded to the Convention on Recognition and Enforcement of Foreign Arbitral Awards in May 2012. This is a major step forward in improving the investment image. The new tax code draft has been prepared and is a significant improvement over the current version, but the authorities are concerned over potential revenue loss. The revised tax code draft is to be submitted to the parliament in September 2012.

Banking sector vulnerabilities remain significant. There have been improvements in accounting and provisioning under the Financial Sector Stability Action Plan (FSSAP) but profitability remains low with high non-performing loans ratio. State directed lending practices have further exposed banks to risks related to poor credit quality.

Tajikistan made first steps towards joining the Extractive Industries Transparency Initiative (EITI). The first meeting of the working group for introduction of the EITI in Tajikistan took place in Dushanbe in October 2011. The initiative is aimed at strengthening transparency, good governance and accountability in extractive industries.

Real GDP (1989 = 100)

Fiscal balance and current account balance



TUNISIA

HIGHLIGHTS OF THE PAST YEAR

- **The macroeconomic situation is particularly precarious.** GDP contracted by an estimated 1.5 per cent and unemployment jumped to over 18 per cent in 2011, amid rising twin fiscal and current account deficits.

- **The outlook for the economy hinges on the political transition and the external environment.** Recent political developments have had adverse effects on confidence, and the eurozone's persistent weakness continues to weigh on growth.

- **Despite earlier reforms, a level playing field has not been established in many sectors, and steps to improve the business environment have not yet been taken.** Unemployment has continued to rise over the past year, driven by excessive labour market regulations and a significant mismatch of skills.

KEY PRIORITIES FOR 2013

- **Addressing the systemic risks in the financial sector should be a top priority.** Major balance sheet restructuring is needed as non-performing loans (NPLs) continue to rise. The poor state of the banking sector limits small and medium-sized enterprises' (SMEs) access to credit and the broader capital market is underdeveloped.

- **The infrastructure and transport sectors lack investment and require regulatory reforms.** A strategy is needed to disentangle operational and regulatory responsibilities in order to attract private capital into these sectors. Developing transparent PPP solutions to attract private sector participation will be important for structural policy as well as fiscal sustainability reasons.

- **Tunisia's most pressing economic issue is its persistently high level of unemployment, especially among the educated youth and women.** Excessive labour market regulations and a significant mismatch of skills are some of the core issues in need of attention. Shifting towards a more inclusive growth model could also help reduce the stubbornly high and rising unemployment rate.

MACROECONOMIC PERFORMANCE

The economy continues to face substantial challenges, brought about by weak external conditions and an increasingly uncertain domestic political environment. The economy contracted by 1.5 per cent in 2011, despite a slight recovery following the Arab uprising and a boost associated with the end of the Libya conflict. Tourism revenues fell by 33 per cent in 2011, along with a fall by 26 per cent of FDI. The economy registered a sharp slow-down in the second quarter of 2012, with GDP growth of 2.7 per cent year-on-year, owing to slumping manufacturing and industrial activities. On the positive side, agriculture and the services sectors remained resilient. In particular, tourism has continued to recover, posting its second consecutive year-on-year growth in five quarters. The economy is expected to grow only moderately in 2012, due to overall weakness in both domestic and foreign demand, and this will delay reducing the country's high unemployment, which jumped to 18.9 per cent in 2011, up from 13 per cent in 2010.

The external position weakened markedly. The current account deficit widened to 7.4 per cent of GDP in 2011 as tourism receipts fell by 33 per cent and foreign direct investment inflows declined by 26 per cent. The increase in the current account deficit continued in the first half of 2012, on the back of faltering exports and a high energy import bill. On the capital account side, FDI inflows have started to recover, but remain low by historical standards. Despite robust international financial support, Tunisia has not managed to fully fund its external financing gap. As a result, gross central bank reserves declined to a critical level of US$ 6.9 billion in August 2012 (equivalent to just 2.5 months of imports) from US$ 9.5 billion at end-2010.

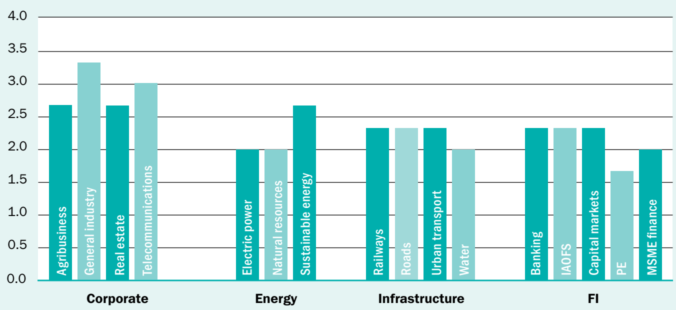
The fiscal deficit deteriorated throughout the year. It widened to 3.8 per cent of GDP 2011 from 1.1 per cent in 2010 due to increases in wages and subsidies, especially for energy. This has led to funding pressures and limits room for further fiscal stimulus. Estimates for Tunisia's financing needs in 2012 range from US$ 5 billion to US$ 6 billion. So far, the government has been able to tap into both domestic and foreign sources to fund the fiscal deficit. In 2011, the country received US$ 1.3 billion (including two US$ 500 million budget support loans from AfDB and World Bank), in addition to a US$ 500 million loan from Qatar in April 2012. In July 2012 Tunisia issued a seven-year, US$ 485 million US government-guaranteed bond at 1.69 per cent, marking the country's entry back into capital markets for the first time since 2007.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	3.2	3.2	-1.5	2.4
Inflation (end-year)	3.7	4.5	3.5	5.3
Government balance/GDP	-3.0	-1.1	-3.8	-6.6
Current account balance/GDP	-1.8	-4.7	-7.4	-7.5
Net FDI (in million US$)	1688	1520	1143	1050
External debt/GDP	49.5	49.7	51.4	na
Gross reserves/GDP	22.8	20.5	16.1	na
Credit to private sector/GDP	9.9	19.3	13.5	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

The most pronounced threat to the economy stems from an uncertain political transition coupled with the rising twin deficits. There is a risk that the current political set-up, which rests on a fragile coalition of three parties, could begin to unravel if differences remain acute. These differences have already led to the dismissal of the central bank governor and the resignation of the finance minister, which have had adverse impacts on markets: in July 2012, Moody's downgraded Tunisia's sovereign debt rating to Baa3 reflecting these developments.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

A number of structural reforms are needed to complement those that were undertaken in the first half of the last decade. Coupled with prudent macroeconomic policies, earlier reforms brought about higher growth rates and a more diversified economy, but failed to generate sufficient jobs to resolve the structurally high unemployment rates, especially among the youth and the educated. In addition, the privatisation agenda remains incomplete, especially in the financial sector, where around a third of banking assets are under majority state ownership. In this regard, the Government Action Plan for 2012 includes a commitment by the government to divest some of its assets. Reforms are needed to close the gap between the liberalised, FDI-attracting, export-oriented "offshore" economy and a backward "onshore" economy with no similar tax incentives and continued government intervention. More generally, improvements to the business environment can be achieved by narrowing the gap that exists between *de jure* institutional frameworks and their implementation and effectiveness.

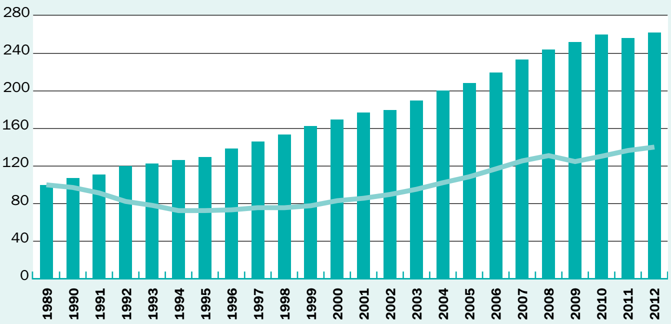
A number of reforms need to be enacted in the financial sector, which is plagued by solvency and liquidity issues. High non-performing loans (NPLs) indicate a weak balance particularly in the state-owned banks that have been involved in directed lending to connected business and over-exposed to a few sectors. Major restructuring of these banks is needed. These banking system weaknesses have partly crowded out lending to SMEs. Strengthening the supporting institutional framework for lending to SMEs will be required to enhance their access to finance. Information on borrowers is limited and there are major information gaps in the existing credit registry, especially with regards to the smaller loans. There is no unified collateral agency, and contract enforcement is currently a lengthy and costly process.

Additional reforms are needed in the power and energy sectors. Although there have been efforts to encourage private sector participation in power generation, it still only accounts for around a fifth of total generation. The power sector in Tunisia is dominated by the state with natural monopoly elements, especially in transmission and distribution. While account unbundling has taken place within the main state-owned company, further steps are still needed in the form of legal, management, and ownership separation. On the regulatory side, current laws need to be supplemented by additional reforms to address the lack of an independent energy regulator and the single buyer wholesale model that is non-conducive to competition and heavy subsidies for both fuel and financing. Lastly, support schemes to promote the implementation of sustainable energy measures have been introduced through direct financial incentives and tax incentives.

Reforms in infrastructure, especially in the municipal and transport sectors, have had mixed success, and there is only limited decentralisation and decision-making at the local level. Further unbundling, tariff reform, and regulatory independence are key reform challenges. Laws have not yet been developed to ensure the separation of regulatory and operational responsibility of municipalities, negatively affecting the efficiency of water and wastewater services as well as urban transport management. In a sector with an ineffective tariff system, in which service fees cover only half the operating costs, and a high dependence on subsidies, developing transparent public-private partnership (PPP) solutions to attract private sector participation is an important pillar of structural reform policy. In this regard, the legal framework based on the Concessions Law is adequate for PPP formulations, but does not provide a formal platform for private sector engagement, and the more specific PPP Law currently being drafted could contribute to lower negotiation times and greater cost effectiveness. This can be modelled after the success of the Digitial Economy Initiative, in which a PPP framework was established to channel digital economy-related PPP projects regarding the upgrade of the country's ICT sector.

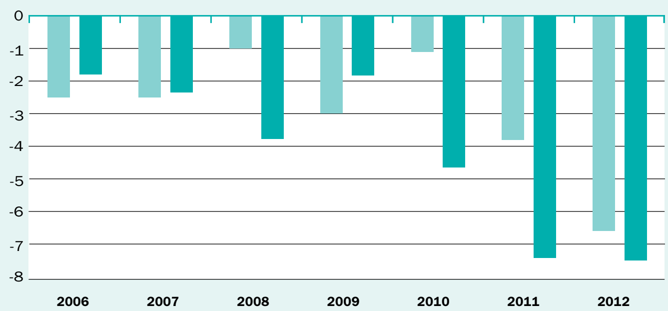
Real GDP (1989 = 100)

■ Tunisia ■ EBRD-33



Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



TURKEY

HIGHLIGHTS OF THE PAST YEAR

- **Economic growth is decelerating.** Growth rates have come down from 8.5 per cent in 2011 to 2.9 per cent in the second quarter of 2012, driven by substantially declining domestic demand, a key driver of growth, and spill-overs from the eurozone.

- **Structural reforms in 2011-12 were targeted on helping to boost domestic savings through supporting the private pension system.** A combination of lower taxes for longer-term bank deposits and state contributions up to US$ 125 per month to the individual's private pension account were introduced in 2012.

- **Efforts to tackle unemployment and improve labour market efficiency are under way.** The government has started to implement a number of measures to reform existing labour market regulations, including reduction in severance payments and more flexible working hours.

KEY PRIORITIES FOR 2013

- **Municipal financing could attract more private sector investment by decentralisation and further commercialisation.** Corporatisation, coupled with good financial performance, is an important prerequisite to attract private sector investors. In addition, expansion of public-private partnership (PPP) structures can complement fiscal decentralisation which would in turn enhance local sustainability, especially in the least developed regions.

- **Further capital market development to ensure a stable long-term local currency source.** The corporate bond market is still small and asset-backed or covered bond offerings have been limited, but these could provide a viable source for long-term capital – in particular, in light of exposure to a deteriorating eurozone.

- **Further reforms in the natural resources sector are needed.** Progress should be made in unbundling, corporatising the state-owned gas company and establishing transparent regulatory mechanisms, including setting oil and gas transport tariffs as well as third party storage access.

MACROECONOMIC PERFORMANCE

After a strong growth performance in 2010 and 2011, the Turkish economy has slowed down significantly in 2012. Real GDP grew by only 3.3 per cent year-on-year in the first quarter of 2012, down from 5.2 per cent in the fourth quarter of 2011, and continued to slow in the second quarter, reaching 2.9 per cent year-on-year, its slowest pace since 2009. The key macroeconomic vulnerability of the Turkish economy remains the current account deficit, which stood at 10 per cent in 2011, but has gradually narrowed throughout 2012, with the 12-month rolling deficit reaching 7.9 per cent of GDP in July. To tackle the trade deficit the government raised indirect taxes in several categories of imported consumer durables (mobile phones and some high-end cars) and introduced wide-ranging investment incentives aimed at import substitution in areas such as mining, chemicals and defence electronics that contribute to the trade deficit.

Inflation is only slowly declining from its double digit heights of end-2011. The central bank cut its lending rate for the first time in seven months in September 2012. It also increased banks' reserve option coefficients in order to manage currency pressures associated with potential capital inflows brought about by quantitative easing in the US and the ECB's bond purchase programme. In an effort to help tame domestic consumption, the central bank succeeded in guiding bank credit growth to 19 per cent in August down from as high as 40 per cent in 2010. Moderating food, energy and import prices during the first half of the year has led to a lowering of inflation, which has fallen in recent months to 8.8 per cent year-on-year in August, down from 11.1 per cent in April. The central bank has maintained its inflation target of 5.5 per cent by end-2012, but has revised its end-year inflation forecast in July from 6.5 per cent to 6.2 per cent. Meanwhile, the general government deficit has fallen by more than half to 1.4 per cent of GDP in 2011 from 3.6 per cent in 2010.

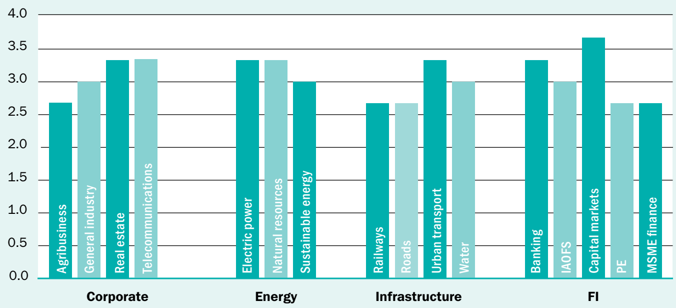
The economy is likely to continue to grow but the possibility of a significant drop in growth remains. While the current account deficit has begun to fall, the pace of re-balancing has been moderate in the first half of the year, and there are risks that it will lose momentum in the second half as domestic demand picks up and the lira appreciates. However, the government has also shown its readiness to act promptly if needed to smooth the possible adverse impact of the new global financial turmoil and economic slow-down by the means of monetary and fiscal policies.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-4.8	9.2	8.5	3.0
Inflation (end-year)	6.3	8.6	6.5	9.1
Government balance/GDP	-5.6	-3.7	-1.4	-2.6
Current account balance/GDP	-2.2	-6.4	-9.9	-7.5
Net FDI (in million US$)	6858	7574	13440	11300
External debt/GDP	43.7	39.4	38.5	na
Gross reserves/GDP	11.2	10.8	9.9	na
Credit to private sector/GDP	13.4	40.4	32.8	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

The government is supporting the private pension system with new incentives. The essence of the new law adopted in June 2012 is a combination of tax incentives, such as a zero tax withholding tax rate for equity mutual funds (versus a 10 per cent tax for all other mutual funds), a lower withholding tax rate for longer-term bank deposits and, most crucially, direct government contribution to the private pension system. The government will start matching 25 per cent of individual contributions, up to a limit that is based on 25 per cent of the minimum wage (currently about US$ 125 per month, helping reduce incentives for early retirement). An important difference to other pension systems is that Turkey's private pension system is a voluntary defined–contribution system with currently only 2.8 million members, and the majority of Turkish citizens still relying on the government-funded social security PAYG (pay as you go) system. The new incentive package is expected to increase pension fund growth, supporting the Turkish government's overall efforts to help develop local capital markets. However, the reform package does not include any measures towards making overall asset management more competitive.

Progress has been made in developing infrastructure PPPs. The government has identified a number of road sections to be developed on a PPP basis and BOT contracts for both the Eurasia Tunnel and the Gebze-Izmir Road have been tendered, with financing packages currently under negotiation. Also a number of potential PPPs in the railways sector await tendering, including a high speed railway line between Istanbul and Ankara.

Reforms on improving labour market competitiveness are ongoing. As part of a reform package under the "National Employment Strategy (NES)" the government has started to implement changes to mandatory severance pay, flexible working hours as well as providing for different fixed-term contract options. In April 2012 a new incentive scheme was introduced to minimise the cost of labour, whereby new employees hired in the least advanced eastern regions are exempt from employer social contributions and from employee contributions and income taxes.

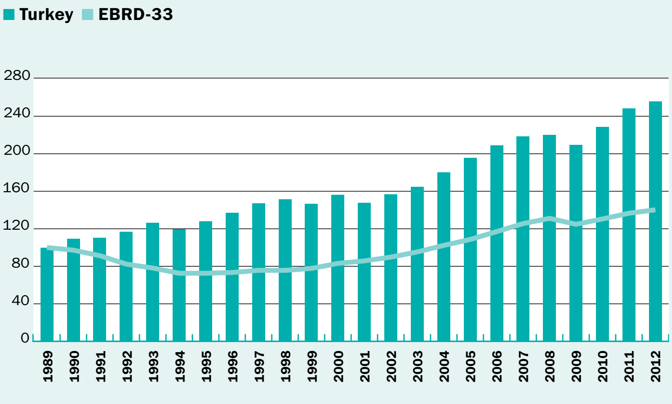
Some reforms in the financial sector have been adopted to strengthen the robustness of the system and contain expanding credit to the economy. In mid-2011, the Financial Stability Committee (FSC) was established to foster the necessary cooperation between monetary and financial market authorities to contain credit booms fuelled by capital inflows. Members of the committee include the central bank, the Treasury, the Banking Regulation and Supervision Authority (BRSA), the Saving and Insurance Deposit Fund and the Capital Market Board.

The FSC is also tasked with monitoring and containing systemic risk to the financial sector. Additional measures to reign in credit expansion were undertaken in June 2011, in which the BRSA imposed loan-to-value ceilings on commercial, housing and real-estate loans, and raised provisioning requirements on loans. As a result, growth in credit to the private sector fell throughout the year, from 41 per cent year-on-year in June 2011 to 21 per cent in June 2012. Finally, Turkey's financial sector switched to the Basel II regime in July 2012, encouraging improvements in risk management and mitigation.

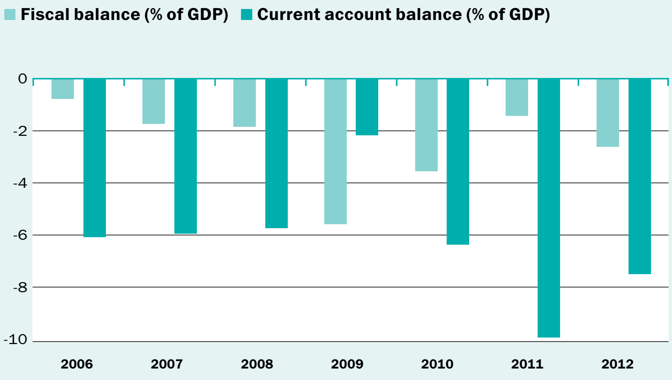
An incentive package has been adopted to spur domestic and foreign investments. Having come into effect in June 2012, the new incentives complement the existing incentive structure by encouraging additional capacity in the tradeable sector, with a special emphasis on the least developed provinces. Priority sectors have been identified to receive stronger investment incentives in tourism, mining, rail and maritime transport, and pharmaceuticals. Other incentives target sectors that reduce Turkey's import dependence.

Agriculture reforms have been accelerated. After identifying around 30 agricultural areas in 2010 designated to receive differentiated support, the government has stepped up its commitments in 2012. Area-based payments are being disbursed, especially for irrigation investments, and land consolidation efforts have been accelerated, particularly in regions that have been defined as top priority, such as the south-eastern and eastern parts of the country. Irrigation projects are being designed to promote efficient use of water.

Real GDP (1989 = 100)



Fiscal balance and current account balance



TURKMENISTAN

HIGHLIGHTS OF THE PAST YEAR

- **Turkmenistan's economy was among the fastest growing economies in the world in 2011.** GDP grew by 14.7 per cent in 2011, driven by increasing hydrocarbon production and surging public infrastructure spending. Increased gas exports to China as well as growing exports of oil have supported the strong external balance.

- **Prices for food and other products and services remain regulated by the state.** The threefold increase in prices for bread in July 2012 and looser controls over meat prices were a step in the direction of price liberalisation, but constituted an unexpected negative shock for consumers.

- **Some progress has been made in the area of structural reform.** State regulation in the agriculture sector has decreased and IFRS accounting standards have been introduced for banks. A number of programmes have been developed in other areas but progress with implementation has been slow.

KEY PRIORITIES FOR 2013

- **The government should speed up progress with its stated goals to increase the share of the private sector and reduce government intervention in the economy.** A number of sectors remain distorted by production targets and subsidised inputs that hamper their productivity and the effective use of resources. The remaining controls on prices, interest rates and the exchange rate should be gradually phased out and production targets should be abolished.

- **The business climate needs to be further improved.** Participating in various cross-country surveys would help the authorities to identify major obstacles to businesses and develop policies to improve the business environment and investment climate.

- **Further exchange rate regime liberalisation would boost trade and financial intermediation.** The new law on foreign exchange regulations is an important step forward, as it allows for advance payments on imports, but faster progress needs to be made with implementing the regulations.

MACROECONOMIC PERFORMANCE

Economic growth in Turkmenistan has been among the fastest in the EBRD region and reached 14.7 per cent in 2011. This was mainly driven by good performance in the hydrocarbon sector and by state-supported infrastructure spending. Inflation remained moderate compared with other countries in the region. However, in July 2012 the price of bread and meat increased, with the price of the former soaring by three times. Further price increases are expected throughout 2012, likely related to lower than expected (targeted) wheat production. Moreover the announced 10 per cent increase in government wages and 15 per cent in pensions from 2013 may lead to a spike in inflation.

Gas exports have become more diversified with increased exports to China and Iran. In May 2012 the governments of Turkmenistan and Afghanistan signed a long-awaited Memorandum of Understanding (MoU) on long-term gas cooperation, while the state gas company Turkmengaz simultaneously signed sales agreements with its Indian and Pakistani counterparts. There are, however, a number of concerns including financial support to the pipeline construction through the territory of Afghanistan due to security reasons. Recently China offered to build another pipeline that would go through Afghanistan to China, offering investment for building the infrastructure.

The country's vast hydrocarbon revenues have helped create twin surpluses. After having been in deficit for two years, the current account balance turned into a surplus of around two per cent of GDP in 2011, driven by higher oil and cotton exports and lower FDI-related imports. At the same time, the fiscal balance was estimated to have reached a surplus of 3.6 per cent of GDP in 2011.

Credit growth reached about 30 per cent in 2011, mostly due to state-supported lending programmes financed by stabilisation fund resources. While most banking system lending has continued to be channelled to state-owned enterprises, directed lending by the central bank has decreased and credit to the private sector has started to increase, in part due to state-subsidised lending programmes for small and medium enterprises and agriculture.

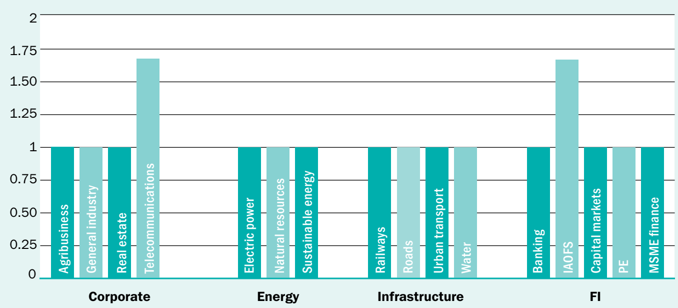
The growth outlook remains positive with balanced risks. In the short term, GDP growth will continue to be driven by hydrocarbon production and further diversification of export routes. The economy is expected to continue to grow at a double-digit rate in 2012. However, heavy dependence on hydrocarbon production and exports and excessive state regulation and intervention impedes progress with market-oriented reforms and will weigh negatively on the outlook in the longer term.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	6.1	9.2	14.7	10
Inflation (end-year)	0.1	4.8	5.6	6.5
Government balance/GDP	7.0	2.0	3.6	6.8
Current account balance/GDP	-14.7	-10.6	2.0	0.0
Net FDI (in million US$)	4553	3631	3399	3159
External debt/GDP	2.4	10.6	7.3	na
Gross reserves/GDP	na	na	na	na
Credit to private sector/GDP	1.4	2.0	2.5	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Turkmenistan remains among the least reformed of all transition countries, but the authorities continue to express commitment to gradual privatisation and private sector development. Although small-scale privatisation has proceeded since the start of transition, an estimated 75 per cent of the national economy remains under the control of the state and large-scale privatisation still needs to be started in a significant way. However, the authorities have begun drafting a privatisation law. They have also stated their intention to privatise state banks between 2016 and 2020 and they continue to express their commitment to their stated goal of increasing the share of the private sector to 70 per cent of non-hydrocarbon GDP by 2020.

Some progress was made with strengthening the banking sector, but state involvement remains prevalent. As part of the government's programme to develop the banking system during 2010-30, various new laws have been adopted, including a Law on Accounting and Financial Reporting Standards (July 2010), new laws on the CBT and on Lending Institutions and Banking (March 2011) and a Law on Microfinance (April 2011). The government has a banking sector development programme for 2010-30, which also envisages the privatisation of all state banks between 2016-20. Foreign shareholders do not appear to be excluded. In addition to various laws adopted in 2010 and the first half of 2011, two important reforms that will help this privatisation process are: (i) the introduction of IFRS reporting standards in all banks as of January 2012, and (ii) the transfer of all state-directed loans financed by the Stabilisation Fund (constituting an estimated 70-80 per cent of all banking assets) to the newly created State Development Bank as of November 2011. This has helped to clean banks' balance sheets and could increase competition between banks for private sector projects.

There are plans to develop non-bank financial institutions and securities markets. The government has adopted a programme to develop private insurance companies (currently there is only one insurance company, which is state-owned) and is drafting a new insurance law that is expected to be adopted in 2012. The authorities also aim to establish a notional defined-contribution pension fund in 2012 and the Ministry of Social Affairs is working with the UNDP on pension reform. In addition, efforts are under way to establish a legal framework to support the government's programme and action plan for securities market development for 2012-16 that was approved in November 2011. The World Bank is offering technical assistance in this area.

Plans to increase private sector involvement in the telecommunications sector have been announced. In 2011 the authorities announced plans to privatise the state-owned mobile operator Altyn Asyr and to create three more private mobile companies with foreign participation under condition of 50 per cent ownership by Turkmenistan. There has, however, been no progress in this area. MTS, the Russian mobile operator, whose license had been suspended in December 2010, has been in negotiations with the authorities and is expected to resume its work in August 2012.

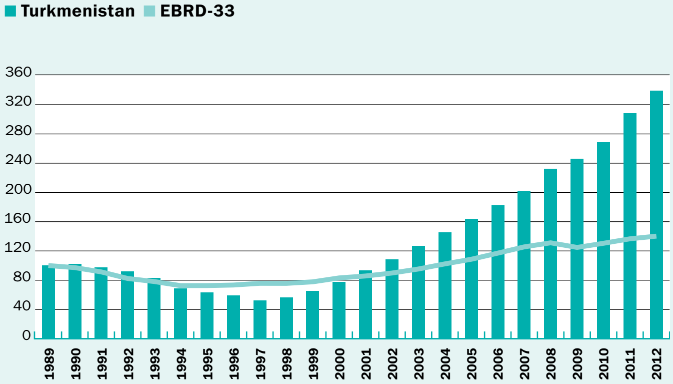
Negotiations on the Turkmenistan – Afghanistan – Pakistan – India (TAPI) pipeline project have progressed. Turkmenistan has continued its export-diversification policies and has signed a number of important agreements for construction of the TAPI pipeline. The challenge now is to find a commercial champion for the project.

State regulation has decreased in the agricultural sectors. In mid-2012 the government cancelled the flour rationing that had been introduced by the previous President in the early 2000s as part of a social protection package. At the same time, the maximum price of bread increased threefold and controls over the meat price were eased, also leading to an increase in meat prices.

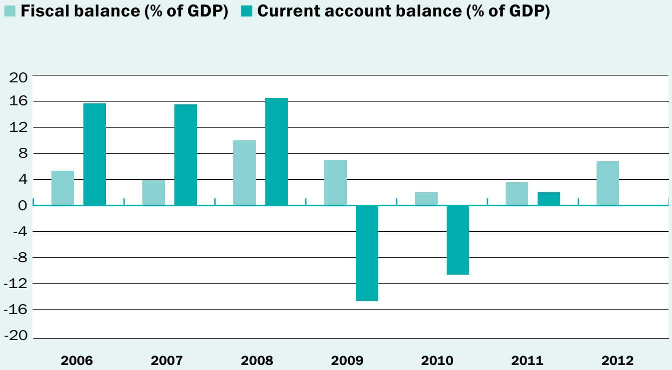
Some progress was made in the area of foreign exchange and trade restrictions. In particular, local private small and medium-sized enterprises (SMEs) can now have foreign currency accounts to conduct import/export operations without needing a license or permission from the cabinet of ministers. Moreover, under the new foreign exchange law adopted in October 2011, residents will now be allowed to provide trade credit to non-residents (that is, local firms will be able to make advance payments for imports and deferred payments for exports). In addition, it allows banks to conduct foreign exchange transactions with non-public customers without seeking prior approval from the central bank. These are long-awaited reforms, but they have not yet become effective as the relevant central bank regulations and other enabling legislation remain to be developed.

The business climate remains weak. The country lags behind other Central Asian countries in terms of reforms. While barriers to entry for new private businesses remain very large, there is evidence that they were reduced somewhat in 2011, including: a reduction in state duties for registration; elimination of the commission needed to register a local company; elimination of the requirement to re-register a company when adding a shareholder; and the distribution of land for project sites to entrepreneurs in late 2011. This was not reflected in any international business environment surveys (such as the 2012 World Bank's *Doing Business* Report), as Turkmenistan is one of the few countries that does not yet participate in them.

Real GDP (1989 = 100)



Fiscal balance and current account balance



UKRAINE

HIGHLIGHTS OF THE PAST YEAR

- **The pace of recovery from the crisis has slowed down.** As the global economic environment deteriorated, growth of Ukraine's commodity-based export sectors decelerated. Credit growth has suffered from deleveraging by European banks and tight monetary policy focused on a stable exchange rate.

- **The business environment has deteriorated further, notwithstanding recent administrative reforms.** Illegal corporate raids have increased. Tax administration policies - including delayed VAT refunds, limited ability of companies to deduct investments from corporate tax and advance tax payments - have deterred investors.

- **The authorities made steps to reform the gas sector.** A decision was made to reorganise the national oil and gas company Naftogaz along functional lines into production, transit and distribution units. Licenses to explore shale gas were auctioned to multinational companies, and discussions initiated to widen geographic sources of gas imports.

KEY PRIORITIES FOR 2013

- **Improvement of the country's difficult business environment remains a top priority.** The justice system should be reformed to ensure that procedures for resolution of commercial disputes are fair, and commercial courts should be de-politicised. The government should effectively implement various measures adopted in recent years to improve governance and reduce corruption.

- **The announced reforms of the gas sector should be implemented.** Household gas tariffs should be adjusted towards the import parity levels and implicit energy subsidies should be monitised. Reorganisation of Naftogaz along functional lines should be completed, and individual companies' accounts be made transparent.

- **Post-crisis stabilisation in the financial sector should be completed.** It will be necessary to reverse the unconventional crisis-time policies, such as local currency provisions on foreign currency loans, that exposed banks to currency movements. The National Bank and the government should pursue policies to develop capital markets in local currency.

MACROECONOMIC PERFORMANCE

The pace of economic recovery has slowed down. After expanding quickly through much of 2011, Ukraine's output growth decelerated to 2.5 per cent in the first half of 2012 due to a substantial slow-down in the steel and chemical sectors and machine building, and stagnation of agriculture and construction. More recent data suggest that agriculture and construction have also declined. For much of the year, the contraction of external demand was offset to some extent by buoyant domestic consumption, stimulated by fast growth of public sector wages and social expenditures. The National Bank of Ukraine (NBU) and the government adopted various measures to contain depreciation pressures, which included tightening further the banks' open currency positions, introducing additional administrative requirements on forex purchases by households, issuing domestic dollar, euro and devaluation-protected hryvnia bonds and removing export tariffs on some grains to stimulate exports. The Eurobond issue in July 2012 at a historically high interest rate, the rollover of VTB loans and new credits from China should provide temporary relief. Inflation has decreased from 11.9 per cent year-on-year in June 2011 to a record low of minus 1.2 per cent in June 2012, due to lower global food prices and tight monetary policy. Inflation increased more recently as food prices crept up again.

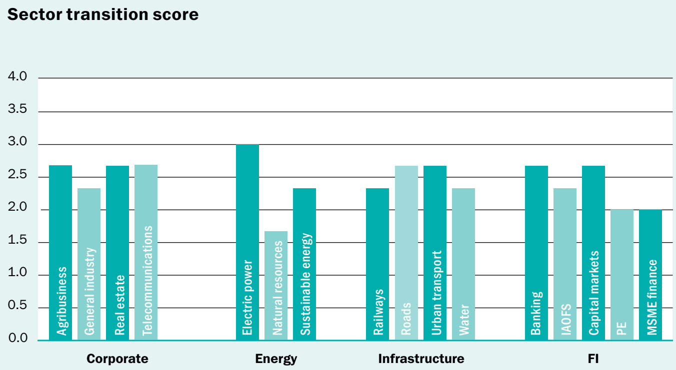
The economy remains vulnerable to external shocks. Although Ukraine's exports are less energy and resource-dependent than those of neighbouring countries, the share of low value-added steel and chemicals remains very high. The stock of external private and public debt is also high, most of it with relatively short maturities and denominated in foreign currencies, and gross external financing requirements remain large. After a large devaluation in 2008, the hryvnia - de facto pegged to the US dollar since then - appreciated in real terms against currencies of its main trading partners, thus erasing most of the competitiveness gains. A further escalation of EU banking and sovereign crises may have a negative effect on the Ukrainian financial sector as it is highly exposed to the euro area.

A return to fast growth experienced before the crisis is unlikely without deep structural reforms. The financial sector is recovering from the crisis and is unlikely to stimulate demand for some time as most banks prefer reducing their balance sheets to further capital injections. The public sector's future ability to provide a countercyclical boost will be limited by the high gross financing needs. Growth is expected to remain subdued, at around three per cent in 2012-13 as spare capacity left after the crisis is exhausted, the external environment remains difficult and bank lending is limited. Over the longer term, acceleration of growth will primarily depend on external demand, but also the authorities' ability to credibly stabilise the financial system, pursue countercyclical macroecnomic policies based on a floating exchange rate, and attract significant domestic and foreign investment.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	-14.8	4.1	5.2	1.0
Inflation (end-year)	12.3	9.1	4.5	4.1
Government balance/GDP	-11.3	-9.9	-5.3	-5.3
Current account balance/GDP	-1.5	-2.2	-5.5	-7.0
Net FDI (in million US$)	4654	5759	7015	7000
External debt/GDP	88.2	86.0	76.4	na
Gross reserves/GDP	22.6	25.3	19.2	na
Credit to private sector/GDP	73.4	62.4	55.9	na

2012 sector transition indicators



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

Progress in improving the country's difficult business environment has been mixed. The National Anti-Corruption Committee, chaired by President Yanukovych, has focused the authorities' attention on the country's long-standing corruption challenge. Although the tax authorities increased the share of VAT refunds paid through the fast-track system, many international companies continue to face long delays. To boost tax revenues, tax legislation was amended in November 2011 to slow the pace of deduction of capital investments from the corporate profit tax. Companies also report frequent requests of advance tax payments by the tax authorities. The procurement legislation was amended to exempt state enterprises from public procurement rules. The increasing incidence of illegal corporate raids has had a negative effect on Ukraine's image as a destination for foreign direct investment.

Development of the financial sector continues to suffer from the legacy of the crisis. The authorities have been working to improve regulatory frameworks for the financial sector, by developing policies to increase transparency of banks' ownership, supervision and resolution frameworks. Although the banking system is reasonably well capitalised, following the mandatory recapitalisations of 2009-10, banks' balance sheets are weakened by a large stock of non-performing and restructured loans, which are 9.2 per cent of the total as of July 2012. The balance sheets of many international banks have long *de facto* positions in hryvnias, reflecting the unconventional crisis-time policy of the National Bank to require provisioning in local currency on foreign currency loans aimed at exchange rate stability. The stock of liquidity provided to the banking system during the crisis remains high, at around five per cent of GDP, and several banks nationalised during the crisis have suffered from governance problems and are yet to be resolved. The country has become a participant in the Vienna 2 Initiative, which aims at improvement of home-host country coordination and managing the process of bank develiveraging.

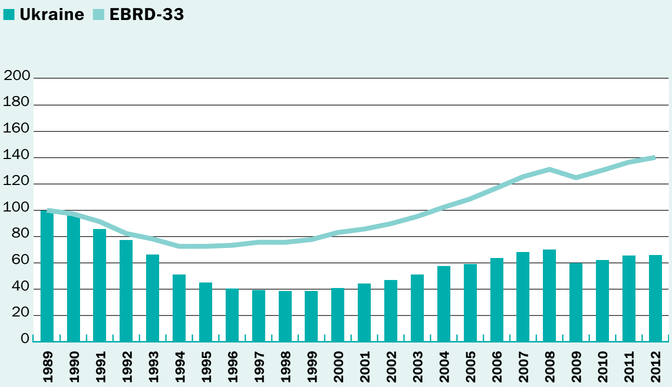
A new Customs Code was implemented. The new code, which came into force on 1 June 2012, is intended to simplify import procedures, by permitting registration of imports at any customs agency, including before goods are imported, reducing the length of customs registration procedures from one day to four hours, introducing electronic declarations and implementing the single-window principle. The new rules also provide for decriminalisation of merchandise smuggling and restrict the customs service's authority to confiscate contraband. If implemented in letter and spirit, the code should help improve Ukraine's business environment as difficult and cumbersome procedures have complicated Ukraine's integration into international production chains.

The authorities have continued to reform the country's gas sector. In March 2012 the parliament approved legislation allowing the government to separate the national energy company Naftogaz into production and transportation divisions. If implemented, the reform will move Ukraine towards compliance with EU legislation, which requires the separation of energy production, transportation and sales, a commitment Ukraine made as a member of the European Energy Community. The government has been working to diversify sources of gas consumed in Ukraine. In May 2012 it auctioned licenses to explore the Olesska and Yuzivska blocks of shale gas, purchased by major international companies Chevron and Shell. Discussions on potential imports of gas from western Europe and construction of an LNG terminal are ongoing. However, the sector continues to suffer from very low domestic household gas tariffs. Naftogaz generates a deficit of two per cent of GDP, covered by the government, and distributes around five per cent of GDP in implicit subsidies.

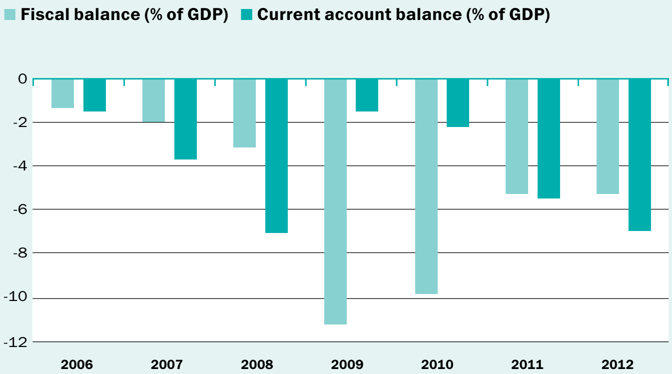
The government has pursued policies to increase private sector participation in the modernisation of the country's infrastructure. In February 2012 the parliament passed a law allowing transformation of the state railway agency and related enterprises into a state-owned joint stock company. The corporatisation should lead to separation of regulatory functions from operations, promoting transparency, efficiency and competitiveness and paving the way for greater involvement of private businesses in the railway sector. In June 2012 the law on sea ports was adopted permitting leasing and concession of sea ports to private operators. Privatisation of remaining public stakes in the regional energy producing and distributing companies should improve quality of delivery, if underpinned with a robust regulatory framework. In May 2012 the government adopted the draft bill on changes in the legislation on lease or concession of water and wastewater and district heating utilities, which among other things is aimed to facilitate private investments in the sector. Tariff setting responsibilities, which were until recently within the purview of the municipalities, have been transferred to the single national regulator. The main risk is that privatisation of infrastructure services would only benefit sector incumbents, who would also control the regulatory bodies.

The institutional framework for development of the local capital market is being established. In May 2012, the parliament approved in first reading amendments to the Law on Securities Market that would enable international financial institutions to issue hryvnia bonds. The draft changes include requirements that issuance volumes and interest levels are to be approved by the Cabinet of Ministers and bond proceeds are to be used exclusively for the crediting of Ukraine's real economy or long-term development projects. The amendments should enable the further development of local capital markets in Ukraine. Derivatives legislation is under preparation.

Real GDP (1989 = 100)



Fiscal balance and current account balance



UZBEKISTAN

HIGHLIGHTS OF THE PAST YEAR

- **Uzbekistan's economy continues to show strong growth.** In 2011 the economy was reported to have grown by 8.3 per cent, driven by strong domestic demand and fiscal stimulus, including through the state industrialisation programme. To support further growth the government approved a number of sector development programmes for 2011-15.

- **The authorities announced a new privatisation programme for 2012-13.** The new programme includes minority and majority stakes in almost 500 enterprises that will be offered to local and foreign investors via open public tenders.

- **The overall business environment remains difficult, notwithstanding the streamlining of a number of registration and licensing procedures.** Firm registration and tax reporting procedures have been simplified and a significant number of licenses and permits have been abolished. At the same time, the overall business environment remains difficult and businesses remain constrained by foreign exchange restrictions.

KEY PRIORITIES FOR 2013

- **The economy needs to be liberalised with government intervention further reduced.** Priority measures include reducing discriminatory barriers against imports and eliminating state procurement quotas in agriculture. The role and the function of a regulator in each sector should be clearly defined. Privatisation should proceed in a transparent fashion.

- **Distortions and indirect restrictions in the foreign exchange market need to be eliminated.** Increased exchange rate flexibility and easier access to foreign currency are crucial in order to reinvigorate trade and private investment.

- **Financial sector development will require better banking supervision and reduction of state interference in the banking system.** Direct lending at preferential rates distorts competition among banks, interferes with a sound risk culture and challenges effective banking supervision. More transparent banking practices would enhance the supervision ability of the central bank.

MACROECONOMIC PERFORMANCE

Uzbekistan's economy continues to grow at above eight per cent according to official statistics. Official GDP growth amounted to 8.3 per cent in 2011, driven mainly by fiscal stimulus and strong domestic consumption, and supported by large wage and pension increases and continued state investment as well as increasing remittance inflows. According to official estimates, growth has continued in the first half of 2012 and reached 8.1 per cent year-on-year. Despite lower global food prices in 2011 and early 2012, inflation in Uzbekistan remained on the rise caused by fiscal stimulus, currency depreciation and administrative price hikes. The fiscal and current account balances remained firmly in surplus. Imports have increased, reflecting growing capital goods imports under the ongoing government programme for industrial modernisation.

The banking sector remains stable but has required continued capital injections by the authorities. Banking supervision and regulation remain weak. According to the rating agency Moody's, the banking sector outlook remains stable in 2012-13 based on the assumptions of favourable growth prospects and continued state support. The non-performing loan portfolio of state-owned banks was massively restructured in 2011 with nearly 20 per cent being debt-to-equity swaps and capital injections by the state to support funding needs. This has positively affected the banks' balance sheet.

Uzbekistan signed the CIS free trade agreement at the beginning of 2012 that eliminates custom duties for its products including those going to its major trade market, Russia. While it is likely that Uzbekistan will remain outside of the custom union, the elimination of customs duties will increase the competitiveness of its products in CIS markets.

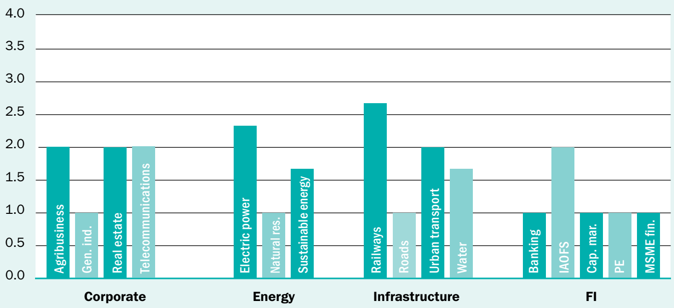
The government is expected to keep economic growth high at around eight per cent in 2012 and 2013, with the help of continued large government spending. In the medium-to-long term, however, Uzbekistan's growth prospects will likely be constrained by the slow progress with structural reforms, continued directed lending practices by the state, limited currency convertibility and continued disengagement with international financial organisations.

Main macroeconomic indicators (% – unless indicated)

	2009	2010	2011 estimated	2012 projected
GDP growth	8.1	8.5	8.3	7.5
Inflation (end-year)	10.6	12.1	13.3	11.5
Government balance/GDP	2.8	4.9	9.0	3.0
Current account balance/GDP	2.2	6.2	5.8	4.7
Net FDI (in million US$)	842	1628	1467	1094
External debt/GDP	15.0	14.8	13.3	na
Gross reserves/GDP	30.5	29.1	37.6	na
Credit to private sector/GDP	16.7	16.6	na	na

2012 sector transition indicators

Sector transition score



Source: EBRD.
Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity.

MAJOR STRUCTURAL REFORM DEVELOPMENTS

State ownership and interference in the economy remain dominant. The authorities have recently renewed a privatisation programme that includes a list of almost 500 enterprises, with minority or majority stakes possibly being offered to private and foreign investors. The list includes enterprises across all sectors of the economy, including oil and gas and mining. In addition, the authorities drafted a list of over 50 enterprises where production facilities are currently unfinished or inactive. These can be transferred to interested investors free of charge in exchange for binding investment obligations on the part of investors. While this programme could signal the beginning of a renewed transition process, the prospects are still uncertain given previous privatisation announcements that did not materialise. Major investment programmes and projects will be supported by the Fund for Reconstruction and Development into which the government has accumulated nearly US$ 10 billion.

There has been some progress with improving banking regulations and state directed lending practices. All banks are currently audited by international agencies under IFRS standards, and the banking system has remained stable due to the capital injections by the government. However, the regulatory framework remains weak. While some foreign banks are operating in the country, the state still owns 70 per cent of the banking sector. There has been increasing competition in the sector and major state-owned banks are undergoing internal restructuring and transformation. The state support programmes now target specific sectors, with control over use of funds performed by the relevant line ministries and specialised agencies.

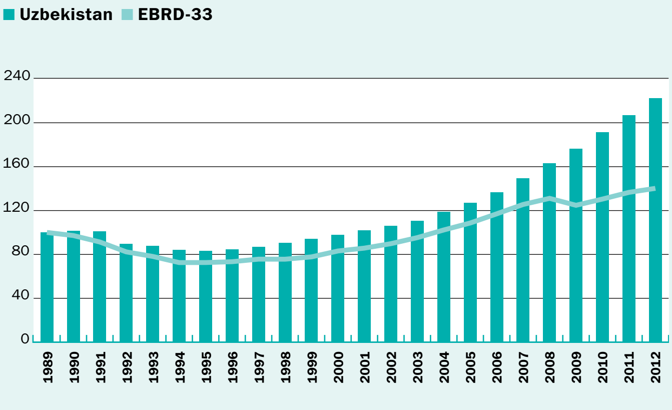
The situation in non-banking financial institutions has deteriorated. In 2011 the government revoked the licenses of all credit unions, on the grounds that they lacked transparency and were engaged in money laundering. At that time there were nearly 140 licensed credit unions providing funding access to entrepreneurs and involved in the micro lending industry. This move has potentially pushed a sector accounting for 15-20 per cent of loans to the grey economy.

There has been no progress with eliminating distortions in the foreign exchange market. Foreign traders continue to experience major market distortions with respect to trade and foreign exchange, related to delays in currency conversion for imports, restrictions on cash and foreign exchange availability and a restrictive trade policy. The lack of a liberal trade and foreign exchange regime continues to be a major constraint to foreign investment and private sector development.

The energy sector remains largely unreformed and state controlled and has only recently embarked on a programme of efficiency improvements. However, implementation of this programme is complicated by obsolete equipment that requires substantial investment for modernisation and reconstruction. Based on its renewable energy programme, the government has received nearly US$ 500 million in support from the Asian Development Bank. There are now four solar panel plants in the country with two already in operation. In the telecommunications sector the license of a major mobile operator, subsidiary of MTS of Russia, was suspended in July 2012 on the basis of alleged tax irregularities and other violations. Other foreign operators remain present in the market.

The business climate remains very poor but may benefit from a number of recent initiatives. Uzbekistan ranked 166th among 183 countries in ease of doing business in the 2012 World Bank *Doing Business* Report. The country scored poorly in every component of the ranking, although improvements were recorded in the area of starting a new business as the authorities reduced the minimum capital requirement, eliminated a number of procedures and lowered the cost of registration. Moreover, a presidential decree signed in July 2012 significantly reduced the number of financial, statistical and tax reporting procedures as well as procedures for obtaining licenses and permits. Eighty permission procedures and 15 licenses were eliminated from 1 August 2012, and the requirement for monthly tax reporting by businesses will be abolished from 2013. From 2014 businesses should be able to obtain licenses and permissions online. In August 2012 procedures for opening business bank accounts and authorising bank payments have been streamlined. A law on pledge registry has been drafted and is expected to be adopted by the end of 2012.

Real GDP (1989 = 100)



Fiscal balance and current account balance