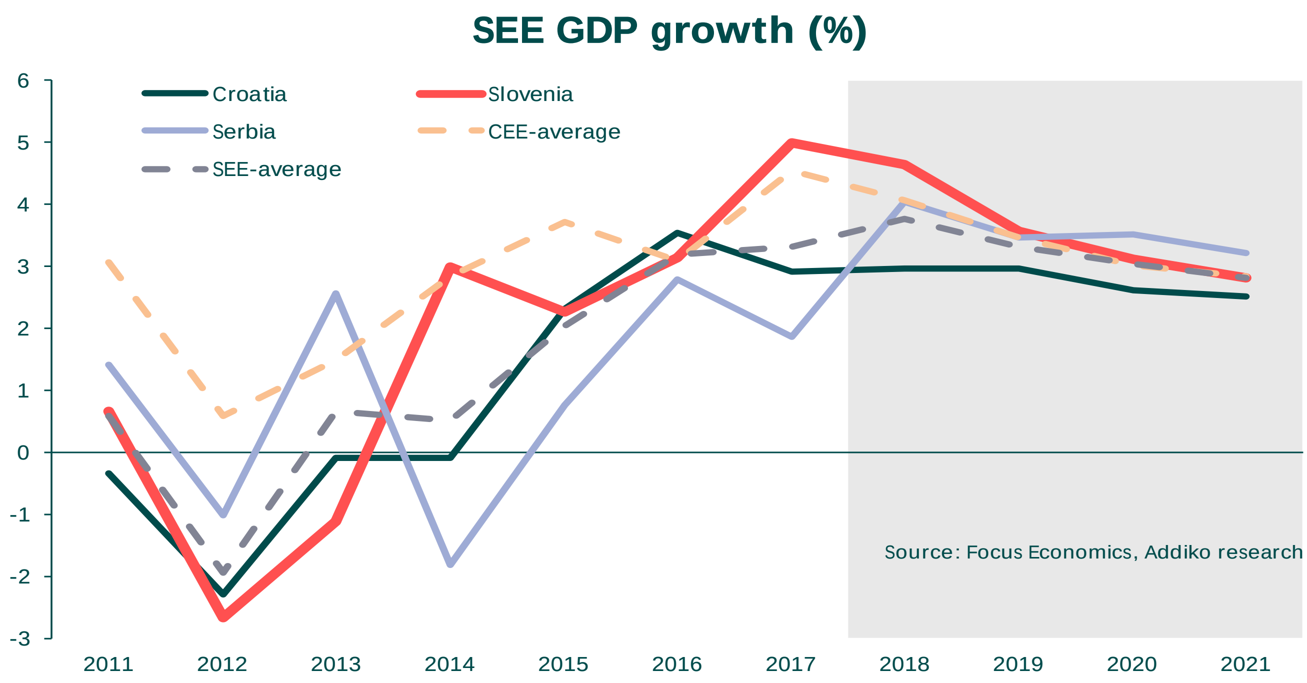
SEE Quarterly

Addiko Bank

09 July 2018

DOMESTIC DEMAND SAVES MOMENTUM



FOCUS ECONOMICS ANALYST FORECAST AWARDS 2018 #1 BEST OVERALL FORECASTER - SLOVENIA

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2018 #1 BEST OVERALL FORECASTER - SERBIA

Consensus Economics Forecast Accuracy Award Winner Slovenia 2017

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2016

Consensus Economics Forecast Accuracy Award Winner 2014 Croatia

EXECUTIVE SUMMARY

Bottom LINE: In Serbia and Montenegro, we upgrade our 2018 GDP growth forecasts on stronger-than-envisaged 1H18 development and stronger investment outlook. In Slovenia, we keep above-trend 4.7% growth forecast on resilient domestic demand, ultra-loose monetary conditions and improved consumer sentiment. Our above-consensus call at 3.0% in Croatia is based on strong consumer momentum, steady exports/tourism outlook, accelerating investments and fiscal easing. In Bosnia-Herzegovina, we keep 2018 growth forecast at 3.1% unchanged. Inflation is set to increase slightly in 2018 in all countries on hefty oil price hikes, food price inflation and strong domestic demand, except in Serbia where we lowered our CPI forecast to 1.8% amid stronger dinar and generally subdued import prices. We see small budget surpluses in all countries, except Montenegro, where higher public capex and EPCG buy-back will keep deficit at elevated levels.

3-month view	Government yields	FX vs EUR	Monetary policy
Slovenia	▼	▼*	unchanged
Croatia	▼	▼	easier
Serbia	▼	▼	easier
Bosnia and Herzegovina	◀▶	◀▶	unchanged
Montenegro	▼	▼*	unchanged

*vs USD

KEY POINTS:

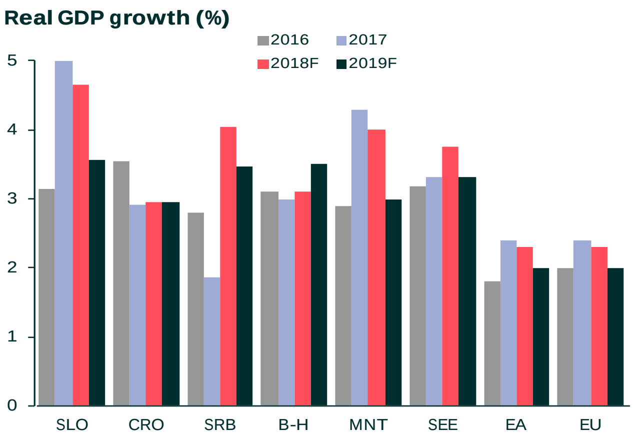
1. In Slovenia, we keep our above-trend 4.7% growth forecast in 2018 on resilient domestic demand, ultra-loose monetary conditions, improved consumer sentiment, stronger EU funding and investment demand. Despite higher external uncertainty, we keep above-consensus 3.0% GDP growth forecast in Croatia based on strong consumer momentum, steady exports/tourism outlook, accelerating investments and fiscal easing. In Serbia, we upgraded 2018 growth forecast to 4.0% given stronger-than-envisaged 1H18 development, better agricultural season, stronger investment outlook and strong private consumption amid employment and wage growth, re-leveraging and higher entitlement spending. In Bosnia-Herzegovina, we keep 3.1% growth expectations, thanks to stronger private consumption, external demand and externally-financed public capex. In Montenegro, we lifted GDP growth forecast to 4.0% as Q1 beat expectations. Growth will be driven by private consumption, tourism, highway construction and FDI in tourism and energy.

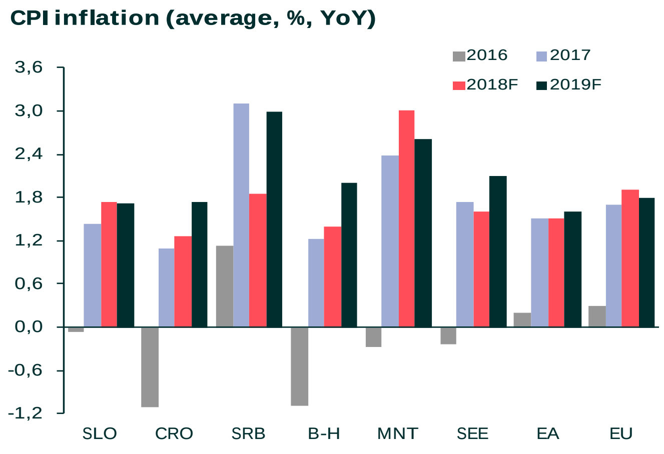
2. As for fiscal performance, we see a small budget surplus in Slovenia as tax-rich demand growth, interest rates savings and BAMC offset entitlement spending hikes and higher EU-sponsored capex. In Croatia, we expect tax-rich demand to surprise on the upside on the wings of another stellar tourist season, which alongside lower interest spending and contained wage and social spending will result in a small budget surplus, despite higher EU-sponsored public capex, defence spending and healthcare overruns. Similarly, in Serbia we see a budget surplus on resurgent domestic demand that will ensure strong tax intake growth, further interest bill and guarantees cuts, offsetting soaring capital investments and pension hikes. We see public debts as a percentage of GDP declining in all countries except Montenegro, where elevated deficit level amid higher public capex and EPCG buy-back will push public debt up.

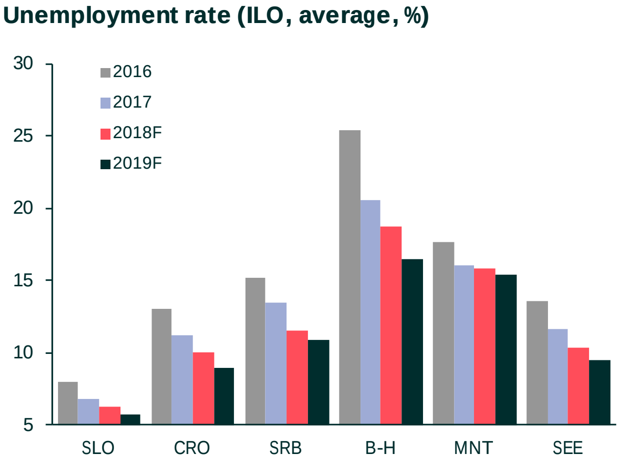
3. Given recent strong increases in tourism and energy prices, we lift our 2018 average inflation forecast for Slovenia to 1.7% but remain below 2% consensus as core inflation rate remains sluggish. In Croatia we keep, our 1.4% average CPI forecast on hefty oil price hikes, food price inflation and strong domestic demand, while structural changes in retail trade, including fierce competition for Agrokor's retail space and stronger kuna will keep ex-food/energy CPI subdued. In Serbia, we lower our average CPI call at 1.8% on stronger dinar, generally subdued import prices and still low food processing costs.

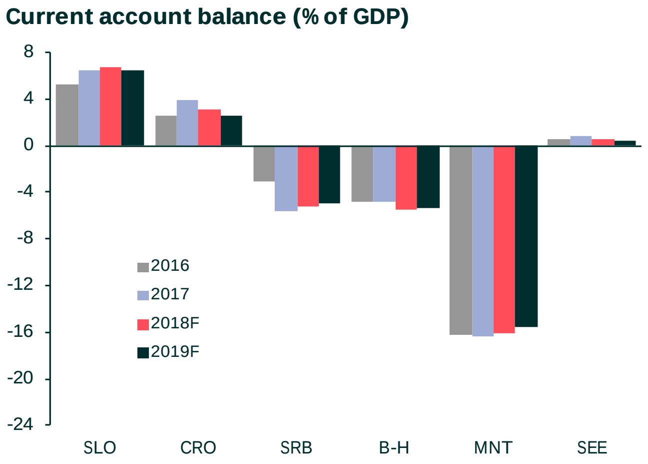
4. In the face of mounting euro zone tensions in the next months, Slovenian increasingly semi-core-perceived bonds may continue the recent outperformance with a further 20-30bp spread tightening potential. The Slovenian base case stays strong with macro/fiscal outperformance over most peers, proactive asset/liability management and hence cheaper debt service staying supportive of future opportunistic prefunding. In Croatia, we see short-end rates at record lows despite continuously growing new kuna disbursements given CNB easing with multi-billion kuna liquidity creation potential via FX transactions, moderate bank lending dynamics and stable FX. With local bond issuance for 2018 completed, successful Agrokor debt settlement and sound sovereign prefunding options for 2019, Croatian spreads should find a near-term reprieve. In Serbia, we expect NBS to stay 'on-hold' for the time being and continue to intervene against excessive dinar strengthening. Given still very gradual recovery in core inflation, perceived auto-pilot Fed tightening and the ECB rate normalization only in late 2019 or even 1Q20, we see the first (25bp) NBS rate hike in 1Q20 at the earliest.

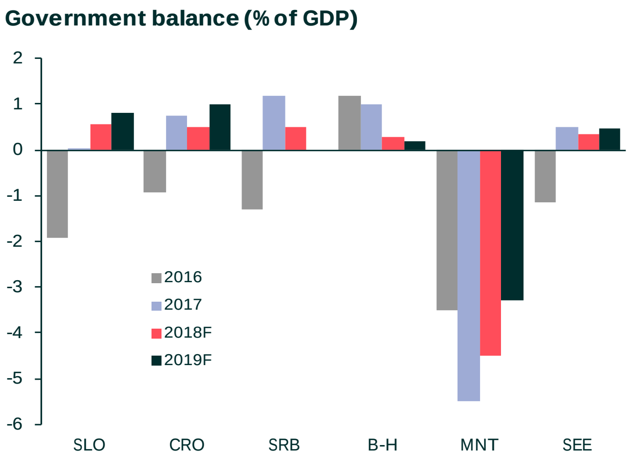
SEE data trends

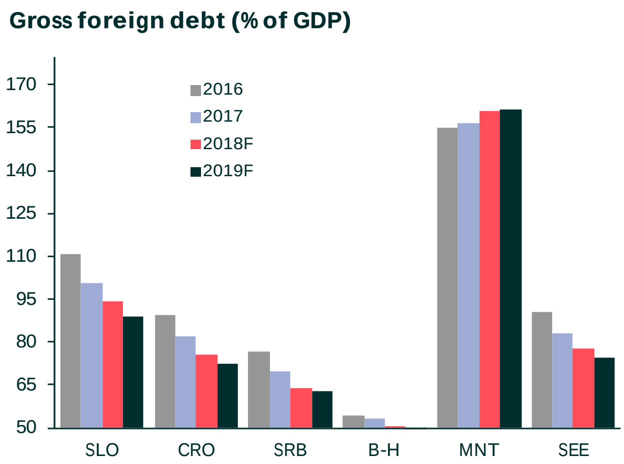








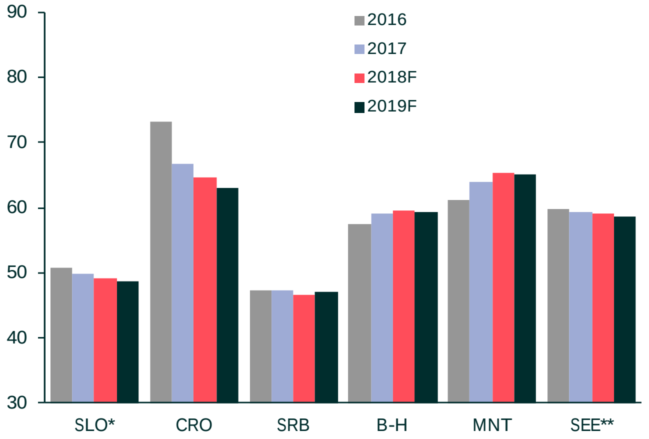




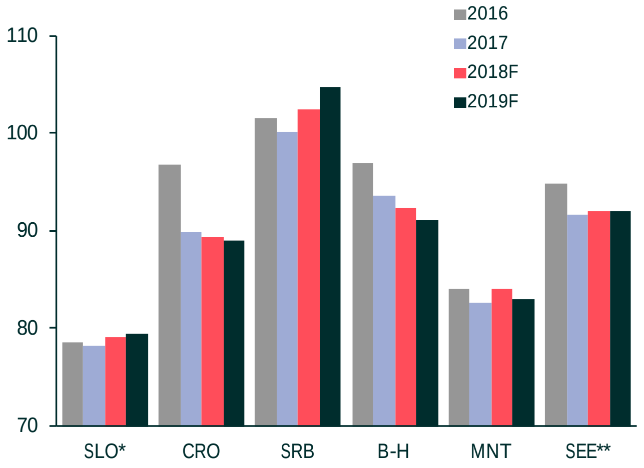
Source: National sources, Addiko research

SEE banking sector trends

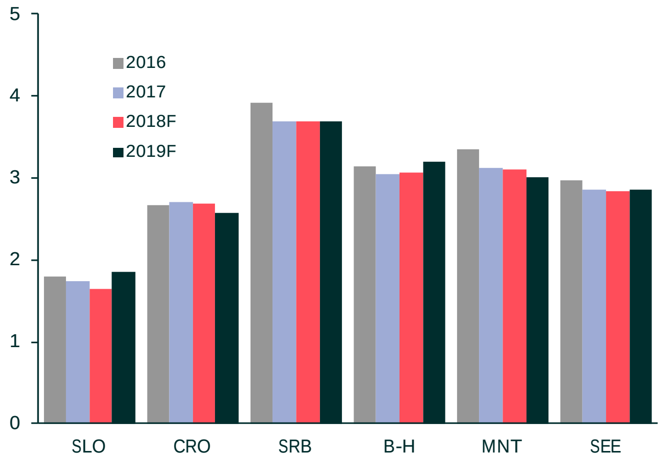
Gross loans (% of GDP)



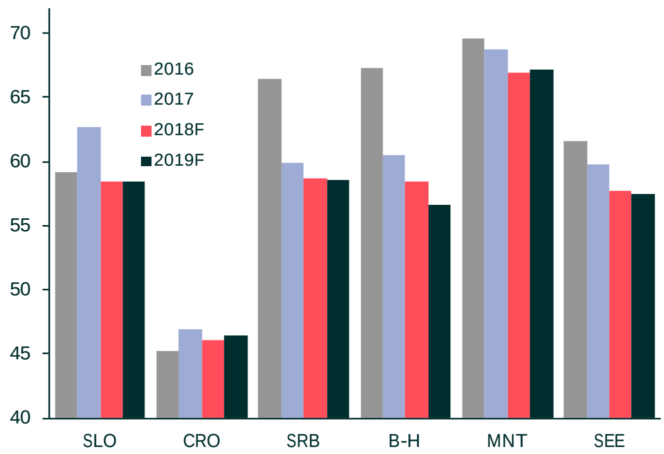
Loan-to-deposit ratio (%)



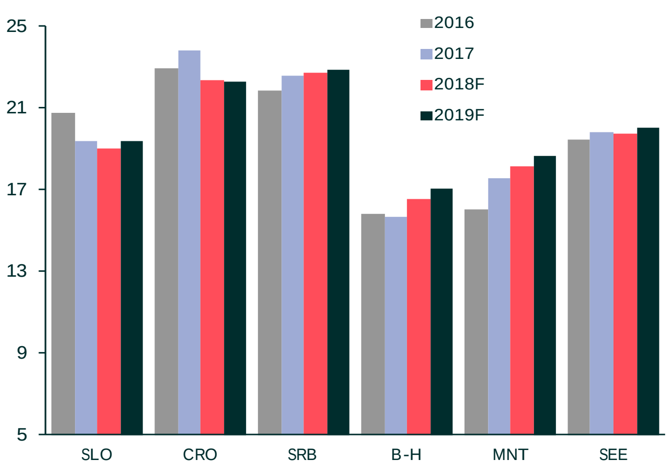
Net interest margin (%)



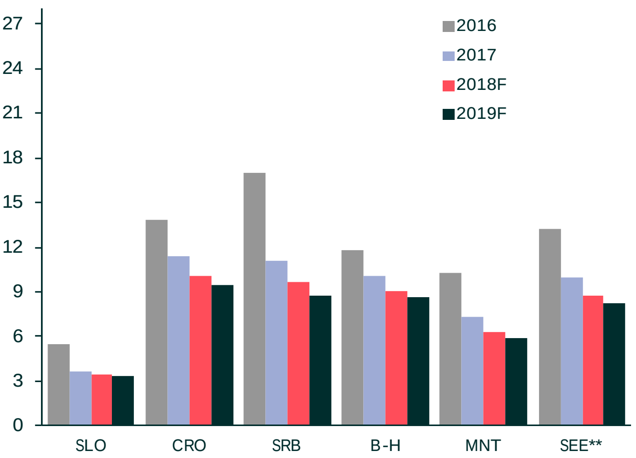
Cost-to-income ratio (%)



Capital adequacy ratio (%)



NPL ratio (%)



*Net loans; **Slovenia excluded; Source: central banks, Addiko research

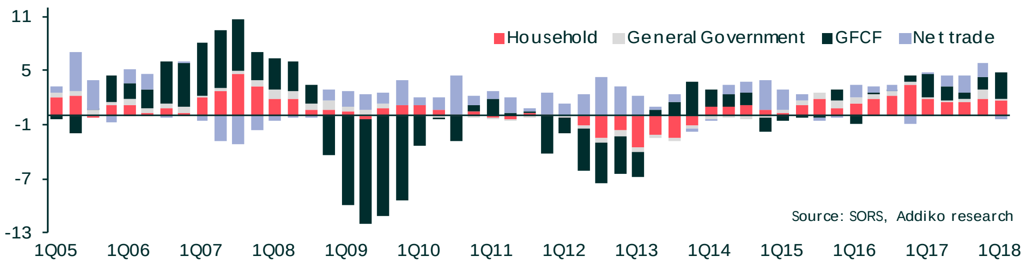
Strong Growth Momentum Continues

Slovenia continues with one of the strongest growth rates in CEE (let alone EU) as resilient domestic demand and ultra-loose monetary condition counter weaker external demand momentum. While fiscal metrics continue to improve, a brand-new heterogeneous political coalition could be more complacent on reforms and privatization, and may not survive a full mandate, in our view. Despite protracted local political uncertainty, macro and fiscal overperformance over the euro zone peers, further rating upgrades and the ECB dovish tapering reality underpin Slovenian bonds.

Momentum still matters...

Buoyed by domestic demand, Q1 GDP growth (0.7% qoq, 5.0% yoy seasonally adjusted) met our expectations, with soaring investment on resurgent construction and private equipment capex thanks to exporters' ample replacement needs, easier SMEs' access to credit and real estate frenzy. Private consumption is fuelled by stronger labour market and income expectations, alongside continued re-leveraging and household market recovery. Inventory build-up also contributed strongly (1.3pp), typical for strong growth periods. Meanwhile, exports growth (+7.4% yoy, prev. +12.3% yoy) succumbed to weaker euro zone activity, which alongside persistent import pressures amid accelerating domestic demand left net trade contribution slightly negative (-0.3pp). GDP growth is set to maintain similar pace in Q2 (and thereafter) as stronger consumer and investment momentum and some fiscal easing ahead of June elections comfortably offset slowing external demand for some time to come.

Slovenia: contributions to quarterly changes in real GDP (in pps)



... as Slovenia outperforms CEE peers in 2018 as well

The outcome of June elections is a hung parliament, with any coalition likely unable to push for material entitlement reform, red tape cuts, let alone privatization. Policy communiqué of most political parties and the outgoing cabinet moves show greater entitlement spending appetite, with new competitiveness reforms prioritized lower. While uncertain global trade environment and Italian politics, combined with higher oil prices and strong euro, have put downward pressure on external demand outlook, we expect resilient domestic demand and ultra-loose monetary conditions still support our 4.7% growth forecast for 2018 for several reasons. First, consumer sentiment improved in Q2 versus Q1 on stronger disposable income outlook. Second, strong domestic demand will further broaden toward investment, and this could offset the weakness coming from abroad. A still-high reservoir of firms' savings, cleaner balance sheets and stronger EU funding in H2 suggest plenty of scope for capex to contribute positively going forth. Third, the ECB has endorsed adjourned rate hike expectations to at least 4Q19 from 1Q19 largely seen at the start of this year. Fourth, earlier this year, we did not fully integrate upgrades to euro area outlook, leaving some buffer to the downside. While we also kept 2019 growth forecast at 3.5%, downside risks arise from serious trade conflicts, wider bond spreads (from escalating Italian risk) and in turn euro zone slowdown. Slovenia is more exposed to Italian slowdown than CEE peers as the share of domestic value added in final Italian demand (15% of exports) is three times higher than for the CEE average.

Inflation picks up, but still around low euro zone average

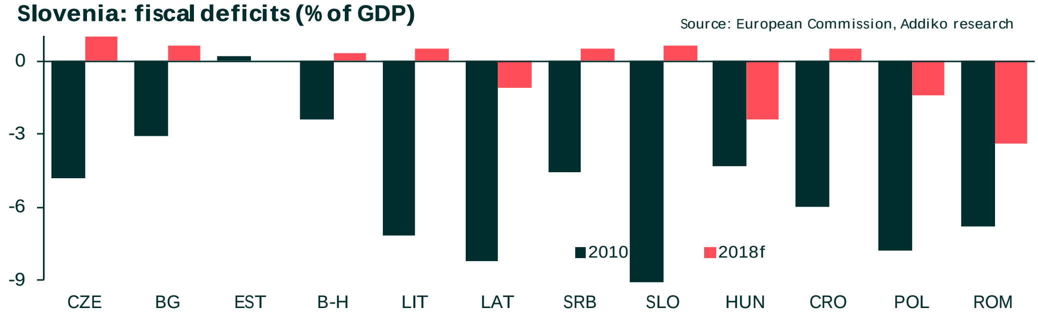
The recent strong increases in tourism and energy prices brought about the acceleration in CPI just above 2.0%, where we also see inflation in the rest of the year. Marking the last few months and the recent increase in oil prices to market, we lift 2018 average inflation forecast to 1.8% but remain below 2% consensus. Namely, if one excludes not only energy and food prices but also the prices of package holidays, which are often influenced by calendar effects, from the inflation rate, the resulting core inflation rate rose only slightly during Q2. This means that although the underlying price upswing in Slovenia is showing an upward trend on stronger disposable income and consumer demand outlook, this movement has so far been moderate, due to strong competition from hard discounters and the 'amazonization' of traditional retail trade channels. With prolonged sluggishness in core inflation owing to the lagged impact from last year's euro appreciation, the ECB may be able to start hiking only in late 2019 or even early 2020.

C/A surplus is moderating, but international position improves further

We expect C/A surplus to moderate in 2018-2019 amid stronger domestic demand, higher commodity prices and private sector re-leveraging. Strong goods export growth, increasingly diversified and composed of more high value-added niche items (less elastic to business cycle), higher tourism earnings and hefty EU transfers will keep C/A surplus at high levels close to 6% of GDP in the medium term. Sizeable C/A surpluses and sharply reduced external leverage allow further improvement in net international investment position towards -25% of GDP in 2018 (twice below CEE median), and the IMF predicts NIIP will turn positive in five years.

Given hefty C/A surplus and successful new Eurobond and USD buybacks earlier this year, funding position stays on very strong footing, and the average debt duration is also significantly extended. With 2018 financing already concluded, we expect Slovenia's pro-active asset-liability operations to result in further opportunistic (re)financing given still relatively dovish ECB. Beyond pre-election halt, we expect Gorenje take-over, second phase of Magna expansion and Adriatica insurance sale and a few smaller deals etc. to propel FDIs and in turn exports in the years ahead. Changing the approach to "strategic assets" criteria in further privatization process, including the final solution for NLB bank, incentives for bank consolidation and product market reforms are the final steps required to create an equal level playing field for investors.

Slovenia: fiscal deficits (% of GDP)



Fiscal consolidation continues…

A EUR26.6m budget surplus in the year to May (vs. EUR133m deficit a year ago) is driven by buoyant tax intake (+7.7% yoy, from PIT, CIT to VAT), EU receipts vs. just 1% higher spending. While revenues reflect stronger tax-rich demand contribution, employment, current spending subduedness largely owes to interest bill cuts to 1.9% of GDP after 2.7% in 2016 nd temporarily lower social security outlays. This year, we see a small budget surplus (around 0.5% of GDP) as the ever stronger tax-rich demand growth (ongoing 6% tax revenue growth), interest rate savings and BAMC positive effect offset entitlement spending hikess and higher EU-sponsored capex. The main source of uncertainty is though a 'temporary' EUR50m overshot in social safety net just before elections that the technical cabinet hopes to offset by stronger-than-expected PIT, declining pensioners' inflow and material cost cuts. Among the first steps of the new cabinet will be 2019 budget, amendments to the last Economic Reforms Program built on no-policy change scenario and curbing the current increased political posturing in the growing entitlement spending pressures. Small budget surplus still hides the structural budget gap at 1.5% of GDP due to expiry of previously implemented temporary consolidation measures, which suggests further wrangling with the EC on structural effort models. The required annual structural adjustment of 0.65% of GDP in 2019 as ever hinges on healthcare and pension reforms, as well as real estate taxation, without which the zero structural deficit target for 2020 will be compromised.

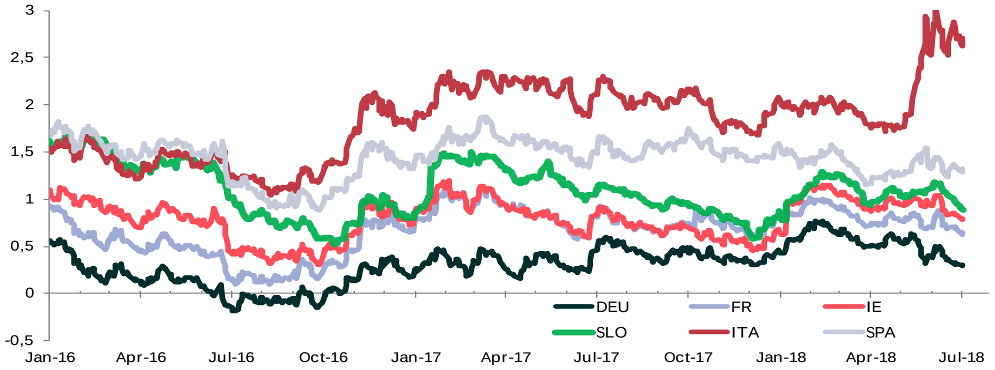
…as public debt and interest costs stay on a firm downward trend

After last year's drop below 74% of GDP on strong deficit reduction, we expect public debt to fall further this year and next to 65% of GDP in 2019 on stronger nominal GDP growth, primary surpluses, record low interest cost (below 5% of general budget revenues from 7.3% in 2014) and some rundown of fiscal reserve (currently 7.8% of GDP). This also brings adjusted net public debt ratio below the Maastricht-enshrined 60% of GDP in 2019 and on a declining path below 50% by 2021. While contingent liabilities on the books of large quasi-fiscal entities are significant by EU standards, we think the likelihood of such risks materialising on MinFin accounts is mitigated by sound macro tailwinds, and the government ambitiously plans to halve guarantees toward 7.5% of GDP by 2020. Moreover, pro-active debt management has not just appeased risks to potential interest rate shock, but also brought about a significant reduction in the sovereign-banks nexus. Public debt reduction could be faster in the medium term if privatization agenda (including NLB, Telekom Slovenije) can be resumed alongside more active sale and stronger recovery in BAMC assets (at the assumed p.a. pace) and stronger reform content in further fiscal consolidation. Further banking sector consolidation, development of alternative sources of funding for SMEs and SOEs' restructuring are equally important in mitigating the risks in public finance in the medium term.

Risk aversion and inflation undershooting lower yields…

After a bout of upward volatility amid Italian political and global trade tensions, safe haven demand for Bunds on German political and the euro zone growth downgrade risks helped Slovenian yields on their way below 1%. Strong macro/fiscal performance, further interest bill cuts as well as S&P's rating outlook upgrade have only supported sentiment. Although the Fed lifted it policy rate and 2018-2019 dots, the Treasury yield curve flattened to its lowest level since 2017, and the risks to long-term Bund/Slovenian yields are skewed to the downside (negative territory for Bunds?) in case of escalating euro zone tensions in the next months. Meanwhile in the periphery, Italy remains in the spotlight with domestic factors likely to demand higher (spread) premia amid the growing challenges of keeping actual and finding new foreign buyers at times of rising net issuance and the expected ECB QE tapering by end-year.

Slovenian bonds outperform

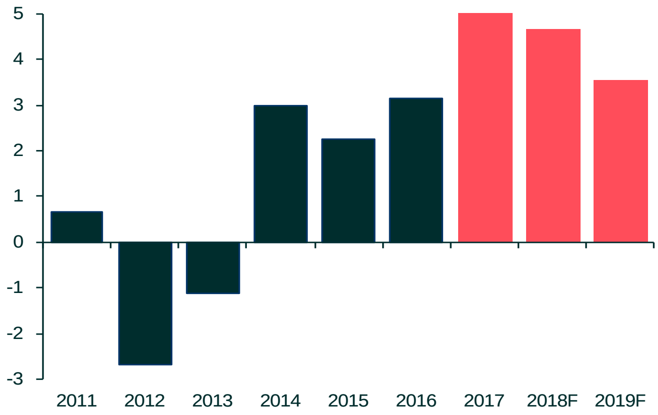


… as ECB is eyeing monetary normalization

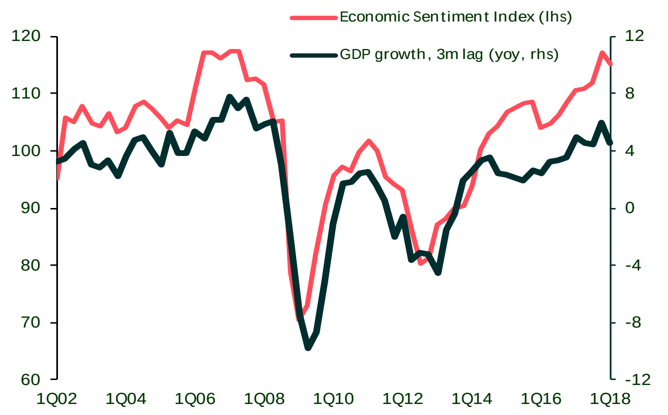
The ECB in fact delivered a dovish surprise despite announcing the likely end of QE program by sharpening forward guidance with key rates on hold “at least through the summer of 2019” to ensure inflation convergence toward target. Despite the tapering, the ECB will continue to be a source of demand for duration risk in the next years via reinvestments of maturing bonds on its balance sheet. With ECB officials endorsing the market pricing out of 2019 ECB rate hike expectations, the ECB policy is also set to manage downside risks emanating from trade wars and Italy. With Slovenia completing financing needs already in Q1 and no sudden changes in the ECB policy ahead, the Slovenian base case stays strong with macro/fiscal outperformance over most peers, proactive asset/liability management and hence cheaper debt service staying supportive of future opportunistic prefunding (for 2019). That said, in the face of mounting euro zone tensions in the next months, Slovenian increasingly semi-core-perceived bonds may continue the recent outperformance with a further 20-30bp spread tightening potential. In the short term, it is 'good' news that the market’s focus remains on global trouble spots rather than on the increased likelihood of Slovenian wide coalition with heterogeneous interests that pose the risks to ongoing fiscal adjustment and structural reforms in the medium-term. That said, positive risks for bond performance include further sovereign asset/liability management, sustainable growth without signs of overheating, revival of the long overdue privatizations (NLB, Telekom Slovenije) and ensuing rating upgrades that would all ensure faster public debt reduction closer to sub-50% single-A median.

Slovenia's data trends

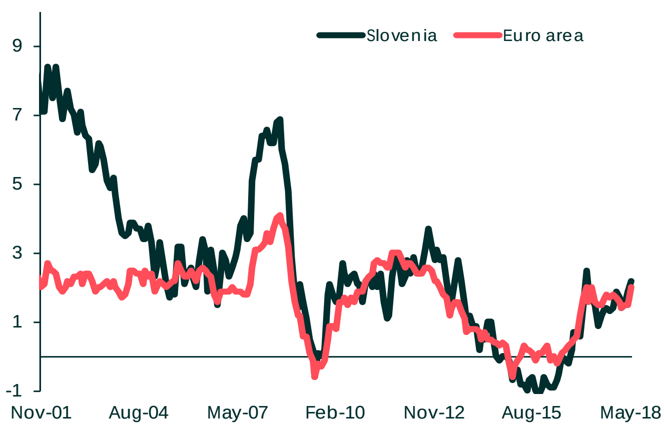
Real GDP growth (% YoY)



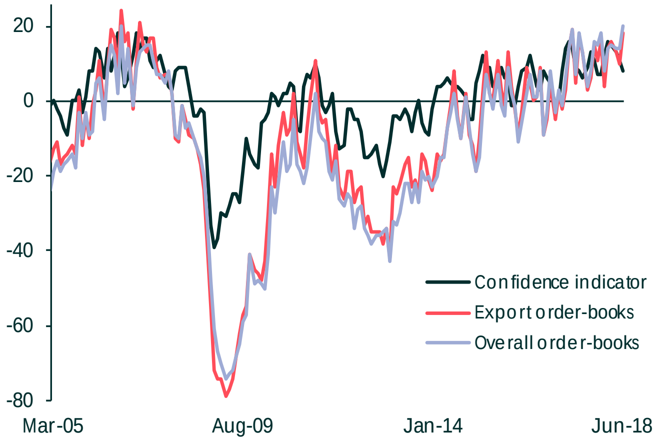
Economic confidence vs. GDP growth



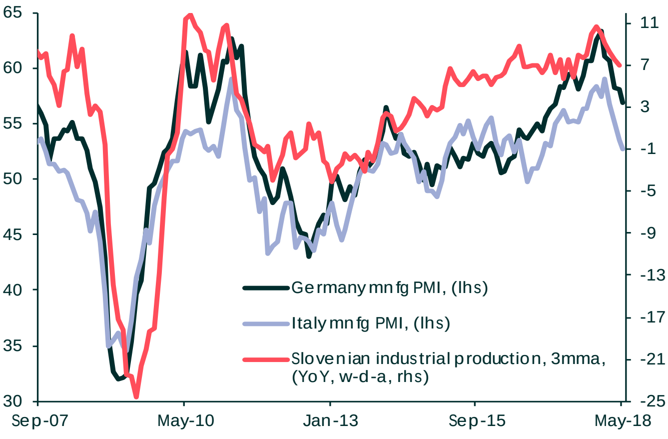
CPI inflation dynamics (% YoY)



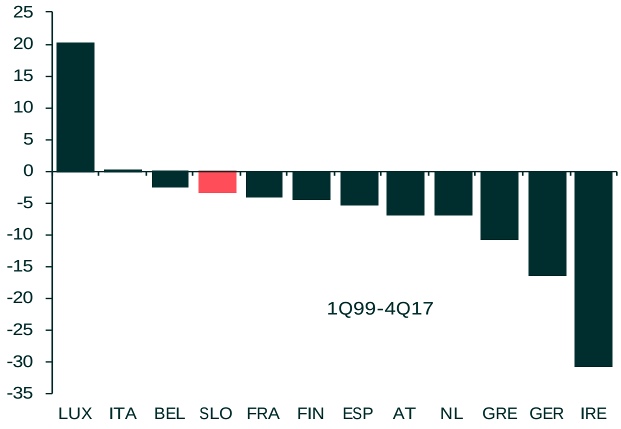
Business sentiment in manufacturing



PMI vs Industrial production - Slovenia



Unit labour cost for the total economy



Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, ECB, European Commission, Bloomberg, Addiko research

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Activity									
Nominal GDP (EURbn, current prices)	36,9	36,1	36,2	37,6	38,8	40,4	43,3	46,1	48,6
Nominal GDP (USDbn)	51,4	46,4	48,1	50,0	43,1	44,8	48,9	53,5	57,5
GDP per capita (EUR)	17.971,9	17.538,2	17.591,8	18.250,0	18.826,5	19.580,6	20.948,8	22.299,6	23.490,8
GDP per capita (USD)	25.027,7	22.554,1	23.363,7	24.245,2	20.880,6	21.683,3	23.653,3	25.897,3	27.836,6
Real GDP (constant prices YoY, %)	0,6	-2,7	-1,1	3,0	2,3	3,1	5,0	4,7	3,6
Private consumption (YoY, %)	0,0	-2,4	-4,2	1,9	2,1	4,3	3,2	3,9	3,2
Fixed investment (YoY, %)	-4,9	-8,8	3,2	1,1	-1,6	-3,6	10,3	8,7	7,4
Industrial production (YoY, %)	1,3	-0,8	-0,9	1,7	5,1	7,8	8,5	5,9	6,2
Unemployment rate (ILO, average %)	8,2	8,9	10,1	9,7	9,0	8,0	6,6	5,7	5,2
Prices									
CPI inflation (average % YoY)	1,8	2,6	1,8	0,2	-0,5	-0,1	1,4	1,8	1,8
CPI inflation (end-year % YoY)	2,3	2,7	0,7	0,1	-0,5	0,5	1,7	1,7	1,7
PPI inflation (average % YoY)	4,5	0,9	0,3	-0,6	-0,2	-1,4	2,2	2,1	2,4
Net wage rates (% YoY, nominal)	2,1	0,4	0,6	0,8	0,7	1,8	2,7	3,4	3,3
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,7	-4,1	-15,1	-5,5	-2,9	-1,9	0,0	0,6	0,8
Public debt	46,6	53,9	71,0	84,4	81,8	78,6	73,4	68,7	64,8
Gross public funding needs	10,5	8,2	19,3	14,5	6,4	9,6	6,4	5,1	5,1
External balance									
Export of goods and services (EURbn)	25,948	26,363	27,010	28,520	29,905	31,401	35,596	38,515	41,635
Import of goods and services (EURbn)	25,516	24,934	24,569	25,641	26,569	27,690	31,406	34,194	37,135
Merchandise trade balance (EURbn)	-0,974	-0,081	0,708	1,181	1,476	1,537	1,626	1,561	1,740
Merchandise trade balance (% of GDP)	-2,6	-0,2	2,0	3,1	3,8	3,8	3,8	3,4	3,6
Tourism receipts (EURbn)	1,975	2,008	2,043	2,060	2,098	2,190	2,386	2,526	2,646
Current account balance (EURbn)	0,068	0,775	1,594	2,179	1,698	2,108	2,813	2,995	2,962
Current account balance (% of GDP)	0,2	2,1	4,4	5,8	4,4	5,2	6,5	6,5	6,1
Net FDI (EURbn)	0,6	0,5	0,0	0,6	1,3	0,9	0,5	1,2	1,3
FDI (% of GDP)	1,7	1,3	0,1	1,6	3,3	2,2	1,2	2,6	2,6
FDI cover (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0,767	0,722	0,669	0,837	0,760	0,700	0,800	0,800	0,800
Import cover (months of imports)	0,4	0,3	0,3	0,4	0,3	0,3	0,3	0,3	0,3
Debt indicators									
Gross external debt (EURbn)	41,669	42,872	41,658	46,314	46,627	44,805	43,460	43,310	43,110
Government (EURbn)	8,748	11,092	15,459	22,416	24,824	22,953	21,777	22,227	23,477
Private (EURbn)	28,534	25,709	23,457	21,815	19,587	18,395	18,033	17,583	16,133
Gross external debt (% of GDP)	112,9	118,8	115,0	123,1	120,1	110,9	100,4	94,0	88,8
Gross external debt (% of exports)	160,6	162,6	154,2	162,4	155,9	142,7	122,1	112,4	103,5
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,19	1,15	1,23
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,13	1,16	1,19
Money supply M1 (% YoY)*	1,5	4,4	0,1	18,5	24,9	17,1	16,0	14,5	12,6
Broad money M3 (% YoY)*	3,5	-1,4	-1,3	6,1	4,6	7,1	7,8	5,1	4,6
Domestic credit (% YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,9	5,4	4,5
ECB reference rate (end-year %)	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,00
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,30
SLO 5Y yield (average %)	3,96	4,55	4,35	2,14	1,64	0,70	0,33	0,45	0,80
SLO 10Y yield (average %)	4,98	6,01	5,87	3,28	1,67	0,82	1,12	1,10	1,40

* Since 2007 ECB data

Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, IMF, Addiko Research

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Balance sheet									
Assets (EURm)	48.748	46.125	40.344	38.714	37.383	37.050	37.946	38.829	39.483
Assets (%, YoY)	-3,1	-5,4	-12,5	-4,0	-3,4	-0,9	2,4	2,3	1,7
Assets (% of GDP)	132,1	127,9	111,3	102,9	96,3	91,7	87,7	84,3	81,3
Net loans (EURm)	32.875	30.964	24.338	21.540	20.275	20.534	21.542	22.701	23.729
Net loans (%, YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,9	5,4	4,5
Net loans (% of GDP)	89,1	85,8	67,2	57,3	52,2	50,8	49,8	49,3	48,9
Deposits (EURm)	24.170	23.856	22.550	24.426	25.140	26.133	27.528	28.956	30.420
Deposits (%, YoY)	2,8	-1,3	-5,5	8,3	2,9	3,9	5,3	5,2	5,1
Deposits (% of GDP)	65,5	66,1	62,2	64,9	64,7	64,7	63,6	62,9	62,6
Loan-to-deposit ratio (%)	136,0	129,8	107,9	88,2	80,6	78,6	78,3	78,4	78,0
Capital adequacy ratio (%)	11,6	11,9	14,0	19,2	20,8	20,8	19,4	19,0	19,4
Performance									
Net interest income (EURm)	1.018	886	708	832	746	670	652	683	695
Net interest income (%, YoY)	-2,0	-12,9	-20,1	17,5	-10,4	-10,2	-2,7	4,8	1,7
Total operating income (EURm)	1.447	1.566	1.091	1.231	1.158	1.127	1.075	1.148	1.165
Total operating income (%, YoY)	-1,9	8,2	-30,3	12,8	-6,0	-2,6	-4,6	6,8	1,5
Pre-provision profit (EURm)	670	823	370	544	472	460	401	478	484
Pre-provision profit (%, YoY)	-5,4	22,8	-55,0	47,0	-13,3	-2,5	-12,8	19,1	1,4
Provision charges (EURm)	1.207	1.599	3.809	650	313	96	-43	15	23
Profitability and efficiency									
Net interest margin (%)	2,1	1,9	1,6	2,1	2,0	1,8	1,7	1,7	1,9
Pre-tax ROAA (%)	-1,1	-1,6	-8,0	-0,3	0,4	1,0	1,2	1,2	1,2
Pre-tax ROAE (%)	-13,3	-20,3	-92,9	-2,7	3,7	8,1	9,5	9,6	9,2
Cost-to-income ratio (%)	53,7	47,4	66,1	55,8	59,3	59,2	62,7	58,4	58,4
Operating expense (% of assets)	1,6	1,6	1,7	1,7	1,8	1,8	1,8	1,7	1,7
Credit quality and provisioning									
NPL ratio (%)	11,2	14,4	13,4	11,9	9,9	5,5	3,7	3,0	2,8
NPL coverage (%)	37,8	42,7	56,8	60,8	65,0	65,2	66,8	67,0	67,5
Provision charges (% of loans)	2,4	3,4	8,8	1,6	0,8	0,3	-0,1	0,0	0,1
Provision charges (% of PPP)	180,1	194,3	1.029,2	119,5	66,4	20,9	-10,6	3,2	4,9

Source: BSI, Addiko research

Private sector drives credit activity

Lending activity increased modestly in the year to March, with net loans up by 0.5% ytd on the back of higher private sector lending as public sector continues to de-leverage. Retail loans thus increased 1.4% ytd supported by strong economic situation, improved labour market conditions, record low interest rates and the ensuing record consumer sentiment. Corporate credit followed on almost equal pace, growing 1.6% ytd. Deposits barely grew 0.2% ytd in March, solely thanks to 1.7% ytd higher households' deposits reflecting traditionally strong saving habits, despite the low level of interest rates. On the other hand, corporate and public sector deposits contributed negatively, with former down 1.5% ytd amid stronger capex needs, while the latter sank 7.9% ytd. Regarding profits, NII decreased by 3.3% yoy as 6.0% yoy lower interest income could not be offset by lower funding costs (-19.4% yoy). Nonetheless, the banking sector earned EUR143m pre-tax profit (+1.0% yoy) owing to higher non-interest income, alongside stagnating opex and lower provisioning costs.

Economic prospects support credit acceleration

After 1Q18 results, we still expect credit growth continuing at 5.4% rate, with private sector again as the main driver. Corporate loan demand remains supported by strong investment outlook and export activities, despite significant availability of internal funding (retained profits). Meanwhile, retail loans growth should continue on the back of improved employment conditions and disposable income growth, supported by high sentiment indicators and still relatively low indebtedness. With NPL ratio already reaching low 3.2% level at 1Q18, we expect limited further decline towards 3.0% mainly owing to SME NPL resolution efforts, while the new lending cycle could increase pressures on credit quality in the medium term. Deposit collection should decelerate to 4.3% amid high-base effect, persistently low interest rates and stronger capex needs. Regarding profits, we see slightly higher level of NII as higher lending volumes should finally overcome the effect of lower interest rates. Although increased credit activity could result in new provisioning costs, we expect somewhat improved 2018 pre-tax profit level compared to 2017.

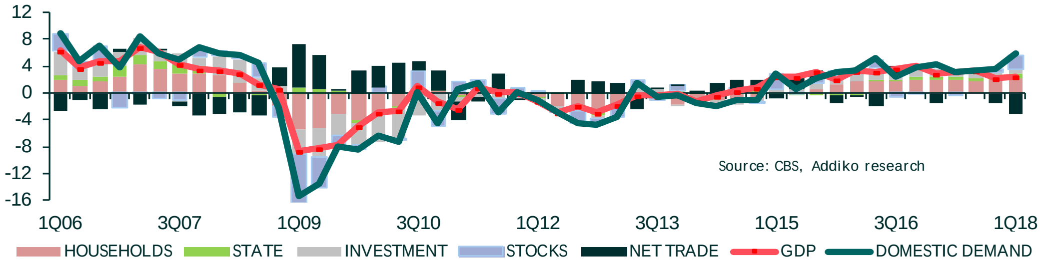
Growth Momentum Ain't Over Yet

Growth stays robust at 3% this year as stronger domestic demand, another record tourist season, fiscal impulse and accelerated EU funding offset weaker external demand momentum. The key signposts for sustained macro/fiscal performance and competitiveness are further tax and red tape cuts, potential economic restructure after Agrokor debt settlement, plus labour, entitlement and education reforms. All that in combination with dovish ECB, Croatia's stronger external financing position, accelerated ERM II bid prospects, and thus stronger sovereign rating prospects suggest lower risk premia.

A temporary slowdown, not a turning point...

Short-term GDP growth picked up in 1Q18 (0.2% qoq, 2.5% yoy), driven by private consumption on the back of employment and real wage growth, soaring car sales, re-leveraging and stronger tourist consumption (foreign tourist overnights soared 31.2% yoy in Q1) and entitlement spending. Despite halted capex by Agrokor, intertwined firms and the related uncertainty, plus operating problems in a few bigger industrial firms, investments accelerated on the hills of stronger business optimism, EU funding, record firms' profit (outside Agrokor universe) and re-leveraging. Net trade surprised negatively on temporary weaker goods exports (pharma, shipbuilding), and soaring imports, a flip side of strong local demand. Sentiment gauges suggest GDP growth acceleration in Q2 to 3% yoy and in particular private consumption and services sectors. While stabilization in EU demand and another record tourism activity continue to push exports, we expect import-driven demand will cut net trade contribution to growth.

Croatia: contributions to GDP (in pps)



Stronger potential growth needed to shield against future shocks

Despite external uncertainty, we keep above-consensus 3.0% GDP call for 2018 and 2019 on: (i) strong consumer momentum, (ii) steady exports/tourism outlook, (iii) accelerating investment and (iv) fiscal impulse after years of consolidation. On top of record tourist season, private consumption is driven by steady real wage growth, higher entitlement outlays, job growth, foreign workers' remittances, new HRK2bn tax cuts in the pipeline and the ensuing record consumer optimism. Investments are driven by record low cost of funding and faster pace of EU funding in support of re-leveraging, rising SMEs' profits, resurgent construction activity (hotels, Peljesac bridge, commercial real estate) and exporters' ample replacement capex needs. Looking into 2019, further corporate tax cuts and 30% administrative burden cuts, stronger EU/SME funding and the feel-good factor from widely-supported Agrokor debt settlement help sustain 6%-alike capex growth. While the risks to our baseline are balanced, further softening of EU demand, labour shortages amid high emigration, corporate de-leveraging and political risks (culminating with DPM Dalic's resignation) are the main risks on the downside. HDZ-lead thin parliamentary majority may navigate through resurgent political risks given the weak opposition, but we do not see a constant politicisation of the reform process (including Agrokor restructuring) and thriving populisms leading to far-reaching public sector and entitlement reforms as the political cycle matures. Finally, upside risks stem from unthinkable tourism record, EU funding, fiscal expansion and rating upgrade prospects.

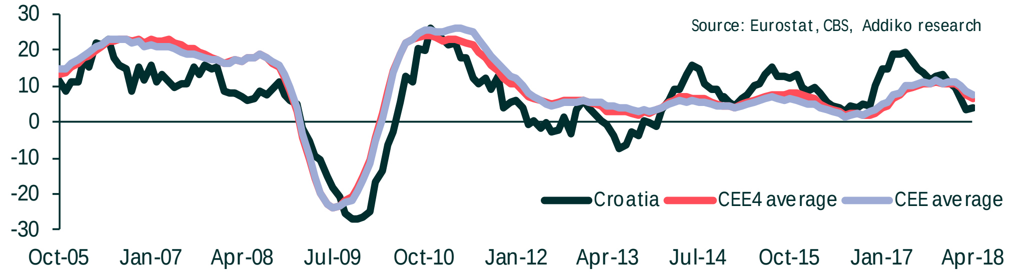
Inflation still weak, for now

Inflation went up noticeably in the past few months toward 2% yoy on hefty oil price hike, higher catering prices and food price inflation as elsewhere in the CEE region. While strong domestic demand and wage hikes imply stronger price dynamics going forth, the underlying ex-food/energy CPI (1.0% yoy) is still at only a half of the headline, reflecting structural changes in retail trade, including fierce competition for Agrokor's retail space, stronger kuna and perhaps citizens' de-leveraging in response to stronger disposable incomes. All in all, the upside surprise in Q2 price developments implies headline CPI around 2% in the next months, to be followed by renewed moderation below 1.5% in Q4, which leaves our 2018 average CPI forecast close to 1.5%. Upside risks in price pressures may emerge if the boost to oil prices persists and/or from seasonally higher leisure/catering prices. In 2019, we see a bit higher inflation as tax reforms boost demand and energy prices normalize further.

External position improves strongly on de-leveraging and persistent C/A surpluses

While the euro zone PMIs are certainly past their peaks, they still signal solid external demand ahead, which alongside stabilization in domestic industrial output points to a renewed pick-up in goods exports after the Q1 soft patch. The ongoing above-trend EU demand/global trade growth and Croatia's further competitiveness gains driven by stronger propulsive SMEs' participation, tax/red tape cuts and market share gains will drive exports into 2019 albeit at moderating pace. Strong consumer demand and accelerating private capex are driving imports as well, leading to ~1.5pp higher goods trade gap over 2018-2019 and C/A surplus moderation relative to 2017 when foreign-owned banks' profit slump on Agrokor-related provisioning inflated the balance. Still, record FC tourism intake and EU transfers will on our estimates keep C/A surplus at 2.5% of GDP on average. External debt slump owing to record firms' profit used to retire leverage and Agrokor-related write-offs, high banks' net foreign assets and portfolio/FDI inflows lead to revival in net international investment position toward -50% of GDP in 2019 from -71% in 2016.

Croatia: merchandise exports (seas.adj. 6mma, %, yoy)



Easy, easy: CNB on the trail of the ECB

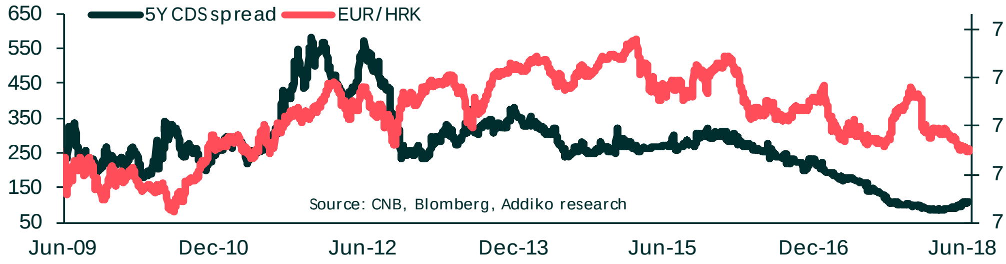
With the ECB's dovish QE tapering announcement and further delays in rate hike expectations, we expect the CNB to keep on easing via excessive kuna liquidity at 8%+ of GDP at least through 2019 on top of excessive FC liquidity above 5% of GDP. The anticipated halt of bond purchases by end-2018 is not a signal of imminent tightening since the ECB will reinvest QE holdings. Lax monetary conditions accompanied by banks' de-risking and sound macro help to anchor short-term rates at record lows and support private-sector re-leveraging. While mandatory reserve cuts fit into EMU entry strategy, the CNB will be in our view more attuned to appropriateness of accommodative policy, pegging liquidity provision to assessment of corporate demand since housing loans may be affected by tighter regulation. While citizens' vulnerability to floating interest rate and FX risks is reduced, it is far from satisfactory, boosting the case for ample long-term kuna funding options like long-term FX swaps, longer/cheaper REPO or interest rate swaps. Thankfully, there are delays in the ECB's rate hike expectations, and stronger REPO capacity on collateral pooling could be used in the future to support the CNB's bank lending objective, both supporting our long held view of a slow monetary policy normalization and lower rates for longer. From a risk perspective, firmer private-sector external positions, stable kuna and fiscal de-risking allow the CNB's easing. As ever, banks needs unambiguous criteria for automatic NPL resolution, tax incentives, capital raising platforms and stronger insolvency framework in a bid to slash cost of risk and sustain monetary transmission.

Stronger kuna profile to persist

After non-resident dividend payouts and reversal of car-import-related trade balance worsening, the main depreciation forces keeping the cross around 7.40 have largely gone. With the approaching peak tourist season, appreciation pressures on the kuna have revived, sending the EUR/HRK lower. Given steady kuna development, record interbank excess liquidity and monetary easing, short-end rates hit record lows, which supported the last week's HRK5.5bn 5Y and HRK5bn 11Y benchmark issues. Meanwhile, Fed tightening, stronger USD, trade tensions that weigh on 'synchronised' global growth scenario, EM bond fund outflows and increased volatility in the global financial markets have all affected EM/CESEE debt before the ECB dovish tapering brought about some respite. Croatian bonds have in most occasions followed the destiny of regional peers, while domestic political bickering lead to some underperformance.

Following favourable seasonal patterns during another record peak tourist season (supportive of C/A trends) within 7.30-7.35, we expect the EUR/HRK to inch up a bit in the rest of 2018. In the meantime, we expect the CNB to actively intervene in the FX markets during the summer months due to its competitiveness considerations. Depreciation pressures are though limited as tourist-related and other exporting firms-induced FX supply, soaring EU funding continue in Q4 and comfortably tame upward pressures. Given, moreover, sharply higher CNB FX reserves this year (1.6x gross external funding needs), contained broader sovereign risks and little (if any) sensitivity to regional FX risk aversion, we do not see stronger volatility for the time being. All considered, we expect the EUR/HRK inside 7.30-7.50 in the coming quarters, predominantly shaped by robust C/A trends, stronger capital inflows and EU transfers in support of further kuna structural appreciation.

Croatia: 5Y CDS spreads and EUR/HRK



Croatian bond performance supported by better fiscal and external positions, Agrokor debt resolution

The CNB easing with multi-billion kuna liquidity creation potential via FX transactions, moderate bank lending dynamics and stable FX combined, we see short-end rates at record lows. Namely, despite continuously growing new kuna disbursements, new volumes are still too low to push MM rates higher. With successful EUR750m 10Y bond and domestic bond sales for 2018 completed, successful Agrokor debt settlement, fading the risks of contingent liabilities, and sound prefunding options on super-liquid local market, Croatian spreads may find a near-term reprieve. Our bullish near-term outlook assumes a track record of fiscal overperformance (i.e. nearly twice as much public debt cuts as required under the Maastricht 1/20th rule), easing in debt issuance pressure, further improvement in external position, increased readiness to accelerate competitiveness reforms under fast ERM II bid and OECD prospects, potential economic restructure upon Agrokor operating reshuffle and thus enhanced sovereign rating prospects. All mentioned alongside the ECB dovish QE tapering reality aside, Croatian bond performance will depend very much on risk appetite this summer. In a risk-off scenario, EM/CEE assets may continue to be challenged by higher USTs, USD strength and idiosyncratic factors (escalating trade wars, spillovers from Italian bonds' volatility), but even then Croatian fundamentals may benefit from more differentiation across EM issuers. In a risk-on environment, we expect investors to buy into cheaper EM valuations, steeper CEE yield curves, improving fiscal/external position metrics and, in case of Croatia, investment grade prospects.

Fiscal overperformance continues

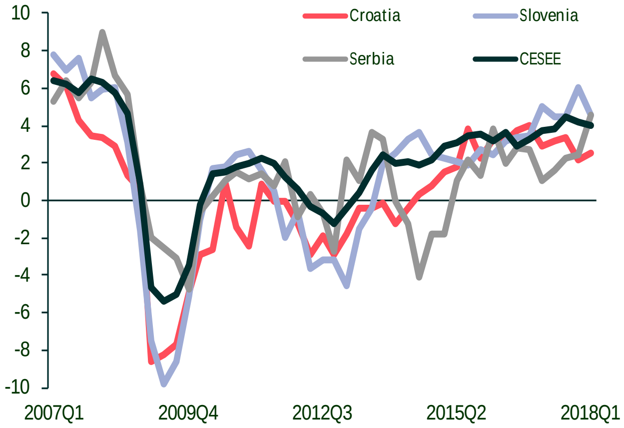
Croatian fiscal accounts show a good performance to date, and we see upside risks to budget balance ahead against the planned -0.5% deficit. According to early indications, stronger-than-expected revenues to date are driven by VAT and CIT, higher wage contributions and EU transfers, despite personal income taxes fully transferred to the local government. While increased EU-co-funded investments, higher wage/entitlement spending, defence costs and healthcare arrears boost spending, we expect tax-rich demand will surprise on the upside on the wings of stellar tourist season. All these mentioned alongside at least 10% yoy lower interest spending and contained wage and social spending (below nominal GDP growth) bode well for 0.5%-alike surplus in 2018. Despite simultaneous structural deficit re-widening toward -0.5% of GDP (as the output gap also becomes positive), it remains well within the MTO of -1.75% of GDP. Stronger-than-expected fiscal consolidation in the past years will likely enable a new round of HRK2bn tax cuts, albeit this time likely skewed to VAT cuts rather than direct tax relief (with more positive impact on private firms' competitiveness). It would be also prudent to align tax cuts to non-discretionary spending rationing. In our base scenario, with stronger nominal GDP growth and lower interest bill and consolidation of agencies' sovereign debt, we see public debt just below 70% of GDP in 2019. This is not only below one-notch higher rated Hungary, but one big difference is that Croatian mandatory and fully funded pension funds hold almost 20% of public debt (unlike in Hungary), and Croatia is more diligent at including contingent liabilities compared to a number of CEE peers with lower public debts.

(Same old) country specific recommendations...

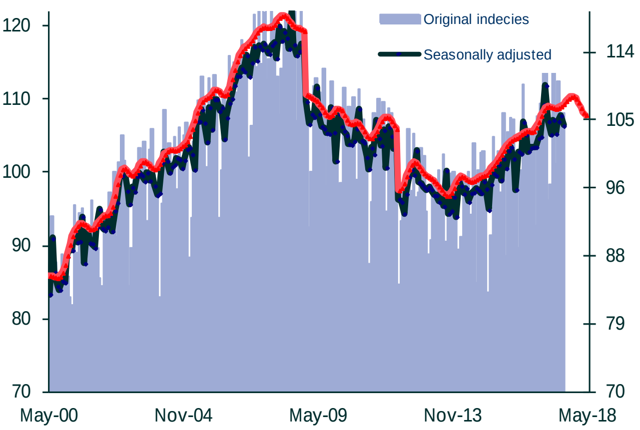
The focus in the EC's last country-specific recommendations is on stronger fiscal framework via independent Fiscal Council and property taxes. While the EC recognized cautious budgeting (projecting 0.7%/GDP surplus vs. official 0.5% deficit target), it perhaps wants to see more active public debt management given still-high public debt and 1pp/GDP higher interest rate spending compared to the EU average and above-average high FX exposure. Moreover, property taxation is the unique chance to shift the tax burden from output factors (wages and profits) to property and improve the overall growth-friendliness of tax system. Similarly to what the ongoing process of Agrokor (operating) restructuring is meant to be for equal level business playing field and in turn private firms' competitiveness. Moreover, in order to sustain 3%-alike growth and anchor public debt on the downside, we need to see further pension reforms (notably penalization of early retirement), public sector reforms (incl. healthcare), red tape cuts, stronger SOE governance and privatization, plus better judiciary/insolvency process in NPL resolution (where Croatia is lagging substantially behind EU peers). That said, the cabinet sends the right kind of noise on improvement in business climate, education reforms and public wage bill reforms (to set complexity/work efficiency criteria). The latter raises the authorities' leverage in setting criteria for more flexible social negotiations, durable public wage containment and the next big thing - leaner public administration, including cuts in the number of ministers from 20 to14 as well as territorial administration.

Croatia's data trends

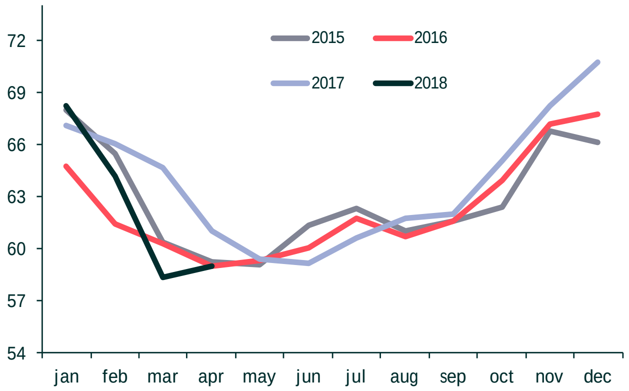
CRO growth in line with CESEE



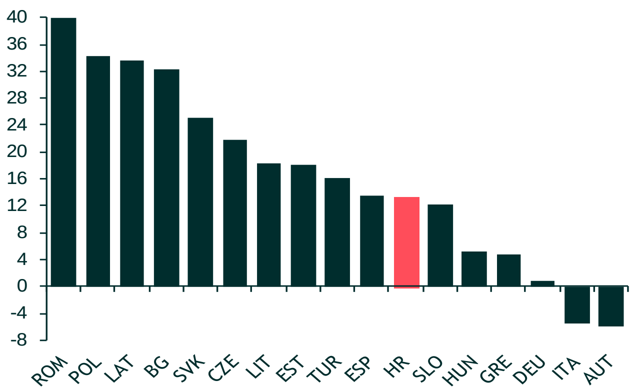
Industrial production, 2015=100



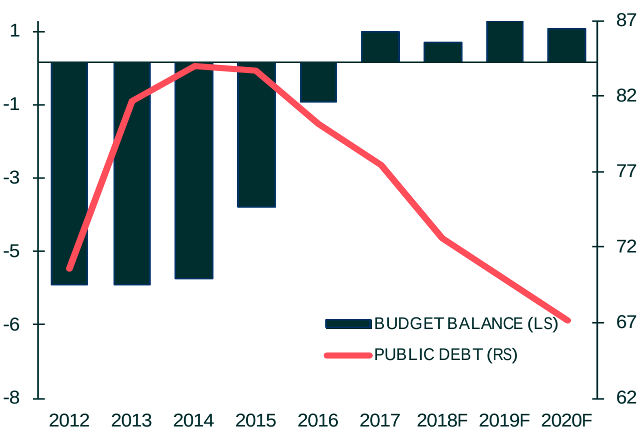
CRO: Merchandise trade import cover on 3mma basis



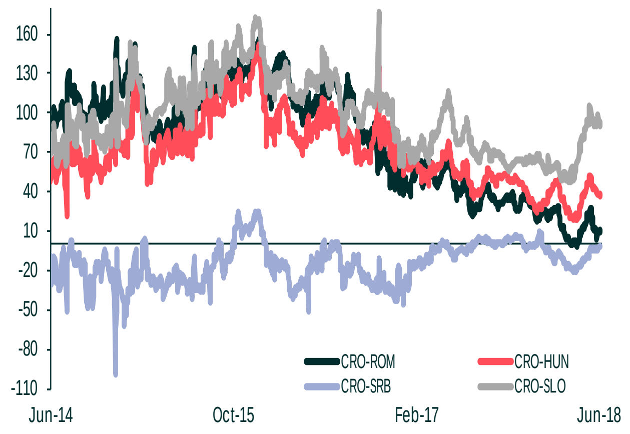
Change in export shares vs EU countries, 2017-2008, (%)



Budget balance and public debt (%/GDP)



Spread on CRO USDs vs peers (bp)



Source: Croatian National Bank, Central Bureau of Statistics, Ministry of Finance, European Commission, Bloomberg, Addiko research

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Activity									
Nominal GDP (HRKbn, current prices)	333,5	330,8	331,8	331,6	339,6	351,3	365,6	382,9	402,5
Nominal GDP (EURbn)	44,9	44,0	43,8	43,5	44,6	46,7	49,0	51,7	54,5
Nominal GDP (USDbn)	62,2	56,5	58,1	57,7	49,5	51,6	55,2	60,0	64,6
GDP per capita (EUR)	10.480	10.311	10.293	10.254	10.616	11.180	11.882	12.635	13.401
GDP per capita (USD)	14.542	13.233	13.663	13.617	11.772	12.372	13.385	14.673	15.880
Real GDP (constant prices YoY, %)	-0,3	-2,3	-0,1	-0,1	2,3	3,5	2,9	3,0	3,0
Private consumption (YoY, %)	0,3	-3,0	-1,9	-1,6	1,0	3,4	3,6	3,3	2,8
Fixed investment (YoY, %)	-2,7	-3,3	1,4	-2,8	3,8	6,5	3,8	5,8	6,5
Industrial production (YoY, %)	-1,2	-5,5	-1,7	1,4	2,5	5,1	1,9	2,6	3,0
Unemployment rate (ILO, average %)	13,7	15,9	17,3	17,3	16,3	13,1	11,2	10,0	9,0
Prices									
CPI inflation (average % YoY)	2,3	3,4	2,2	-0,2	-0,5	-1,1	1,1	1,4	1,8
CPI inflation (end-year % YoY)	2,1	4,7	0,3	-0,5	-0,6	0,2	1,2	1,4	1,6
PPI inflation (average % YoY)	6,4	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,0	2,1
Net wage rates (% YoY, nom., €)	-0,2	-0,4	-0,1	-0,4	1,5	2,9	5,0	5,1	4,4
Fiscal balance (% of GDP)									
State budget balance	-7,5	-5,3	-5,3	-5,1	-3,4	-0,9	0,8	0,5	1,0
Public debt	63,7	70,6	81,6	84,0	83,7	80,2	77,5	72,6	69,8
Gross public funding needs	15,5	17,8	24,8	18,2	19,9	16,3	20,1	14,1	13,8
External balance									
Export of goods and services (EURbn)	18,128	18,319	18,768	19,677	21,473	22,778	25,148	27,030	28,520
Import of goods and services (EURbn)	18,315	18,125	18,599	18,852	20,442	21,456	24,073	26,103	27,997
Merchandise trade balance (EURbn)	-6,381	-6,296	-6,587	-6,512	-6,974	-7,385	-8,254	-9,087	-10,065
Merchandise trade balance (% of GDP)	-14,2	-14,3	-15,0	-15,0	-15,6	-15,8	-16,8	-17,6	-18,5
Tourism receipts (EURbn)	6,617	6,859	7,203	7,402	7,962	8,635	9,493	10,262	10,830
Current account balance (EURbn)	-0,313	-0,050	0,414	0,858	2,018	1,204	1,902	1,510	1,224
Current account balance (% of GDP)	-0,7	-0,1	0,9	2,0	4,5	2,6	3,9	2,9	2,2
Net FDI (EURbn)	1,1	1,2	0,8	0,7	0,2	1,9	1,2	1,8	1,9
FDI (% of GDP)	2,5	2,8	1,9	1,6	0,5	4,1	2,5	3,4	3,5
FDI cover (%)	357,4	2.469,6	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	11,195	11,236	12,908	12,688	13,707	13,514	15,706	17,156	18,789
Import cover (months of imports)	7,3	7,4	8,3	8,1	8,0	7,6	7,8	7,9	8,1
Debt indicators									
Gross external debt (EURbn)	46,397	45,297	45,803	46,416	45,384	41,668	40,069	39,063	39,382
Government (EURbn)	11,449	12,705	14,647	15,841	18,049	16,230	16,312	16,254	16,026
Private (EURbn)	34,949	32,592	31,157	30,575	27,335	25,438	23,756	22,808	23,355
Gross external debt (% of GDP)	103,4	102,9	104,6	106,8	101,7	89,3	81,8	75,6	72,2
Gross external debt (% of exports)	255,9	247,3	244,1	235,9	211,4	182,9	159,3	144,5	138,1
Exchange rates and money growth									
USD/HRK (end-year)	5,82	5,47	5,55	6,30	6,99	7,17	6,27	6,48	6,03
USD/HRK (average)	5,34	5,85	5,71	5,75	6,86	6,80	6,62	6,38	6,23
EUR/HRK (end-year)	7,53	7,55	7,64	7,66	7,64	7,56	7,51	7,45	7,42
EUR/HRK (average)	7,43	7,52	7,57	7,63	7,61	7,53	7,46	7,41	7,38
Money supply M1 (% YoY)	7,3	0,9	11,5	9,6	11,3	18,2	19,1	13,4	13,3
Broad money M4 (% YoY)	5,6	3,6	4,0	3,2	5,1	4,7	2,1	3,9	3,6
Domestic credit (% YoY, euros)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	2,5	3,3
ZIBOR 3M interest rate (average %)	3,19	3,55	1,54	0,99	1,27	0,90	0,65	0,35	0,25
HRK 1Y yield (average %)	3,72	3,93	2,54	1,86	1,50	0,96	0,43	0,06	0,00
HRK 10Y yield (average %)	6,63	6,26	4,30	4,00	4,09	3,60	2,72	2,18	2,35

Source: Croatian National Bank, Central Bureau of Statistics, Ministry of Finance, Addiko research

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Balance sheet									
Assets (EURm)	55.342	54.395	54.338	54.719	54.536	54.689	54.416	55.372	56.764
Assets (%, YoY)	3,7	-1,7	-0,1	0,7	-0,3	0,3	-0,5	1,8	2,5
Assets (% of GDP)	123,4	123,6	124,0	125,9	122,2	117,2	111,0	107,1	104,1
Gross loans (EURm)	38.665	37.678	37.543	36.561	35.941	34.125	32.706	33.536	34.638
Gross loans (%, YoY)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	2,5	3,3
Gross loans (% of GDP)	86,2	85,6	85,7	84,1	80,5	73,1	66,7	64,9	63,5
Deposits (EURm)	29.293	30.087	30.959	31.874	33.660	35.237	36.355	38.186	40.211
Deposits (%, YoY)	0,3	2,7	2,9	3,0	5,6	4,7	3,2	5,0	5,3
Deposits (% of GDP)	65,3	68,4	70,7	73,3	75,4	75,5	74,2	73,9	73,7
Loan-to-deposit ratio (%)	132,0	125,2	121,3	114,7	106,8	96,8	90,0	87,8	86,1
Capital adequacy ratio (%)	19,6	20,9	21,0	21,8	20,9	23,0	23,8	22,3	22,1
Performance									
Net interest income (EURm)	1.540	1.449	1.360	1.366	1.401	1.457	1.477	1.484	1.493
Net interest income (%, YoY)	3,7	-5,9	-6,2	0,5	2,5	4,0	1,4	0,5	0,6
Total operating income (EURm)	2.249	2.015	1.923	1.922	1.904	2.150	2.134	2.154	2.183
Total operating income (%, YoY)	2,0	-10,4	-4,5	0,0	-1,0	12,9	-0,7	0,9	1,3
Pre-provision profit (EURm)	1.127	972	920	934	915	1.178	1.134	1.161	1.175
Pre-provision profit (%, YoY)	3,1	-13,7	-5,4	1,6	-2,0	28,7	-3,8	2,4	1,2
Provision charges (EURm)	500	501	780	645	1.529	380	574	414	392
Profitability and efficiency									
Net interest margin (%)	2,8	2,6	2,5	2,5	2,6	2,7	2,7	2,7	2,6
Pre-tax ROAA (%)	1,2	0,9	0,3	0,5	-1,1	1,5	1,0	1,4	1,4
Pre-tax ROAE (%)	8,4	6,2	1,9	3,9	-8,7	11,4	7,3	9,4	9,7
Cost-to-income ratio (%)	49,9	51,7	52,2	51,4	51,9	45,2	46,9	46,1	46,1
Operating expense (% of assets)	2,1	1,9	1,8	1,8	1,8	1,8	1,8	1,8	1,8
Credit quality and provisioning									
NPL ratio (%)	12,4	13,9	15,7	17,1	16,7	13,8	11,4	10,1	9,4
NPL coverage (%)	41,4	42,6	46,2	51,3	56,9	63,7	61,5	60,8	61,0
Provision charges (% of loans)	1,3	1,3	2,1	1,7	4,2	1,1	1,7	1,3	1,2
Provision charges (% of PPP)	44,4	51,5	84,8	69,0	167,0	32,2	50,6	35,6	33,4

Source: CNB, Addiko research

1Q18 profit normalizing in the absence of Agrokor provisioning costs

After long de-leveraging series, credit activity finally picked-up by 3.2% growth in the year to May, with the strongest positive contribution from 3.7% ytd higher retail lending. Credit activity in the retail segment was mostly carried by increased demand for cash non-purpose loans, in line with stronger labour market and strong consumer sentiment, supported by record low interest rates and strong bank competition. Increased firms' profits and business optimism boded well for corporate lending which recorded 2.8% ytd growth, in the context of more relaxed credit standards, for SME sector in particular. At the same time total deposits increased 2.5% ytd, given 1.9% ytd higher retail a-vista, while corporate deposits fell 1.5% ytd. Regarding profits, NII decreased 5.5% yoy in 1Q18 on 5.5% yoy interest income slump, despite substantially lower funding costs (-29.7% yoy). Total operating income thus increased 4.0% yoy on the back of higher non-interest income (trading result), while pre-tax profit recorded much stronger growth (252% yoy) thanks to ceasing Agrokor effect and consequently lower provisioning costs.

Stronger credit recovery expected going forward

Given somewhat stronger than expected ytd performance, we lift our 2018 credit growth forecast to 2.3% (+0.6pp). Our expectations are driven by solid economic outlook, stronger labour market and household consumption alongside record low interest rates, courtesy of bank competition and lower risk costs. Corporate lending prospects remain supported by stronger fixed investments, EU funding outlook and firms' interest in (re)financing at lower fixed interest rates. Cleaning of banks' balance sheets will continue through further NPL sales, which should bring the NPL ratio down to 10.1% (vs. 11.4% in 2017). We also expect 3.0% deposit growth this year, reflecting low interest rates environment and increasing households' spending propensity. In 2018, we see stronger banks' profitability on lower impairments level, albeit strong bank competition will keep margins under pressure.

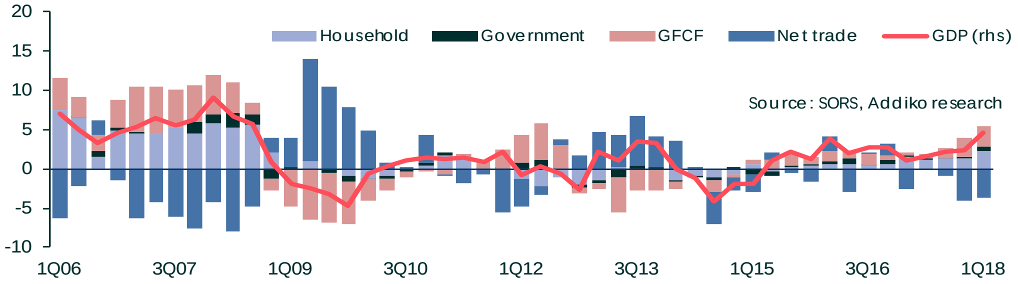
Reacceleration

We lift 2018 GDP growth forecast on stronger-than-expected 1H18, better investment outlook and agricultural season, defying the euro area slowdown. Ongoing budget surplus and lower cost of funding will help public debt to fall below 60% of GDP. The newest IMF program and EU accession talks could bode well for reforms. Despite appreciation pressures on the dinar, we expect the NBS to stay on hold for the time being given the uncertain external backdrop and recovery in inflation. There is still some downside potential in long-term dinar yields on the back of lower supply in 2H18 and especially in 2019, solid fiscal performance to date, and the mix of strong dinar and contained inflation.

Strongest growth in more than 10 years

The broad-based Q1 growth surge (+4.5% yoy) was driven by the explosion of investments (+16% yoy), accelerating private/public consumption, stronger manufacturing recovery and steady goods exports. The low 1Q17 base amid supply shocks due to weather-inflicted agriculture and energy/Fiat output outages admittedly played a big role. Fixed investment jumped on soaring FDI (13% yoy in Q1), long-delayed public capex (+161% yoy) and found further support from nearly double private corporate profits as well as re-leveraging. Meanwhile, private consumption prospered from private job creation (3.7% yoy), 6%+ yoy wage, soaring foreign workers' remittances (+24.5% yoy), pension hikes and higher social transfers and re-leveraging. Given the strong demand leakages into imports, buoyant export growth could not reduce negative net trade contribution much. While external demand lost some momentum recently, we still expect much stronger investment demand (including public capex), consumer momentum, normalized energy output and low base to support 4%-alike GDP growth in Q2.

Serbia: contributions to GDP (pps, %)



GDP growth finally booming and defying Euro area slowdown

Given stronger-than-envisaged 1H18 development, better agricultural season and stronger investment outlook, we upgrade 2018 GDP forecast by 0.5pp to 4.0%. This implies similar growth dynamics in 2H18, with private consumption one of the key drivers thanks to further private employment and wage growth, re-leveraging and higher entitlement spending. Closely following, investments are accelerating their four-year boom, and we expect a re-pricing of growth potential on the heels of strong manufacturing FDIs, climbing up the value chain, state-sponsored EUR2.5bn railway/road construction, doubling corporate profits, easier financing condition and the recently announced corporate tax prospects in 2019. A more vibrant GDP expansion and lower taxes will in our view work its way to further increase formal private employment. Despite high import-intensity of stronger domestic demand, we expect hefty export growth on account of significant export capacity expansion to reduce negative net trade contribution to about -1pp of GDP. Risks to our forecasts are skewed to the upside when it comes to 1-2pp/GDP fiscal (easing) space opening in 2019 (via entitlement spending/capex/tax cuts), agricultural output, manufacturing FDI and policy-induced optimism with the new more reform-oriented IMF agreement. Downside risks mainly come from external factors i.e. global trade wars, EU political risks hitting EU sentiment and demand, public capex under-execution and reform stalemate in the event of prolonged government reshuffle.

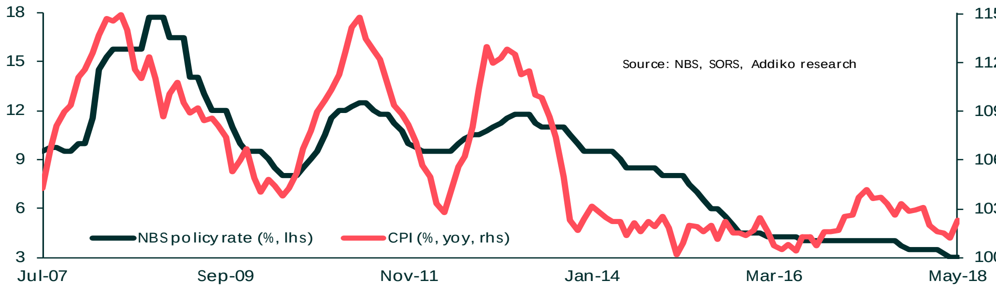
Inflation stabilization ahead

Inflation surprised on the downside mainly due to stronger dinar, generally subdued import prices and still low food processing costs. From the April trough (1.1% yoy and core CPI 0.8% yoy), we expect a combination of strong labour markets, higher commodity prices, firmer domestic demand supported by expansionary fiscal backdrop and private-sector re-leveraging, as well as faster closing of the negative output gap will drive headline CPI towards 2% yoy (or slightly higher) by the autumn. Upside risks to headline inflation mainly stem from the global commodity prices and even stronger domestic wage growth, while the stronger dinar and finally one normal agricultural season without climatic shocks may dampen food prices. All said, we have to lower the average 2018 inflation to 1.8% (prev. 2.1% yoy) in the absence of significant food prices supply-side shocks. In 2019, we expect CPI to average 3.0% on higher commodity prices, strong domestic demand and a few administrative price hikes.

External position continues to improve on hefty FDIs, banks' external positions and de-leveraging

While the global/euro zone growth moderated, it remains supportive, which alongside Serbian exporters' market share gains and stronger agriculture exports suggests a double-digit (10%+ yoy) goods export growth in 2H18 and 2019. We still expect soaring investment demand, consumer goods imports and higher commodity prices to produce flattish trade deficit this year (~11% of GDP). Despite that, record foreign workers' remittances and lower investment income shortfall will lead to slightly lower C/A gap around 5.5% of GDP. At the same time, hefty manufacturing additions, surging non-resident banks' profit, real estate projects and privatizations (Airport Nikola Tesla, copper smelter RTB Bor, etc), growing business process outsourcing and better business climate are driving FDI close to 6.5% of GDP. FDI overfinancing, strong banks' net external positions and external de-leveraging support improvement in net international investment position. We also expect higher foreign inflows into local debt, which combined with sustained fiscal surplus (next page) reduces external borrowing needs.

Serbia: CPI inflation and NBS policy rate



NBS on hold for the time being and intervening

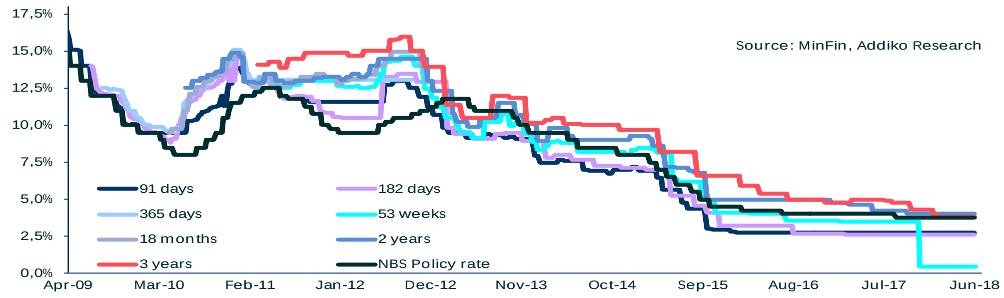
The NBS stopped cutting its key policy rate at 3.00% for more than a few reasons: (i) uncertain external backdrop (EM selloff, Fed/ECB diverging policy, oil shock threat), and (ii) inflation recovery in the context of accelerating domestically-driven GDP growth. While intensified RSD appreciation pressures (see down) could be calling for another rate cut, that was not enough to change the bigger picture, and the NBS preferred to cap FX (intervening heavily in the FX spot market) and halt erosion of competitiveness of exports until more clarity on the global front and EM risk appetite. With the recent NBS inflation forecast downgrade driven by transitory price weakness to date, resurgent oil/commodity prices, coupled with buoyant activity data, our base case is the NBS will stay 'on-hold' for the time being and continue to intervene against excessive dinar strengthening. Given still very gradual recovery in core inflation, perceived auto-pilot Fed tightening and the ECB rate normalization only in late 2019 or even 1Q20, we see the first (25bp) NBS rate hike in 1Q20 at the earliest, but the NBS' reaction function suggests risks are tilted towards a delay into 2-3Q20. From a risk perspective, strongly improved private-sector internal imbalances, contained inflation development, stable FX outlook and low fiscal risk allow the NBS easy stance. Our baseline could be compromised should the Fed/ECB speed up their policy normalization in response to stronger inflation development and/or major volatility in the external environment impacts the dinar like a typical risk-off shock.

Dinar strengthening to persist

Despite stronger corporate FC demand and soaring goods trade deficit, the EUR/RSD has been stable just above 118, with the dinar strength curbed only via accelerated consistently one-sided FX interventions (EUR595m in two months). That said, the RSD appreciation pressures have reflected stronger merchandise exports, FDIs, soaring remittances and stronger FX-linked corporate credit, offsetting the goods import cover deterioration and the recent portfolio outflows. Apart from the NBS easing and stable dinar, we think the downward short-end rates development has been influenced by the MinFin bargaining power in T-bill auctions thanks to hefty cash reserve and ample interbank liquidity, which the NBS has continued to fine-tune through 1W REPO. EM local rates have sold off sharply in Q2 against the backdrop of an upward trajectory of USTs, increasing interest rate risk premium ('term' premium) in EM curves and EM bond fund outflows. The move higher was concentrated in high-yielders, particularly those with large un-hedged USD debt, and Serbian foreign bonds were no exception. Thankfully, long-term dinar yields fell on improving sovereign (fiscal) risk outlook, prospects for EM indices' inclusion alongside some pick-up in Serbian long-term papers over CESEE peers.

Sporadic pullback episodes on import demand surprises aside, we expect appreciation pressures to prevail on strong FDI/privatization flows, rising remittances, macro/political stability, stronger bank lending and inclusion in two major EM bond indices in support of more sustained non-residents' appetite for Serbian assets. Apart from the ongoing NBS' FX purchases, appreciation pressures on the dinar could be offset by potential USD700m MinFin buying ahead of USD1bn redemption in early December, depending also on the EUR/USD development. With the dinar recently showing little sensitivity to regional FX-risk-off episodes, we see the EUR/RSD inside 116.50-118.50 during 2H18, before stabilizing close to 119 early next year. Upside risks to export outlook, EU accession/funding prospects and a more dovish ECB posture point towards a stable to slightly stronger dinar in the medium term.

Serbia: T-bill/notes yields



Serbian rates have further downside potential on growth potential repricing, new IMF deal, fiscal overperformance

Given the NBS' accommodativeness and low inflation, we see short-end rates close to record lows, despite stronger RSD bank lending. Having already sold RSD83bn and RSD92bn in 5Y and 10Y bonds, respectively (to date), we expect the MinFin to grasp this window of opportunity and augment the planned long-term dinar issuance for 2018 to at least RSD150bn from RSD110bn for both 5Y and 10Y maturities and use the difference (RSD80-100bn) for the USD purchases. In 1H18, the MinFin sold RSD83bn and RSD92bn in 5Y and 10Y bonds in 1H18, respectively. The planned significant increase in the gross dinar T-bond issuance (3.8% of GDP vs. just 0.7% in 2017) will be therefore overshot as part of the MinFin's aspirations to raise the share of RSD in public debt to min. 25%, and support the overall dinarization agenda. With domestic debt supply lower in 2H18, solid fiscal performance to date, and EUR1bn lower funding needs in 2019, long-term dinar yields have a little further downside potential. Meanwhile, should the sell-off in the EM high yielding rates markets extend amid deteriorating global prospects, oil prices rally and trade as well as political tensions, Serbian USD rates would naturally suffer in sympathy with some of the high-yielders. While the near-term uncertainty is high, once the dust settles, we see interest in improving Serbian macro (higher potential growth ahead) and fiscal fundamentals additionally supported by the new more reform-minded IMF deal and the prospects of EM indices' inclusion with the eligibility criteria (including the US1bn local market liquidity requirement) met in Q3.

Fiscal overperformance continues…

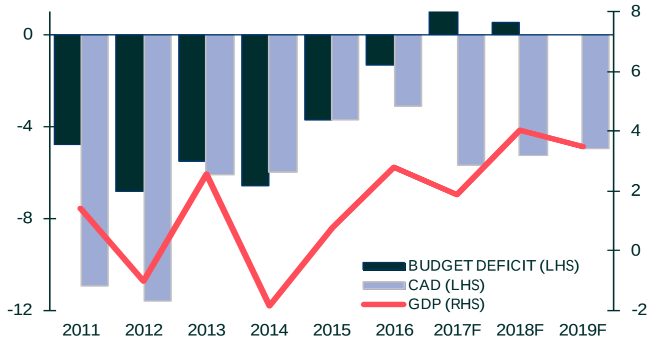
After a remarkable improvement in fiscal metrics in 2017 and the budget surplus at 1.2% of GDP, fiscal accounts remained in good shape in 1H18, with the 5M18 surplus at RSD6.8bn and unofficially around RSD31bn for 1H18. Such performance mainly owes to persistent tax revenue overshooting (+7.6% yoy), increasingly broad-based and driven by tax-rich domestic demand and stronger labour market, as well as better tax compliance. At the same time, expenditures rose 6% yoy on soaring capital investments (notably into infrastructure) and pension hikes, being partly offset by further interest bill and guarantees cuts. While resurgent domestic demand this year will likely ensure an 8%-alike tax growth, interest rate spending falls further, and the MinFin collects EUR430m from airport concession, we still expect the budget surplus to fall to 0.5% of GDP in 2018 on public capex acceleration and additional wages and pension hikes (at least 1pp of GDP). From a competitiveness point of view, it would have been better if labour tax cuts were stronger and public wage hikes milder. Thanks to frontloaded fiscal consolidation, notably during the past few years, GDP growth rebounding, sustained primary surplus and stronger dinar, we expect further drop in public debt toward 57.5% of GDP, which is below the 'BB' median and paves the way for the sovereign rating upgrades.

…but stronger reform momentum is needed to sustain structural adjustment

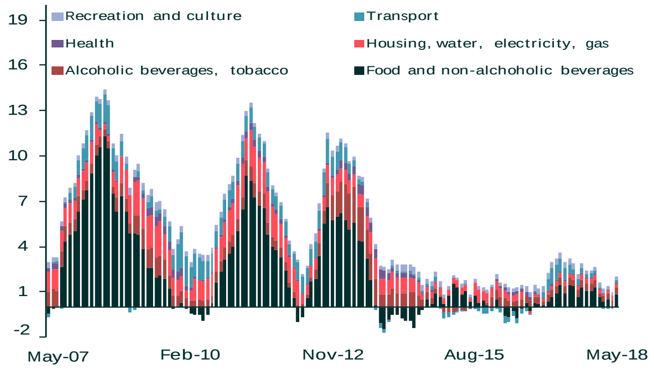
The one silver-lining is that extraordinary fiscal performance is not accompanied by significant reforms (notably when it comes to SOEs' restructuring, despite stronger privatization pipeline) and instead partly gave a boost to entitlement spending, which leaves Serbia vulnerable in the medium term to cyclical shocks. In that sense, the main negative fiscal risks involve contingent liabilities on the part of non-restructured SOEs (EPS, Srbijagas?). No wonder the focus of the EC's country-specific recommendations, coinciding with the newest IMF accord (Policy Coordination Instrument) is on the ongoing improvement in the spending mix by reducing non-interest outlays and boosting capex. The next big thing here is the expected 1-2pp/GDP fiscal space for 2019 as the EC just like the IMF wants Serbia to target a balanced budget in the medium term following the repeated budget surplus this year. The requested electricity price hikes to support funding of the badly-needed energy infrastructure upgrade shall in the first phase contribute to stronger price pressures in our view, but energy capacity expansion is a must if the country wants to continue attracting hefty FDI inflows. While the risks to the near-term economic outlook are currently skewed to the upside and budget surplus may be even higher, the country's new industrial strategy must employ smarter specialisation principles and parafiscal charges must be more predictable and based on a fee-for-service principle. The latter should be importantly accompanied by non-wage labour cost cuts for low-income earners and kick-start inclusive employment policies, all to sustain competitiveness gains in the medium term.

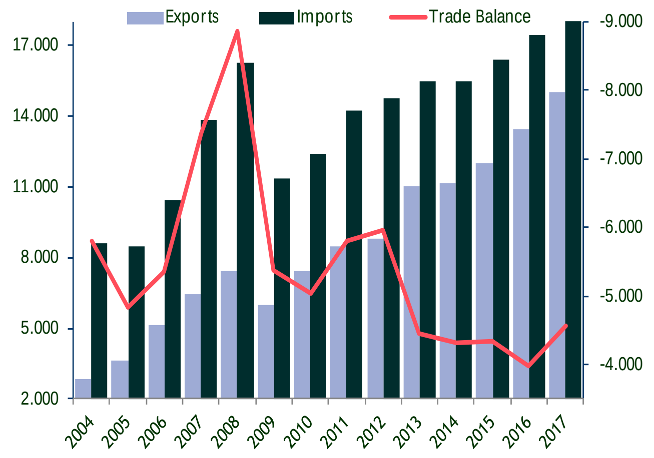
Serbia's data trends

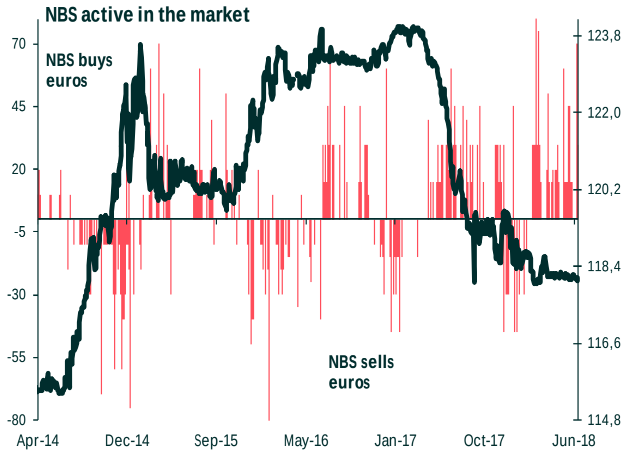
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



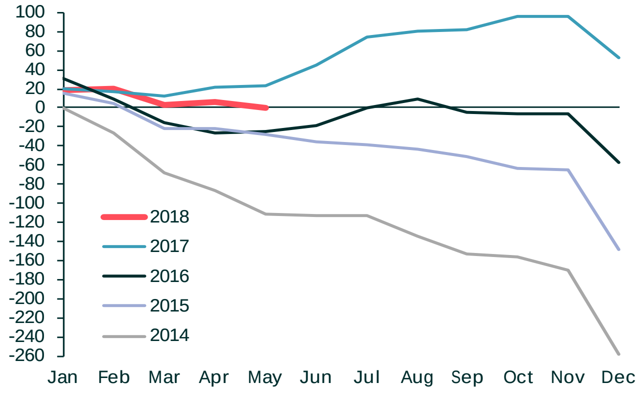
CPI contribution - key categories (pps)



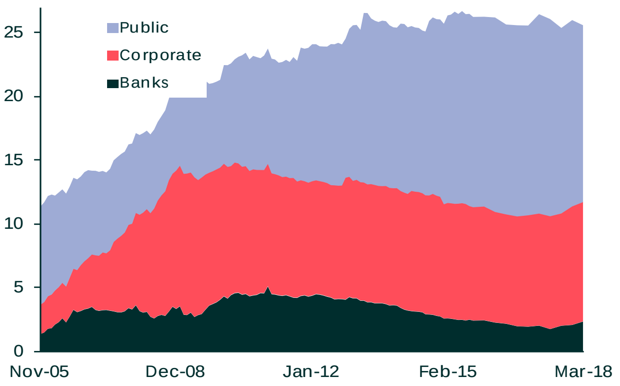




Consolidated government budget balance (RSDbn)



Corporate external de-leveraging comes to a halt? (EURbn)



Source: National Bank of Serbia, Statistical Office of the Republic of Serbia, Ministry of Finance, Consensus Economics, Bloomberg, Addiko research

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Activity									
Nominal GDP (RSDbn,current prices)	3.408	3.584	3.876	3.908	4.043	4.262	4.465	4.733	5.051
Nominal GDP (EURbn)	33,4	31,7	34,3	33,3	33,5	34,6	36,8	40,3	42,7
Nominal GDP (USDbn)	46,5	40,7	45,5	44,1	37,1	38,3	41,5	46,8	50,6
GDP per capita (EUR)	4.620	4.401	4.783	4.662	4.720	4.889	5.226	5.719	6.059
GDP per capita (USD)	6.423	5.650	6.353	6.177	5.234	5.415	5.901	6.642	7.099
Real GDP (constant prices YoY, %)	1,4	-1,0	2,6	-1,8	0,8	2,8	1,9	4,0	3,5
Private consumption (YoY, %)	0,9	-2,1	-0,4	-1,3	0,4	0,8	1,8	3,2	3,2
Fixed investment (YoY, %)	4,6	13,2	-12,0	-3,6	5,6	5,1	6,2	11,4	7,0
Industrial production (YoY, %)	2,5	-2,2	5,4	-6,4	8,4	4,7	3,5	4,8	5,0
Unemployment rate (ILO, average %)	23,0	23,9	22,1	19,2	17,7	15,3	13,5	11,5	10,9
Prices									
CPI inflation (average % YoY)	11,0	7,8	7,8	2,1	1,4	1,1	3,1	1,8	3,0
CPI inflation (end-year % YoY)	7,0	12,2	2,2	1,7	1,5	1,6	3,0	2,2	3,4
PPI inflation (average % YoY)	14,2	5,6	3,6	0,7	0,2	-0,4	3,0	2,0	3,8
Net wage rates (% YoY, nominal, euros)	1,1	-1,8	-1,8	-4,3	-3,3	1,8	5,1	7,4	4,0
Fiscal balance (% of GDP)									
State budget balance	-4,8	-6,8	-5,5	-6,6	-3,7	-1,3	1,2	0,5	0,0
Public debt	45,4	56,2	59,6	70,4	74,7	71,9	61,3	57,6	54,3
Gross public funding needs	13,3	15,4	16,1	17,6	16,7	13,9	8,7	9,8	7,1
External balance									
Export of goods and services (EURbn)	11,145	11,469	13,937	14,451	15,728	17,385	19,330	20,920	22,706
Import of goods and services (EURbn)	16,487	16,992	17,782	18,096	18,643	19,597	22,365	24,670	26,481
Merchandise trade balance (EURbn)	-5,496	-5,634	-4,159	-4,111	-3,645	-3,119	-3,986	-4,781	-4,946
Merchandise trade balance (% of GDP)	-16,4	-17,8	-12,1	-12,3	-10,9	-9,0	-10,8	-11,9	-11,6
Remittances, net (EURbn)	2,110	1,989	2,217	1,931	2,155	1,953	2,151	2,409	2,530
Current account balance (EURbn)	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,090	-2,199	-2,203
Current account balance (% of GDP)	-10,9	-11,6	-6,1	-6,0	-3,7	-3,1	-5,7	-5,5	-5,2
Net FDI (EURbn)	n/a	0,8	1,3	1,2	1,8	1,9	2,4	2,6	2,8
FDI (% of GDP)	n/a	2,4	3,8	3,7	5,4	5,5	6,6	6,4	6,5
FDI cover (%)	n/a	20,5	61,9	62,3	146,2	176,7	115,6	117,9	124,9
Gross international reserves (EURbn)	12,058	10,915	11,189	9,907	10,378	10,205	9,962	11,331	13,908
Import cover (months of imports)	8,8	7,7	7,6	6,6	6,7	6,2	5,3	5,5	6,3
Debt indicators									
Gross external debt (EURbn)	24,125	25,645	25,644	25,679	26,234	26,494	25,630	25,655	26,733
Government (EURbn)	10,773	12,185	13,120	14,145	15,295	15,680	13,911	12,971	12,821
Private (EURbn)	13,352	13,460	12,525	11,534	10,939	10,815	11,719	12,684	13,912
Gross external debt (% of GDP)	72,2	80,9	74,8	77,1	78,3	76,5	69,7	63,7	62,7
Gross external debt (% of exports)	n/a	223,6	184,0	177,7	166,8	152,4	132,6	122,6	117,7
Exchange rates and money									
USD/RSD (end-year)	80,87	86,18	83,13	99,46	111,64	117,93	99,30	101,74	95,93
USD/RSD (average)	73,34	88,12	85,17	88,54	108,88	111,17	107,47	101,20	99,92
EUR/RSD (end-year)	104,6	113,7	114,6	121,5	121,8	123,5	118,5	117,0	118,0
EUR/RSD (average)	102,0	113,1	113,1	117,3	120,7	123,1	121,3	117,5	118,4
Money supply M1 (% YoY)	16,9	-3,3	24,8	5,2	16,4	18,7	14,8	8,0	6,4
Broad money M3 (% YoY)	11,2	0,7	3,7	3,0	5,0	9,9	7,9	5,2	4,6
Domestic credit (% YoY, euros)	8,9	0,8	-5,2	-2,3	2,4	1,0	6,2	7,9	6,9
NBS policy rate (average %)	11,54	10,10	10,90	8,75	5,63	4,13	3,81	3,06	3,00
NBS policy rate (end-year %)	9,75	11,25	9,50	8,00	4,50	4,00	3,50	3,00	3,00
6M BELIBOR interest rate (average %)	13,13	12,00	10,40	8,53	6,43	3,65	3,60	3,05	3,01

Source: National Bank of Serbia, Statistical Office of the Republic of Serbia, Ministry of Finance, Addiko research

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Balance sheet									
Assets (EURm)	25.325	25.326	24.825	24.546	25.060	26.257	28.045	29.167	30.188
Assets (%, YoY)	5,5	0,0	-2,0	-1,1	2,1	4,8	6,8	4,0	3,5
Assets (% of GDP)	75,8	79,9	72,5	73,7	74,8	75,9	76,2	72,4	70,8
Gross loans (EURm)	17.013	17.148	16.255	15.879	16.253	16.412	17.431	18.817	20.115
Gross loans (%, YoY)	8,9	0,8	-5,2	-2,3	2,4	1,0	6,2	7,9	6,9
Gross loans (% of GDP)	50,9	54,1	47,4	47,7	48,5	47,4	47,4	46,7	47,2
Deposits (EURm)	13.099	13.310	13.634	13.967	14.728	16.159	17.404	18.500	19.453
Deposits (%, YoY)	10,1	1,6	2,4	2,4	5,4	9,7	7,7	6,3	5,2
Deposits (% of GDP)	39,2	42,0	39,8	41,9	44,0	46,7	47,3	45,9	45,6
Loan-to-deposit ratio (%)	129,9	128,8	119,2	113,7	110,4	101,6	100,2	101,7	103,4
Capital adequacy ratio (%)	19,1	19,9	20,9	20,0	20,9	21,8	22,6	22,7	22,9
Performance									
Net interest income (EURm)	1.131	1.025	1.044	1.063	1.075	1.006	1.038	1.079	1.117
Net interest income (%, YoY)	7,6	-9,4	1,9	1,8	1,1	-6,4	3,1	4,0	3,5
Total operating income (EURm)	1.590	1.484	1.435	1.489	1.520	1.393	1.554	1.608	1.636
Total operating income (%, YoY)	3,2	-6,7	-3,3	3,8	2,1	-8,4	11,6	3,5	1,7
Pre-provision profit (EURm)	617	571	504	529	574	467	623	664	678
Pre-provision profit (%, YoY)	9,6	-7,5	-11,6	4,8	8,6	-18,7	33,5	6,6	2,1
Provision charges (EURm)	313	339	510	490	494	294	40	50	58
Profitability and efficiency									
Net interest margin (%)	4,6	4,0	4,2	4,3	4,3	3,9	3,7	3,7	3,7
Pre-tax ROAA (%)	1,2	0,9	-0,1	0,1	0,3	0,7	2,1	2,1	2,1
Pre-tax ROAE (%)	5,9	4,3	-0,3	0,6	1,6	3,5	11,0	10,4	9,6
Cost-to-income ratio (%)	61,8	66,1	65,3	64,7	62,2	66,5	59,9	58,7	58,6
Operating expense (% of assets)	3,9	3,6	3,7	3,9	3,8	3,6	3,4	3,3	3,2
Credit quality and provisioning									
NPL ratio (%)	19,0	18,6	21,4	21,5	21,6	17,0	11,1	8,5	8,0
NPL coverage (%)	51,0	50,0	50,9	54,9	62,3	67,8	61,9	61,6	58,8
Provision charges (% of loans)	1,9	2,0	3,1	3,1	3,1	1,8	0,2	0,3	0,3
Provision charges (% of PPP)	50,7	59,4	101,1	92,8	86,0	62,9	6,4	7,5	8,6

Source: NBS, Addiko research

Retail credit leading the way

Lending activity increased by 2.2% in the year to May, with the strongest positive contribution from the retail segment and modest recovery of corporate loans, while public sector continued down the de-leveraging path. Retail loans recorded robust growth of 5.5% ytd on the back of higher cash loans, carried by improved labour market and wage gains and supported by record low interest rates (on both RSD and FX-indexed lending). Corporate lending barely grew by 0.3% ytd partly due to continued cleaning of banks' balance sheets, as manifested in further decline of NPL ratio in 1Q18 to 9.2% (from 9.8% 2017YE). Meanwhile, deposit growth decelerated to 3.1% ytd (vs. 7.7% in 2017) as retail and corporate deposit collection increased at a much slower rate (both +2.8% ytd), mostly owing to high base effect combined with stronger consumer and investment appetite. With 1Q18 P&L results still haven't been published, we expect somewhat higher yoy pre-tax profit thanks owing increased credit activity and lower provisioning costs.

Credit activity set to accelerate

In 2018, we keep our credit growth forecast around 8%, driven by private sector lending amid stronger consumption propensity as well as investment outlook, supported by persistently low interest rates and high interbank competition. Moreover, the cleaning of banks’ balance sheets in the course of last year opened more space for new lending, and we expect this practice to continue, lowering the NPL ratio in 2018 to 8.5% on our estimates. Regarding deposit growth, we expect further deceleration towards 6.3% due to relatively high base and continuously low interest rates environment. We see pre-tax income slightly above 2017 level owing to solid growth of NII, courtesy of increasing credit portfolio and lower funding costs, along with stable provisioning and opex.

Solid Growth Continues

We keep 3.1% GDP growth forecast for 2018 on the back of stronger private consumption, external demand and externally financed public capex. Meanwhile, we expect inflation to accelerate slightly to 1.4% in 2018, supported by private consumption, higher global oil prices and higher excise taxes on fuels. We expect C/A deficit to re-widen on stronger imports underpinned by higher import-intensive infrastructure investments.

GDP expands 3.0% in 2017

Following 3.0% in 2017, high frequency data suggest strong GDP growth is set to continue. Namely, industrial output accelerated to 4.7% in 5M18 (vs 3.1% growth in FY17), driven by energy generation and durable goods production. Such performance translated into stronger goods exports (+10.9% yoy) in 5M18 on the back of stronger foreign demand. Positive trends in the labour market, with 5.7% yoy higher employment and 2.2% yoy higher wages in 4M18, pushed retail sales up 6,9% yoy in 5M18 (vs 5.1% yoy in 2017). On the other hand, stronger private consumption, alongside better construction and investment activity pushed goods imports by 9.6% yoy in 5M18, which offset export gains and resulted in 7.6% yoy higher trade deficit (EUR1.48bn) and 100bp lower import cover (59.3% in May on a 3mma basis).

We keep our GDP forecasts intact

With our assumptions still in place, we are comfortable with GDP growth forecast of 3.1% in 2018, driven by stronger private consumption, employment and wage growth, re-leveraging, higher remittances, another record tourist season and externally financed public capex. Investments will be driven mainly by public capex amid faster road infrastructure construction (Vc corridor) after the IMF unblocked funds early in the year and EBRD committed to invest at least EUR700m (4.4% of GDP) during 2018-2020 for infrastructure upgrades. Moreover the planned EUR722 Tuzla thermal power plant, EUR250m cement factory and EUR200m Dabar hydro power plant constructions alongside FDIs in wind energy will support investment activity in the next few years. Net trade will still contribute negatively as rising private consumption combined with import-intensive infrastructure capex will push imports higher. Upside risks to our baseline scenario stem from even faster capex execution, stronger FC tourist and remittances inflows in support of private consumption, while downside risks stem from political tensions ahead of general elections in October, halting reforms and external financing.

Reform efforts needed

After the B-H authorities finally responded to the EC questionnaire February, they received another set of 655 questions in order to clarify the ambiguities in the answers. Meanwhile, the EU Council responded to B-H Economic Reform Programme 2018-2020 and invited authorities to create fiscal space for public investment by containing current expenditures, labour tax and red tape cuts in a harmonized fashion between entities. We see these reforms, alongside red tape and administrative burden cuts, new labour market reforms and better SOE governance crucial for maintaining GDP growth above 3.0% in the medium run and taking B-H a step closer to the EU candidate status.

We see consolidated budget deficit at 0.3% of GDP this year

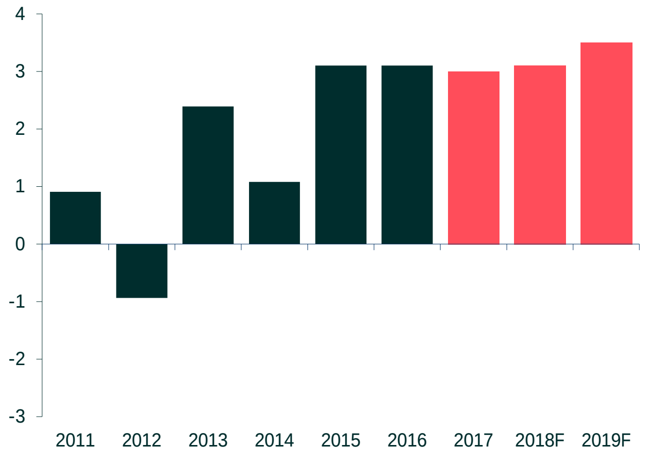
According the B-H Directorate for Economic Planning, budget revenues rose 8.0% yoy to EUR1.8bn in 1Q18, with the strongest positive contribution from 8.4% yoy higher VAT intake, followed by social contributions (+5.9% yoy) and toll revenues (+46.4% yoy) after administrative price hikes. Thanks to positive fiscal trends on the revenue side, Federation B-H cancelled all T-bills auctions in 3Q18 (EUR87m). Meanwhile RS sold its first 5Y EUR168m bond at 4.75% in order to diversify its sources of financing. In 2018, we see the national budget surplus narrowing to 0.3% largely due to higher public capex and higher entitlement spending ahead of elections. While RS government plans to sell its in stakes fourteen SOE this year, we do not expect significant progress on privatization in both RS and Federation B-H that would support public finances, given general elections in October. Furthermore this year budget won't be supported by EUR116m (0.7%/GDP) inflow related to Russian repayment of its clearing debt in 2017.

C/A deficit set to re-widen to 5.3%/GDP

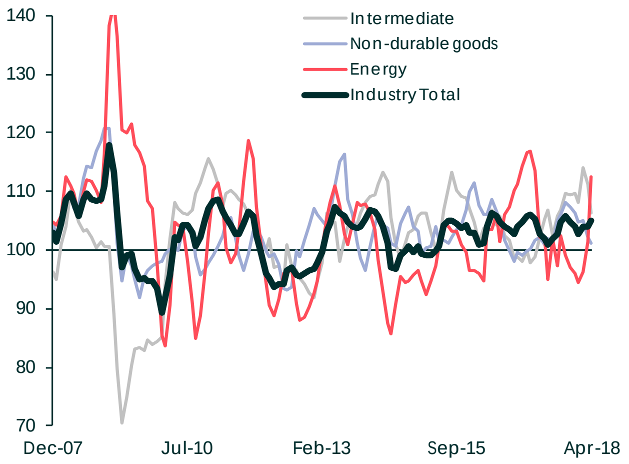
C/A deficit soared 31.4% yoy to EUR193m in 1Q18 due to re-widening of the trade deficit as 12.3% yoy higher goods exports could not offset 9.2% yoy increase in imports from a higher base driven by stronger import-intensive domestic demand. Negative contribution to C/A widening also came from 85.6% yoy lower primary income balance. Services balance rose 4.1% on 12.4% higher FC tourist receipts, while remittances were flat (+0.5% yoy). Notwithstanding stronger exports, record tourist season and higher remittances in the rest of the year, we see C/A deficit widening to 5.3% of GDP (vs. 4.9% of GDP in 2017) on stronger import demand underpinned by higher import-intensive infrastructure investments. Higher global oil and food prices and higher tobacco excises pushed CPI in May to 1.3%, but given subdued inflation development earlier this year, we downgrade 2018 CPI forecast to 1.4% (prev. 1.9% yoy). Going forth, inflation is supported by further acceleration in private consumption, higher excise taxes on fuels as well as higher energy prices.

Bosnia and Herzegovina's data trends

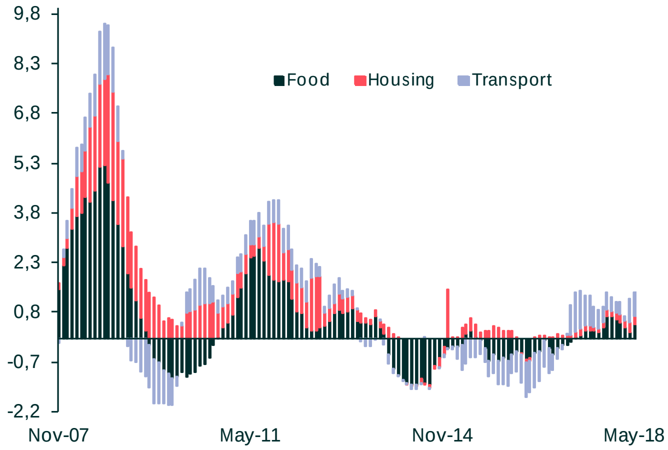
Real GDP growth (% YoY)



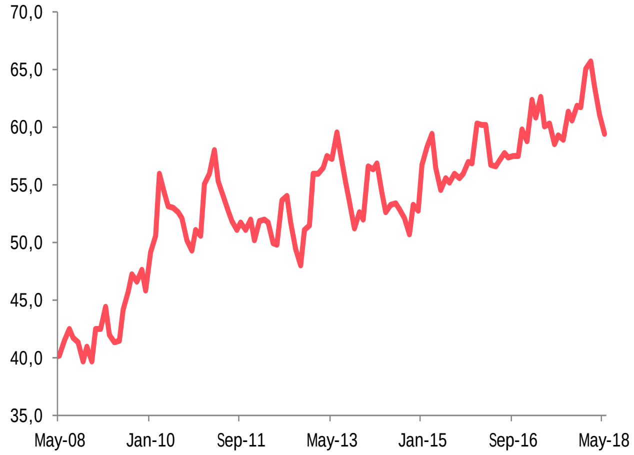
Industrial production (%, yoy, s-a, 3mma)



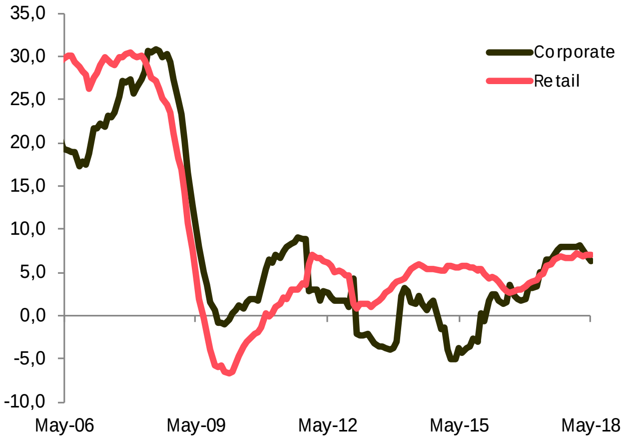
Key CPI contributions (pp)



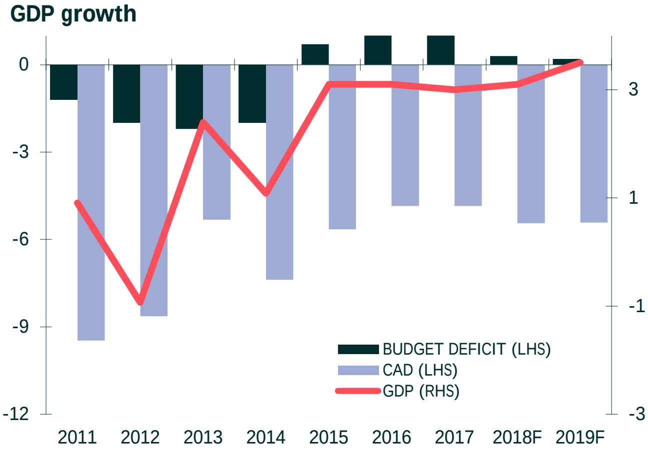
Merchandise import cover (%, 3mma)



Private credit dynamics (%, YoY)



Budget and current account gaps (%/GDP) vs. GDP growth



Source: Central Bank of Bosnia and Herzegovina, The Agency for Statistics, IMF, Ministry of Finance, Addiko research

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Activity									
Nominal GDP (BAMbn, current prices)	26,2	26,2	26,8	27,4	28,6	29,9	31,2	32,6	34,4
Nominal GDP (EURbn)	13,4	13,4	13,7	14,0	14,6	15,3	15,9	16,7	17,6
Nominal GDP (USDbn)	18,7	17,2	18,2	18,6	16,2	16,9	18,0	19,7	21,2
GDP per capita (EUR)	3.635,6	3.675,4	3.798,1	3.922,8	4.133,5	4.346,7	4.532,3	4.738,2	5.002,1
GDP per capita (USD)	5.063,0	4.726,5	5.044,2	5.211,4	4.584,5	4.813,5	5.117,4	5.597,4	6.027,6
Real GDP (constant prices YoY, %)	0,9	-0,9	2,4	1,1	3,1	3,1	3,0	3,1	3,5
Private consumption (YoY, %)	-0,2	-0,7	0,8	1,4	1,8	2,3	2,6	2,8	2,5
Fixed investment (YoY, %)	14,1	4,0	-3,0	8,2	2,9	10,8	-2,8	4,0	4,2
Industrial production (YoY, %)	5,9	-5,2	6,7	0,1	2,6	4,5	3,1	4,5	5,0
Unemployment rate (ILO, average, %)	27,6	28,0	27,4	27,5	27,7	25,4	20,6	18,7	16,5
Prices									
CPI inflation (average % YoY)	3,7	2,1	-0,1	-0,9	-1,0	-1,1	1,2	1,4	2,0
CPI inflation (end-year % YoY)	3,1	1,8	-1,4	-0,4	-1,3	-0,2	1,8	1,9	2,1
PPI inflation (average % YoY)	3,8	1,3	-2,2	-0,2	0,6	-2,1	2,9	2,4	2,4
Net wage rates (% YoY, nominal)	2,0	1,2	0,1	0,4	0,0	0,8	1,9	2,5	2,9
Fiscal balance (% of GDP)									
State budget balance	-1,2	-2,0	-2,2	-2,0	0,7	1,2	1,0	0,3	0,2
Public debt	43,1	43,4	44,5	45,0	45,5	43,7	42,6	41,9	41,0
External balance									
Export of goods and services (EURbn)	4,297	4,337	4,620	4,754	5,056	5,432	6,228	6,652	6,985
Import of goods and services (EURbn)	-7,484	-7,481	-7,419	-7,927	-7,801	-7,985	-8,922	-9,534	-9,820
Merchandise trade balance (EURbn)	-4,131	-3,977	-3,630	-4,026	-3,677	-3,600	-3,835	-4,057	-4,035
Merchandise trade balance (% of GDP)	-30,8	-29,7	-26,5	-28,8	-25,2	-23,5	-24,1	-24,3	-22,9
Remittances (EURbn)	1,027	1,070	1,111	1,181	1,216	1,247	1,335	1,382	1,423
Current account balance (EURbn)	-1,270	-1,159	-0,728	-1,033	-0,826	-0,742	-0,773	-0,908	-0,953
Current account balance (% of GDP)	-9,5	-8,6	-5,3	-7,4	-5,7	-4,9	-4,9	-5,4	-5,4
Net FDI (EURbn)	0,3	0,3	0,2	0,4	0,2	0,2	0,3	0,5	0,5
FDI (% of GDP)	2,6	1,9	1,3	2,9	1,7	1,6	2,1	3,0	3,0
FDI cover (%)	27,1	22,3	24,0	38,8	30,1	32,4	43,9	54,2	55,2
Gross international reserves (EURbn)	3,285	3,328	3,614	4,001	4,400	4,873	4,879	4,753	4,616
Import cover (months of imports)	5,3	5,3	5,8	6,1	6,8	7,3	6,6	6,0	5,6
Debt indicators									
Gross external debt (EURbn)	6,558	6,985	7,134	7,232	7,805	8,316	8,456	8,446	8,436
Government (EURbn)	3,407	3,687	3,867	4,316	4,444	4,536	4,165	4,125	4,095
Private (EURbn)	3,152	3,298	3,267	2,916	3,361	3,781	4,291	4,321	4,341
Gross external debt (% of GDP)	48,9	52,1	52,1	51,7	53,4	54,4	53,0	50,7	48,0
Gross external debt (% of exports)	152,6	161,1	154,4	152,1	154,4	153,1	135,8	127,0	120,8
Exchange rates and money growth									
USD/BAM (end-year)	1,51	1,48	1,42	1,61	1,79	1,87	1,64	1,70	1,56
USD/BAM (average)	1,40	1,52	1,47	1,47	1,76	1,77	1,73	1,66	1,62
EUR/BAM (end-year)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
EUR/BAM (average)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
Money supply M1 (% YoY)	4,8	-0,7	9,0	9,2	11,9	13,7	13,7	9,7	8,9
Broad money M2 (% YoY)	5,8	3,4	7,9	7,3	8,0	8,3	9,5	7,8	7,5
Domestic credit (% YoY)	5,3	4,1	0,5	2,8	2,4	2,0	7,1	5,5	5,2
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,30

Source: Central Bank of Bosnia and Herzegovina, The Agency for Statistics, IMF, Ministry of Finance, Addiko research

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Balance sheet									
Assets (EURm)	11.196	11.414	11.794	12.299	12.756	13.344	14.440	15.019	15.705
Assets (%, YoY)	3,4	1,9	3,3	4,3	3,7	4,6	8,2	4,0	4,6
Assets (% of GDP)	83,5	85,1	86,1	87,9	87,3	87,3	90,6	90,1	89,3
Gross loans (EURm)	7.828	8.151	8.194	8.423	8.624	8.795	9.419	9.934	10.448
Gross loans (%, YoY)	5,3	4,1	0,5	2,8	2,4	2,0	7,1	5,5	5,2
Gross loans (% of GDP)	58,4	60,8	59,8	60,2	59,0	57,5	59,1	59,6	59,4
Deposits (EURm)	6.643	6.814	7.285	7.861	8.452	9.077	10.057	10.759	11.455
Deposits (%, YoY)	3,7	2,6	6,9	7,9	7,5	7,4	10,8	7,0	6,5
Deposits (% of GDP)	49,5	50,8	53,2	56,2	57,8	59,4	63,1	64,6	65,1
Loan-to-deposit ratio (%)	117,8	119,6	112,5	107,1	102,0	96,9	93,7	92,3	91,2
Capital adequacy ratio (%)	17,1	17,0	17,8	16,3	14,9	15,8	15,7	16,6	17,0
Performance									
Net interest income (EURm)	396	389	385	383	398	411	424	451	490
Net interest income (%, YoY)	8,2	-1,8	-1,0	-0,5	3,9	3,3	3,3	6,2	8,7
Total operating income (EURm)	620	610	618	623	642	680	728	775	828
Total operating income (%, YoY)	1,8	-1,5	1,2	0,8	3,1	6,0	7,0	6,4	6,9
Pre-provision profit (EURm)	209	207	184	213	206	222	288	321	359
Pre-provision profit (%, YoY)	-5,1	-0,8	-11,1	15,8	-3,6	8,1	29,4	11,7	11,6
Provision charges (EURm)	-125	-130	-192	-117	-171	-91	-94	-95	-92
Profitability and efficiency									
Net interest margin (%)	3,6	3,4	3,3	3,2	3,2	3,1	3,1	3,1	3,2
Pre-tax ROAA (%)	0,8	0,7	-0,1	0,8	0,3	1,0	1,4	1,5	1,7
Pre-tax ROAE (%)	5,9	4,8	-0,5	5,6	1,9	7,0	9,8	10,5	11,3
Cost-to-income ratio (%)	66,3	66,0	70,2	65,7	67,9	67,3	60,5	58,5	56,7
Operating expense (% of assets)	3,7	3,6	3,7	3,4	3,5	3,5	3,2	3,1	3,1
Credit quality and provisioning									
NPL ratio (%)	11,8	13,5	15,1	14,2	13,7	11,8	10,0	9,0	8,6
NPL coverage (%)	66,3	65,9	66,7	69,7	71,2	74,4	76,7	77,3	78,6
Provision charges (% of loans)	1,6	1,6	2,3	1,4	2,0	1,0	1,0	1,0	0,9
Provision charges (% of PPP)	60,0	62,8	104,1	55,1	83,1	41,1	32,6	29,5	25,5

Source: CBBH, banking agencies, Addiko research

Record high pre-tax in 2017

Following a usual seasonal decline in January, overall loans increased by 2.0% ytd in 5M18 with the strongest positive contribution coming from retail (+3.6% ydt) on the back of rising employment and wages. Furthermore, corporate lending increased by 1.7% ytd amid improving economic outlook. At the same time, public loans fell 8.6% ytd as IMF unblocked the second loan tranche thus enabling the government to transfer some of its funding needs away from the domestic market. NPL ratio continued its downward path and declined to 9.7% in 1Q18 (vs. 10.0% at YE17). In terms of funding, deposit collection recorded further growth in year to May (+4.4% ytd) driven by 2.8% ytd higher household deposit amid stronger labour market and remittances, despite declining passive interest rates and 15.1% ytd higher public deposits amid favourable fiscal trends and unblocked external financing. Regarding profits, in FY17 banking sector saw record high pre-tax profit of EUR194m on the back of higher both NII and non interest income.

Credit growth and deposit collection decelerating in 2018

With currently available data in line with our expectations, we keep our 5.5% yoy credit growth forecast. Credit activity will be supported by further decline in interest rates, higher employment and wages, as well as investment recovery. On funding, we see deposit growth slowing down to 7.0% yoy in 2018 due to a high base, intensifying private capex and higher consumption propensity. We keep our FY18 NPL ratio projection at 9.0% supported by NPL sales, write-offs, recovery and better debt collection, while concerning profits, we expect another record year for B-H banks amid stronger disbursements, steady provisioning and opex.

Strong Growth Momentum Persists

We raise 2018 GDP forecast to 4.0% as Q1 beat expectations and high frequency data suggest stronger growth continues. Growth will be driven by private consumption, tourism, public capex (Bar-Boljare highway) and FDIs in energy and tourism. Budget deficit stays elevated on higher public capex and first EUR69m instalment for EPCG buy-back, while inflation will average 3.0% amid stronger demand, higher energy prices, excise taxes and VAT hikes.

Soaring investments boosts growth

GDP growth accelerated slightly in 1Q18 to 4.5% yoy vs. 3.9% yoy in 4Q17 and 4.3% growth in 2017. The strongest positive contribution came from soaring investments (+32.1% yoy), industry growth (40.2% yoy) and private consumption. Net exports contributed negatively as 16.7% higher exports could not offset 9.3% imports growth. High frequency data suggest strong GDP print in Q2 as well, with real retail trade up 4.4% in April-May (vs. 3.2% yoy in Q1), industrial output up 21.1% yoy, while foreign tourist nights jumped 22.5% in the same period. On the other hand, goods exports growth slowed to 9.9% in April-May, which alongside accelerating imports (+16.7% yoy) dumped already poor 3mma import cover to just 15.2% (-10pp yoy).

We lift 2018 growth forecast to 4.0%

With Q1 GDP growth above expectations and high frequency data suggesting ongoing strong growth in Q2, we upgrade our already above-consensus 2018 GDP growth forecast by 0.5pp to 4.0%. Growth will be driven by another stellar tourist season, stronger investment activity amid Bar-Boljare highway construction, FDIs in tourism and energy (wind power) and new investments in the tobacco factory and aluminium industry. Despite stagnating wages amid public wage cuts this year and childcare support cuts, private consumption will be driven by employment growth, re-leveraging and stronger tourism impact. Notwithstanding soaring industrial production, net trade will contribute negatively as stronger construction (+46.8% in Q1), investment activity and rising private consumption will all boost imports. As always, the main risk upside risk to our forecasts is even stronger tourist season, while downside risks stem from stronger-than-expected negative impact from fiscal consolidation. In 2019, we see GDP growth slowing toward 3% on the back of slower household consumption and public capex growth amid further fiscal consolidation efforts.

Deficit at 4.5% amid elevated capex and EPCG buy-back

After budget deficit hit 5.5% in 2017, the government now targets a deficit of 3.2% of GDP in 2018. The Q1 budget data show flattish deficit at EUR70.1m (1.6% of GDP) as 10.1% yoy higher tax revenues (but still 2.3% below plan) offset 8.0% yoy higher expenditures, driven by 57.2% higher capital expenditures, while current expenditure rose only 6.0% yoy. On financing, Montenegro sold 7Y EUR500m bonds at YTM 3.625% in order to refinance EUR362m maturities in the next three years, while the 12Y EUR250m World Bank loan at 295bp over 6M Euribor will fund the budget deficit. Although fiscal consolidation measures including 2pp VAT hike (21%), higher excise duty on tobacco, alcohol and sugar drinks, employment ban and public wage cuts alongside strong GDP growth will have a positive effect on public finances, we see deficit around 4.5% of GDP amid higher infrastructure capex, the first EUR69m tranche for EPCG buy-back and higher defence cost for NATO membership. Due to high deficit and soaring public debt on energetic highway construction, the IMF called Montenegro in the last Article IV consultations to proceed with fiscal reforms including public-sector workforce cuts, tightening of eligibility for early retirement and revision of tax exemptions on top of already implemented fiscal measures. The IMF also asked for more labour market flexibility, tax wedge cuts and lower state involvement in the economy.

2018 average CPI inflation seen at 3.0%

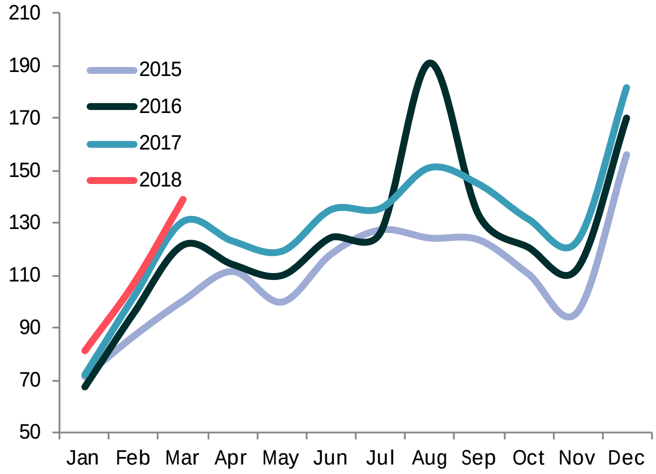
Following an average 2.4% CPI inflation in 2017, higher global energy prices alongside higher VAT, excise duty on tobacco and alcohol pushed CPI inflation to 3.1% yoy in May, shaping up the average 2.9% CPI inflation in the year to May. For the FY18, we keep 3.0% forecast as VAT and excise duty hikes and higher energy prices alongside strong foreign tourist and domestic demand will bolster prices, while in 2019 we see average CPI inflation slowing to 2.6% as administrative hikes fade away. Upside risks mainly stem from persistently higher oil prices and even stronger foreign tourist demand pull pressures.

C/A gap widening continued in 1Q18

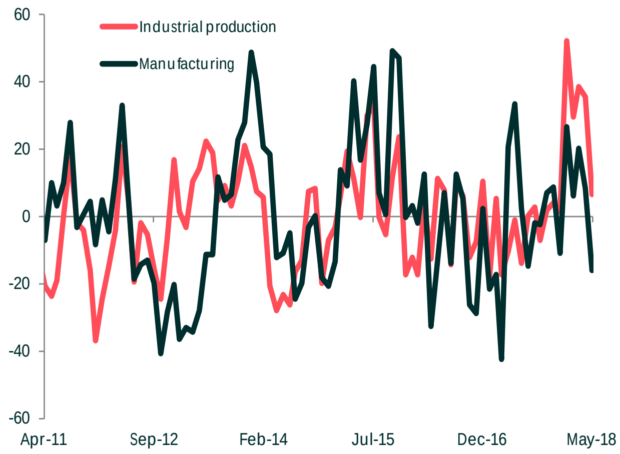
After hitting a high 16.4% of GDP in 2017, C/A gap widening continued in 1Q18. That said, soaring goods exports (+20.3% yoy) from low base could not offset 9.9% higher imports amid stronger domestic demand and infrastructure-related imports. In such circumstances and despite 14.6% higher tourism revenues, C/A deficit rose 4.9% yoy in 1Q18. Meanwhile, net FDI halved to EUR50m, covering just 16.7% of Q1 C/A gap. This year, we see C/A gap at a similar level as another record tourist season, higher goods exports and primary income offset stronger investment driven import demand.

Montenegrin data trends

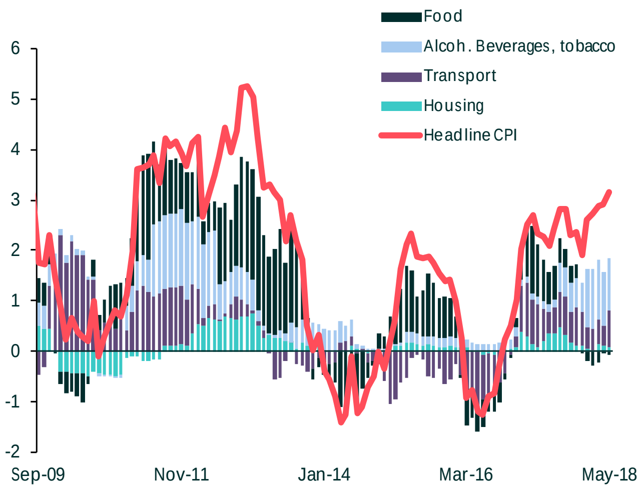
Budget revenue movements (EURm)



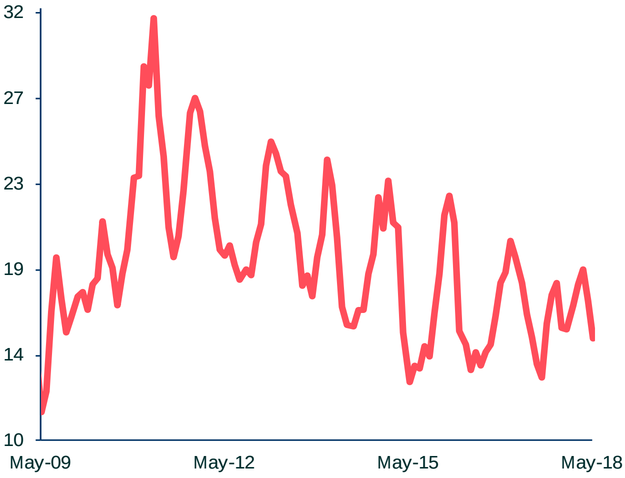
Industrial production (%, yoy)



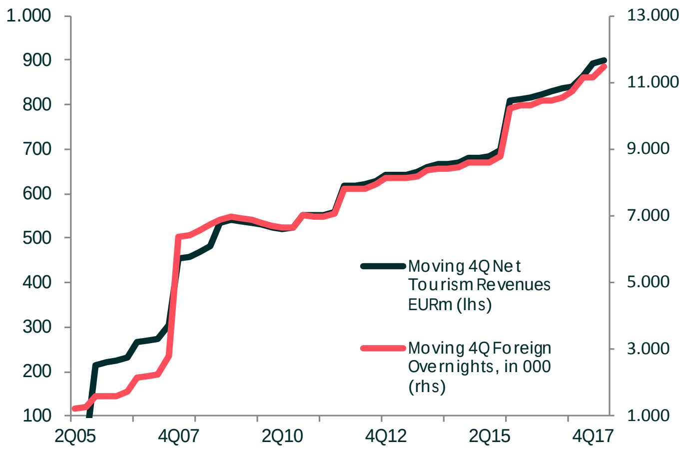
CPI by key contributions (pps)



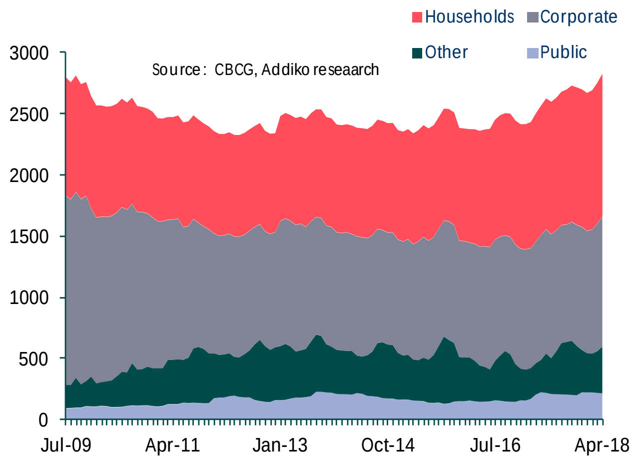
Merchandise import cover (%, 3mma)



Tourism



Gross loans by sector (EURm)



Source: Montenegrin National Bank, MONSTAT, Ministry of Finance, IMF, Addiko research

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Activity									
Nominal GDP (EURbn,current prices)	3,3	3,2	3,4	3,5	3,7	4,0	4,2	4,5	4,8
Nominal GDP (USDbn)	4,5	4,1	4,5	4,6	4,1	4,4	4,8	5,3	5,8
GDP per capita (EUR)	5.261	5.114	5.415	5.564	5.875	6.355	6.784	7.267	7.680
GDP per capita (USD)	7.327	6.577	7.191	7.391	6.516	7.037	7.660	8.585	9.254
Real GDP (constant prices YoY, %)	3,2	-2,7	3,5	1,8	3,4	2,9	4,3	4,0	3,0
Private consumption (YoY, %)	7,0	-3,9	1,6	2,9	2,2	5,4	4,5	3,3	3,0
Fixed investment (YoY, %)	-5,9	-1,0	11,9	-5,0	11,3	27,5	12,0	11,0	7,2
Industrial production (YoY, %)	-8,7	-6,2	10,7	-10,5	9,2	-3,3	-4,3	15,0	5,0
Unemployment rate (ILO, average %)	19,9	19,9	19,5	18,0	17,6	17,7	16,1	15,8	15,4
Prices									
CPI inflation (average % YoY)	3,3	4,0	1,8	-0,7	1,5	-0,3	2,4	3,0	2,6
CPI inflation (end-year % YoY)	3,0	4,4	0,4	-0,6	1,4	1,0	1,9	2,8	2,5
PPI inflation (average % YoY)	3,2	1,8	1,7	0,2	0,3	-0,1	0,4	1,2	1,5
Net wage rates (% YoY, nominal)	1,0	0,7	-1,7	0,1	0,7	3,8	2,5	2,3	1,9
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-5,7	-6,5	-6,0	-3,1	-8,3	-3,5	-5,5	-4,5	-3,3
Public debt	45,6	53,4	57,5	59,9	66,2	64,4	65,3	69,3	68,8
Gross public funding needs	n/a	n/a	9,5	5,1	14,0	21,5	16,6	14,7	22,1
External balance									
Export of goods and services (EURbn)	1,374	1,338	1,390	1,388	1,539	1,605	1,759	1,912	2,048
Import of goods and services (EURbn)	-2,082	-2,109	-2,066	-2,074	-2,214	-2,494	-2,766	-2,985	-3,168
Merchandise trade balance (EURbn)	-1,303	-1,384	-1,329	-1,376	-1,464	-1,658	-1,860	-2,012	-2,130
Merchandise trade balance (% of GDP)	-39,9	-43,5	-39,5	-39,8	-40,0	-41,9	-44,0	-44,5	-44,6
Tourism receipts (EURbn)	0,619	0,643	0,666	0,682	0,813	0,836	0,922	0,991	1,048
Current account balance (EURbn)	-0,482	-0,486	-0,383	-0,429	-0,401	-0,642	-0,691	-0,728	-0,744
Current account balance (% of GDP)	-14,8	-15,3	-11,4	-12,4	-11,0	-16,2	-16,4	-16,1	-15,6
Net FDI (EURbn)	0,4	0,5	0,3	0,4	0,6	0,4	0,5	0,5	0,6
FDI (% of GDP)	11,9	14,5	9,6	10,2	16,9	9,4	11,5	11,8	12,0
FDI cover (%)	80,7	95,0	84,6	82,5	154,4	57,9	70,1	73,2	77,4
Gross international reserves (EURbn)	0,273	0,318	0,395	0,514	0,641	0,780	0,877	1,333	1,625
Import cover (months of imports)	1,6	1,8	2,3	3,0	3,5	3,8	3,8	5,4	6,2
Debt indicators									
Gross external debt (EURbn)	4,734	4,959	5,093	5,353	5,559	6,121	6,612	7,264	7,724
Government (EURbn)	1,460	1,295	1,352	1,646	2,061	2,187	2,361	2,513	2,632
Private (EURbn)	3,275	3,665	3,742	3,707	3,498	3,934	4,251	4,750	5,092
Gross external debt (% of GDP)	145,0	155,9	151,5	154,8	152,1	154,8	156,6	160,6	161,6
Gross external debt (% of exports)	344,5	370,6	366,4	385,6	361,2	381,3	375,9	380,0	377,1
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,19	1,15	1,25
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,13	1,18	1,21
Money supply M1 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Broad money M3 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (% YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	11,8	7,1	5,2
ECB reference rate (end-year %)	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,00
EURIBOR 3M interest rate (average, %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,30

Source: Montenegrin National Bank, MONSTAT, Ministry of Finance, IMF, Addiko research

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Balance sheet									
Assets (EURm)	2.810	2.808	2.959	3.136	3.472	3.790	4.182	4.585	4.906
Assets (%, YoY)	-4,5	-0,1	5,4	6,0	10,7	9,2	10,3	9,6	7,0
Assets (% of GDP)	86,1	88,3	88,0	90,7	95,0	95,9	99,0	101,4	102,6
Gross loans (EURm)	2.359	2.342	2.414	2.367	2.386	2.416	2.701	2.970	3.203
Gross loans (%, YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	11,8	10,0	7,9
Gross loans (% of GDP)	72,3	73,6	71,8	68,5	65,3	61,1	64,0	65,7	67,0
Deposits (EURm)	1.817	1.981	2.098	2.308	2.625	2.872	3.267	3.514	3.751
Deposits (%, YoY)	1,5	9,0	5,9	10,0	13,7	9,4	13,8	7,6	6,7
Deposits (% of GDP)	55,7	62,3	62,4	66,7	71,8	72,6	77,4	77,7	78,5
Loan-to-deposit ratio (%)	129,8	118,2	115,1	102,6	90,9	84,1	82,7	84,5	85,4
Capital adequacy ratio (%)	16,5	14,7	14,4	16,2	15,5	16,1	17,6	18,1	18,4
Performance									
Net interest income (EURm)	106	106	104	111	117	122	125	136	142
Net interest income (%, YoY)	-4,8	-0,1	-1,6	6,6	5,3	4,2	2,4	8,8	4,8
Total operating income (EURm)	221	178	156	158	171	175	189	204	213
Total operating income (%, YoY)	42,6	-19,5	-12,0	1,2	8,3	1,9	8,2	7,8	4,8
Pre-provision profit (EURm)	114	65	48	46	52	53	59	68	71
Pre-provision profit (%, YoY)	114,7	-43,2	-26,7	-2,6	11,5	2,6	11,3	14,4	5,3
Provision charges (EURm)	124	121	44	21	53	44	22	35	46
Profitability and efficiency									
Net interest margin (%)	3,7	3,8	3,6	3,6	3,5	3,4	3,1	3,1	3,0
Pre-tax ROAA (%)	-0,3	-2,0	0,1	0,8	-0,1	0,3	0,9	0,7	0,5
Pre-tax ROAE (%)	-3,2	-18,7	1,0	6,0	-0,4	2,0	7,4	6,2	4,7
Cost-to-income ratio (%)	48,2	63,5	69,6	70,7	69,8	69,6	68,7	66,8	66,7
Operating expense (% of assets)	3,7	4,0	3,8	3,7	3,6	3,3	3,3	3,1	3,0
Credit quality and provisioning									
NPL ratio (%)	15,5	17,6	18,4	16,8	12,6	10,3	7,3	6,2	5,7
NPL coverage (%)	33,0	40,0	39,1	39,5	39,5	41,3	42,9	43,5	46,3
Provision charges (% of loans)	5,1	5,1	1,9	0,9	2,2	1,8	0,9	1,3	1,5
Provision charges (% of PPP)	108,5	185,7	92,5	45,6	103,2	82,2	37,2	52,5	65,1

Source: CBCG, Addiko research

Loan growth surprising on the upside

Overall loans increased by 7.4% ytd in 5M18 (vs 11.8% yoy in 2017), mainly driven by 8.4% ytd higher credits to corporate amid strong construction activity and tourist season preparations. Retail loans and volatile ‘other’ loans (mostly financial institutions) also contributed positively with a 5.3% ytd and 17.7% ytd increase respectively. Public loans fell slightly 5.1% from high base (42.0% yoy increase in 2017). Amid increased credit activity, NPL ratio fell to 7.1% at end April. In terms of funding, deposit collection recorded further growth in year to May (+3.1% ytd). The growth was mainly driven by corporate (+4.5% ytd) and ‘other’ (+9.0% ytd) deposit intake amid strong tourist preseason, while retail and public sector deposits were flat. Retail deposits are subdued by high base effect, wage stagnation and fiscal consolidation. As for profitability, 1Q18 data indicates 62.2% yoy higher pre-tax profit at EUR13m amid lower impairment costs, while TOI and opex remained at the same level as in 1Q17.

Deposit collection decelerating in 2018

As corporate and ‘other’ sector ending dynamics outshone our expectations, we upgraded our credit growth forecasts for this year by 2.9pp to 10.0% yoy, while in 2019 we see credit growth at 7.9% yoy. Credit growth will be supported by a record tourist season, rising employment, soaring construction activity, falling interest rates and high bank liquidity. We see NPL ratio declining towards 6.2% level as banks will continue selling of their non-performing portfolios or transferring them to the factoring companies, while rising credit activity will also support further NPL ratio decline. With ytd deposit dynamics in line with our expectations, we keep our deposit collection 7.6% yoy growth forecast for 2018. Although we see solid NII growth given rising credit activity, higher opex and provisioning costs will result in somewhat lower pre-tax profit in 2018.

ABBREVIATIONS

AUM	Asset Under Management
BAMC	Bank Assets Management Company
BRICS	Brazil, Russia, India, China, South Africa
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CARDS	Community Assistance for Resconstruction, Development and Stabilization
CBS	Central Bureau of Statistics
CEE	Central Eastern Europe
CIR	Cost-to-income ratio
CIT	Corporate Income Tax
CNB	Croatian National Bank
CPI	Consumer Price Index
EC	European Commission
ECB	European Central Bank
EE	Eastern Europe
EMU	European Monetary Union
EU	European Union
FC	Foreign Currency
FDI	Foreign Direct Investment
Fed	Federal Reserve
FX	Foreign Exchange
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
IEA	International Energy Association
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IP	Industrial Production
IPO	Initial Public Offering
ISPA	Instrument for Structural Policies for Pre-Accession
LDR	Loan-to-Deposit Ratio
M&A	Mergers and Acquisitions
M1, M4	Monetary aggregates (the narrowest and the broadest, respectively)
MinFin	Ministry of Finance
MM	Money Market
MoM	month-on-month
NII	Net Interest Income
NIM	Net Interest Margin
NPA	Non-Performing Assets
NPL	Non-Performing Loans (Impaired Loans)
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PER	Price vs. Earnings
Phare	Pologne et Hongrie - Aide á Restructuration Economique
PPI	Producer Price Index
PPP	Pre-Provision Profit / Public-Private Partnership
PSE	Public Sector Entity
REER	Real Effective Exchange Rate
SAPARD	Special Association Program for Agriculture and Rural Development
S-D gap	Supply-Demand gap
SPO	Secondary Public Offering
T-bill	Treasury bill
TOI	Total Operating Income
VAT	Value Added Tax
YE	year end
yoy	year-on-year
ytd	year-to-date
ZIRP	Zero Interest Rate Policy

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Hrvoje Stojic, Economic Research Director (+385-1-603-0509)
Marija van Hemert, Senior Analyst (+385-1-603-3810)
Marin Levaj, Analyst (+385-1-603-3805)

Addiko Bank d.d.
Slavonska avenija 6, 10000 Zagreb
economic-research.hr@addiko.com
phone: +385-1-603-3522
fax: +385-1-604-6522