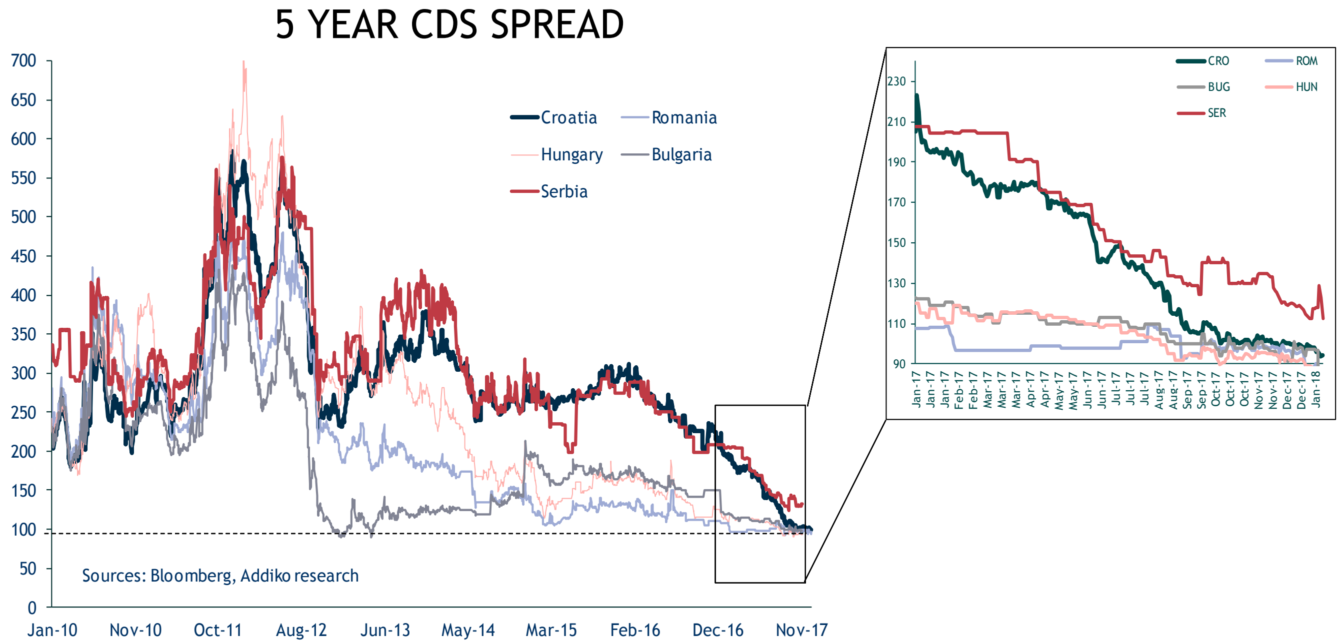
SEE Quarterly

Addiko Bank

19 January 2018

STRETCHING THE SWEET SPOT



FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2016

Consensus Economics Forecast Accuracy Award Winner 2014 Croatia

EXECUTIVE SUMMARY

Bottom LINE: We upgraded our 2018 growth outlook in Slovenia and Serbia. Slovenia is enjoying its growth momentum with 2017 drivers carried forward, outperforming the euro area average. Stronger both domestic and external demand has underpinned Serbian GDP upgrade, along more supportive fiscal stance. We expect foreign demand, record tourist season, private consumption and accelerating investment to support Croatian growth, allowing us to keep 3.0% forecast, despite Agrokor. Bosnia-Herzegovina is set to maintain 3% GDP growth, with external demand as one of the key growth drivers. Given the stronger consumer demand, inflation is expected to pick-up moderately across the region, with the exception of Serbia, where base effects and strong dinar keep it around 2017 level.

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 lifted 2018 GDP forecast by 0.7pp to 4.2% on the back of substantial carry-over, above-potential growth in the euro zone, solid exports, ultra-easy financial conditions, stronger labour market and the overall domestic demand. In Croatia, we hold above-consensus 3.0% GDP forecast for 2018 based on strong EU demand, increased consumption, improved investment outlook and fiscal easing. The growth also remains supported by tourism and cheaper funding. In Serbia, we lifted 2018 GDP forecast to 3.5% thanks to increased domestic and external demand, accompanied by a more supportive fiscal stance. In B-H we keep 3.1% growth forecast for 2018 on stronger external demand, fiscal expansion and domestic investments. Montenegrin GDP growth forecast for 2018 is set at 3.5%, driven by tourism, infrastructure projects, FDI and goods exports strength.

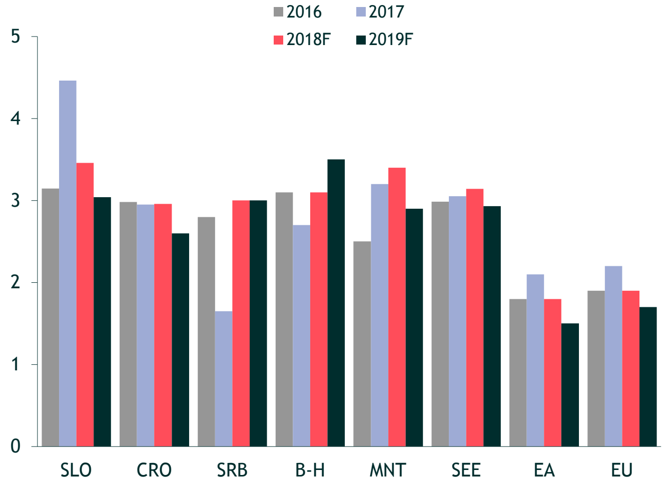
2. As for fiscal performance, in Slovenia we see a balanced budget in 2018 given strong tax revenues and interest rates savings, alongside positive contributions from state banks' dividend and BAMC. In Croatia, 2017 budget ended in a surprising 0.5% surplus, and in 2018 we expect a balanced budget. Fiscal consolidation is mainly driven by lower interest costs, while the expenditures side still lacks substantial reform content, with potential risks hidden in healthcare overruns, war veteran transfers, entitlements and Agrokor. Similarly, in Serbia we see a balanced budget in 2018 after surplus in 2017 amid public capex acceleration, wages and pension hikes and higher non-taxable income threshold.

3. Regarding price movements, in Slovenia we expect the average 2018 CPI inflation at 1.7% in line with the euro area average, picking-up slightly as stronger business cost, robust consumer demand and rising capacity utilization help underlying inflation to recover gradually. In Croatia, we see 2018 CPI at 1.7% with upside risk related to stronger-than-expected consumer demand, even tighter labour markets and domestic fiscal easing. In Serbia, we expect average CPI around but below 3% in 2018, balancing between base effects and strong dinar pulling on the downside, with global commodity market and administered price hikes pulling in the opposite direction.

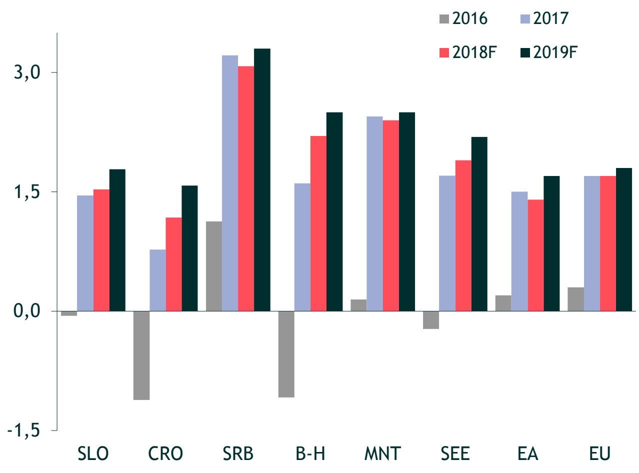
4. In Slovenia, stronger than expected macro and fiscal performance, very active debt management and rating upgrades have added to favourable yields trend, which we expect to continue. Positive risks for bond performance include new USD bond buybacks and the euro curve lengthening along with additional rating upgrades. In Croatia, we expect low rates environment to continue given the ample CNB liquidity position and subdued new bank lending. Croatian spreads may tighten further on continued fiscal discipline, much lower gross public funding needs and stronger structural adjustment prospects under stronger euro ambitions. In Serbia, we see further NBS easing in 1H18 amid strong dinar, subdued inflation and reduced fiscal risks. One of the slowest Fed tightening cycle on record won't have too strong impact on Serbian assets, in our view, thanks to the recent Fitch rating upgrade, record low sovereign risk premium, and further downside potential thanks to significant public/external debt cuts, ongoing IMF co-operation and stable politics.

SEE data trends

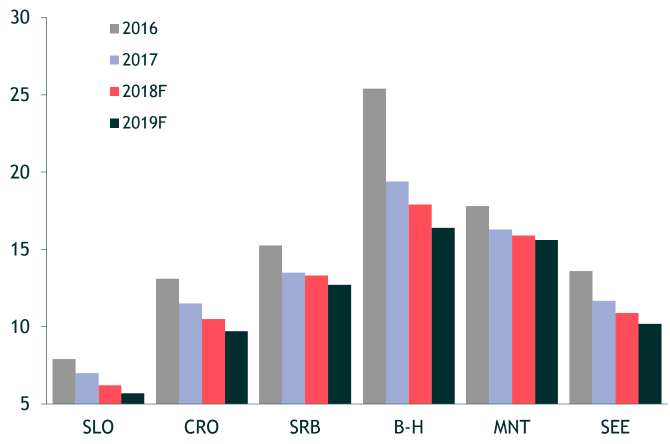
Real GDP growth (%)



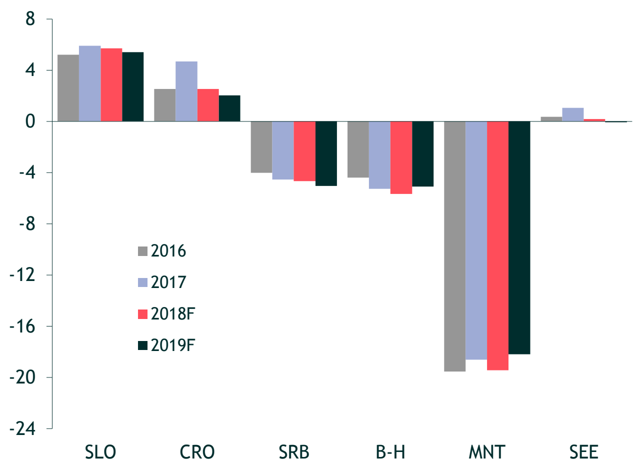
CPI inflation (average, %, YoY)



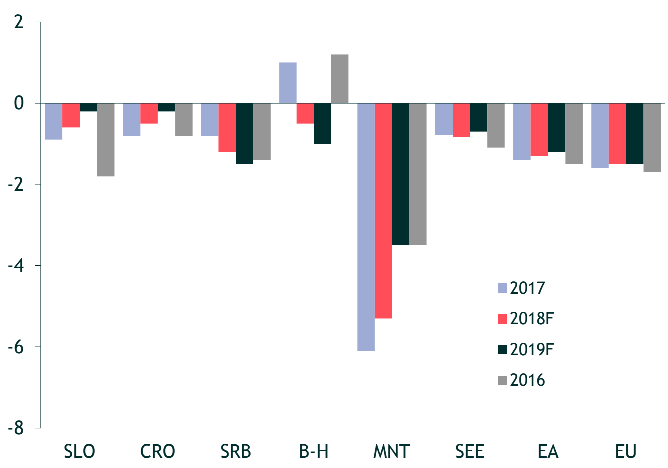
Unemployment rate (ILO, average, %)



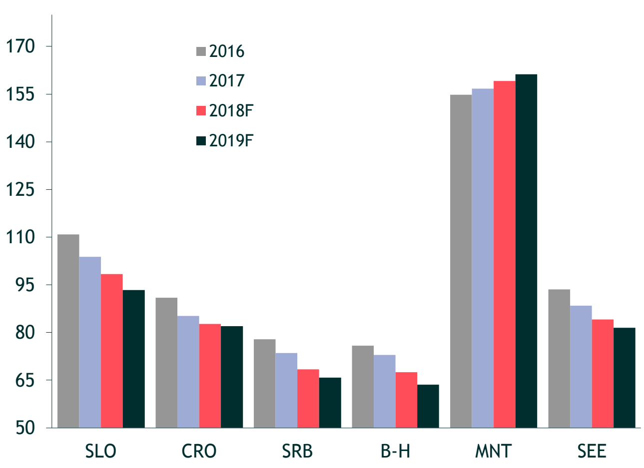
Current account balance (% of GDP)



Government balance (% of GDP)



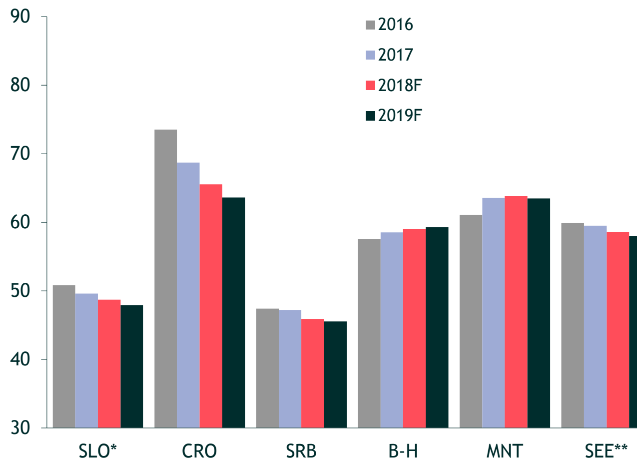
Gross foreign debt (% of GDP)



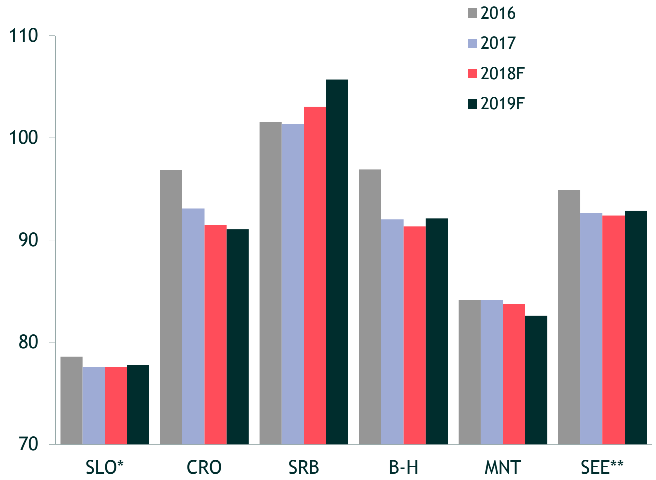
Source: National sources, Addiko research

SEE banking sector trends

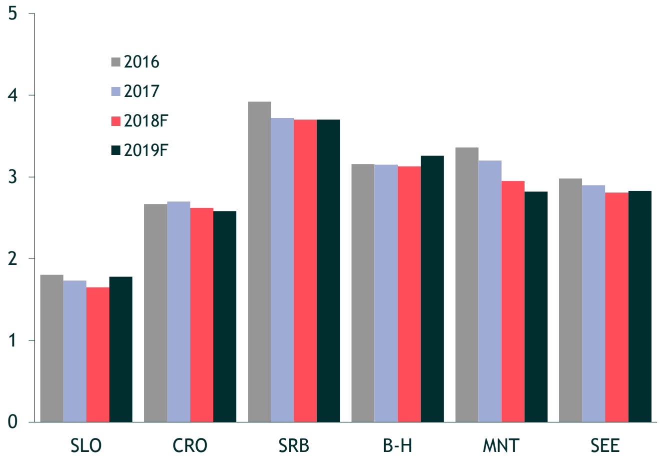
Gross loans (% of GDP)



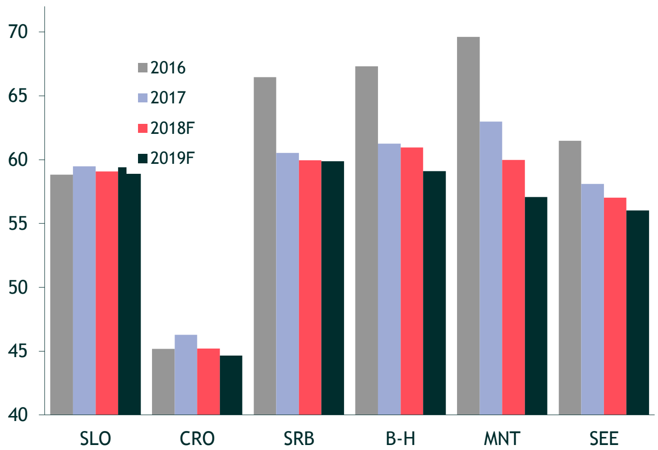
Loan-to-deposit ratio (%)



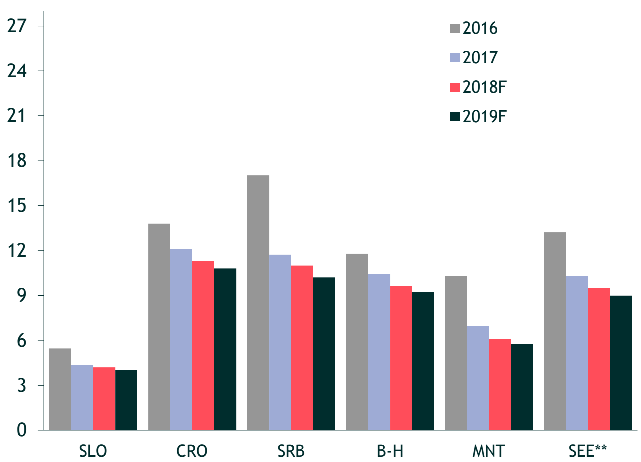
Net interest margin (%)



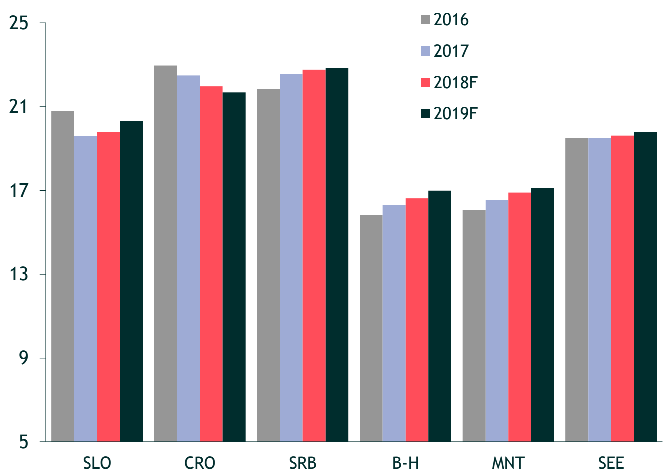
Cost-to-income ratio (%)



NPL ratio (%)



Capital adequacy ratio (%)



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

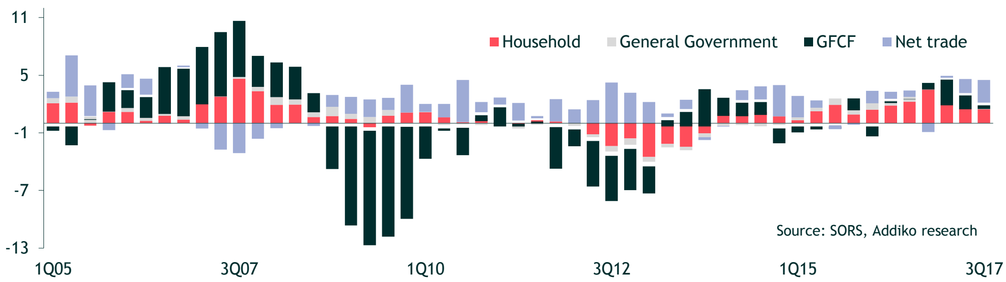
In High Gear

We have above-consensus 4.2% GDP growth forecast for 2018 thanks to hefty carry-over, above-potential growth in the euro zone, stronger exports, ultra-easy financial conditions and, in turn, stronger local labour market and the overall domestic demand. While the budget is set to enter balance and public debt declines further, fiscal stance is slightly expansionary in 2018, as reforms and privatization have been back-loaded after mid-2018 elections. Further macro/fiscal overperformance, further interest bill cuts and stronger rating prospects suggest ongoing Slovenian bonds outperformance despite the coming global monetary policy normalization.

GDP growth approaching the 5% high-water mark in 2017

GDP growth has surprised on the upside in line with the acceleration in the euro area activity has pulled Slovenian exports along with it, ongoing Slovenian competitiveness outperformance of the euro area and a fair movement up the value chain. Moreover, household consumption was fuelled by consumer sentiment at 20Y high, strong employment and disposable income (outlook), foreign tourists' consumption, resurgent retail credit, cheaper debt service and housing market recovery. While slowing relative to 1H17, investment grew solidly as well thanks to much easier SMEs' access to credit, new EU funding cycle, record corporate profits and firms' optimism on the heels of stronger growth outlook. With stronger-than-expected Q3 GDP print (1.0% qoq/4.9% yoy seasonally-adjusted) and Q4 barely easing from 1%+ qoq pace seen in 9M17, driven by much stronger, investment- and exports-led growth in the euro zone in Q4 and soaring domestic demand, we have pushed our FY17 growth forecast pushed to 4.8%.

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



Slower momentum in 2018 but again strongly outperforming the euro area norm

We also revised up our 2018 GDP call from 3.5% to 4.2% on the back of substantial carry-over, stubbornly above-potential growth in the euro zone, stronger Slovenian exports, prolonged ultra-easy financial conditions and, in turn, stronger local labour market as well as overall domestic demand. We primarily expect investment dynamics to accelerate owing to the buoyancy of business investments, including resurgent construction activity, given stronger corporate balance sheets, record capacity utilization, robust exports outlook, improved take-up of EU funds and the continued strength of bank lending particularly at longer maturities. Buoyed by improving labour conditions and higher disposable income, stronger household credit, low debt service costs and tourist consumption, private consumption growth is set to accelerate at 3.5%-alike clip. Despite strong import-intensive local demand, resilient exports ensure positive net trade contribution in 2018, in line with our thesis that export capacity build-up over the past years has pushed potential growth rate higher. While the risks to our forecasts are balanced, uncertainty from Brexit, political wobbles in the euro zone and the growing lack of labour locally are the main risks to the downside. Positive surprises on synchronised strength of the world trade growth, fiscal easing ahead of mid-2018 elections and soaring capex pose the main upside risks.

Inflation normalizing slowly after years of deflation

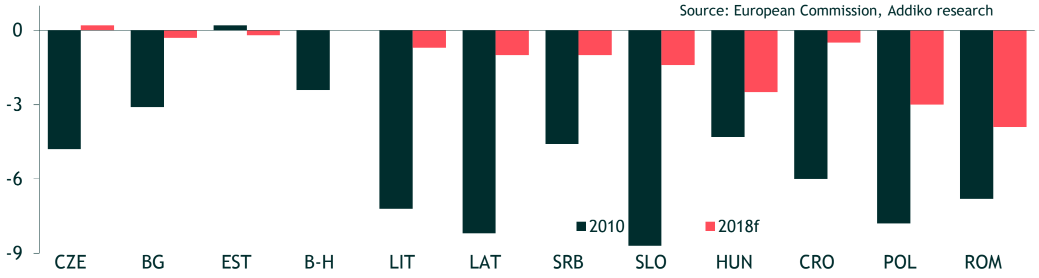
Inflation in both the euro zone and Slovenia was weaker than we expected in Q4 and we have pared our inflation forecasts a little in 2018 to factor in this weaker-than-expected momentum. Nevertheless, we still expect inflation to pick up as stronger business cost, robust consumer demand and rising capacity utilization help underlying inflation to recover gradually in 2018 and thereafter. This combined by base effects from seasonal food prices, peaking producer food inflation, stronger euro and subdued imported energy prices will likely shape the average 2018 CPI inflation at 1.7%. This is roughly in line with the euro area average and, hence, with a neutral impact on competitiveness. While the ECB will justify the reduction of its generous stimulus with the robust economy, it will in our view do it gradually and it recognizes a sustained upward correction. While fundamentals have certainly improved, there is uncertainty whether this will translate into higher prices since economic adjustments seen in recent years and structural changes in retailing keep expectations low, which could slow the process of normalization ahead.

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

Sizable C/A surplus mainly owes to strong export performance, including that of tourism services, higher EU funding and narrower income deficit. This year will in our view see slightly lower C/A surplus courtesy of soaring (import-intensive) domestic demand and partly due to commodity price stabilization. As long as net external debt declines sharply and banks' are flush with liquidity, we see a further improvement in the net international investment position on its way to -25% of GDP, outperforming the Baa-rated median substantially in a further evidence of much lower external vulnerabilities relative to pre-crisis period.

With the continued buoyancy in C/A terms, further USD bonds swaps with the recent much cheaper EUR1.5bn Eurobond and hefty fiscal reserve well above 10% of GDP, funding position is on extremely strong footing as the average debt duration is extended nicely. Given the ongoing ECB accommodation, we expect Slovenia to use opportunity for 2019 (re)financing further in the year. At the same time, FDI ground to a halt and the sale of NLB bank suffered delays again since the approaching elections, authorities' reluctance in letting foreigners buy controlling stakes in 'strategic' SOEs and onerous regulation leave investors sceptical. Cutting the list of 'strategic' asset that is not available for sale, incentives for bank consolidation and competitiveness reforms should serve the right kind of noise when attracting FDI - so far away from the euro zone's average of 5.5% of GDP.

Slovenia: fiscal deficits (% of GDP)



Budget enters balance in 2018...

The budget gap likely fell to just above 0.5% of GDP on constant tax revenue (notably VAT and CIT) overshooting (7.5% yoy), lower interest payments, smaller public capex, positive impact from BAMC activity and lower current transfers, despite public wage, pension and social transfer hikes. While even stronger tax-rich domestic demand and stronger labour market may well lead to substantial overshooting of the 4% tax growth plan, and along with further 0.5%/GDP interest rate savings, larger state banks' dividend payments and BAMC contribution drive fiscal consolidation and a build-up in the budget surplus in 2018-2019, there are also risks on the expenditure side of the budget this side of the elections. Stronger-than-expected capex, additional public wage/employment, pension and social transfer hikes (EUR100m above plan on our estimates) as well as healthcare spending overruns pose the key performance risks. It is also apparent that extra-strong cyclical tax growth has given boost to entitlement spending rather than meaningful structural fiscal measures, which should in our view maintain structural deficit around 1.7% of GDP and leave the EC eager in asking for additional 0.5pp-alike structural effort. With elections likely to produce a reshuffle of the incumbent SMC-led coalition, let alone even more fragmented parliamentary math, this may just add to authorities' complacency on policy front even as the long overdue massive property valuation act paves the way for real estate tax implementation in 2020.

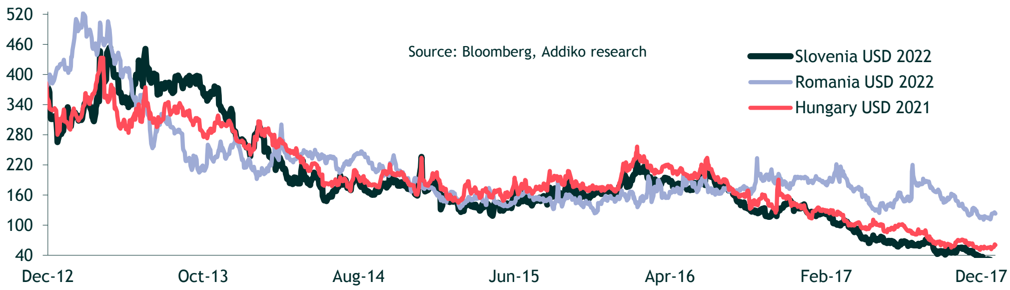
... as public debt and interest bill stay on a clear downward trend

After the last year's drop below 75% of GDP on strong nominal GDP growth and successively lower deficits, we expect public debt to fall further as GDP growth surprises continue, budget enters into surplus, interest rate outlays decline further, and the MinFin deploys a part of its hefty cash reserve (~10% of GDP). This effectively puts public debt net of liquid assets below 60% of GDP and on a declining path through 2019 and beyond. With lower funding needs in 2018 (7.2% of GDP) relative to 2017, Slovenia has perhaps the best position in CESEE being pre-funded by 1Q19 at least on our estimates. Going forth, there is further potential for USD bond buybacks (~12% of total exposure) as well as lengthening of the euro yield curve, which may result in interest spending slump below 4% of general budget revenues from 5% in 2017 and 7.3% in 2014. Importantly, pro-active debt management strategy has not just reduced susceptibility to interest rate shock, but also brought about further reduction in the sovereign's interconnectedness with the banking sector. Public debt reduction could be faster in the medium run in the event of resumed privatization efforts (NLB, Telekom Slovenije), more active sale of BAMC assets (at the assumed UR300m pace p.a.) and hopefully reform-driven fiscal consolidation when it comes to pension system and healthcare. Further bank business model and SOEs' restructuring are equally important to anchor the risks to public finance in the medium term.

Political uncertainty and inflation undershooting lower yields...

The new German government uncertainty, political risk events (notably Italian) and downward revisions for core inflation in the euro zone have supported bond markets incl. Slovenian debt in the final quarter of 2017. Stronger than expected macro/fiscal performance, very active debt management and rating developments have only added to favourable yields trend. The recent revival in EU bond supply, sharply lower net QE purchases due to the new EUR30bn/month run-rate and recent headwinds from UST have brought about some bearish reversal for sentiment in long-dated bonds. With Slovenian bonds more exposed to the ECB QE tapering relative to the EMU periphery and Slovenian longer duration profile more vulnerable upon the recent 10Y UST and bunds sell-off and rising long duration supply - the ensuing profit-taking is not surprising.

Slovenian spreads in tandem with peers

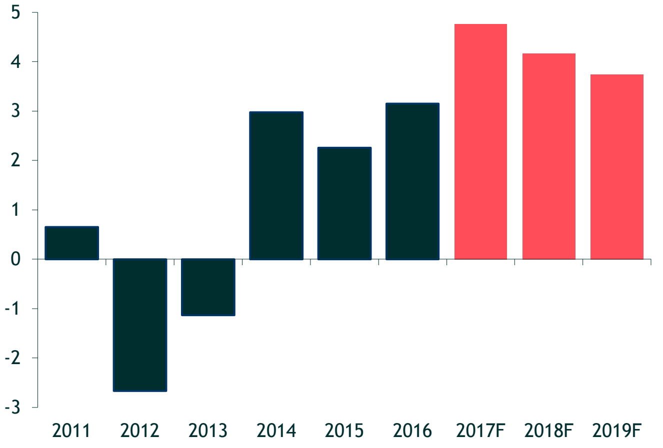


Slovenian bonds continue to outperform on superior macro/fiscal performance

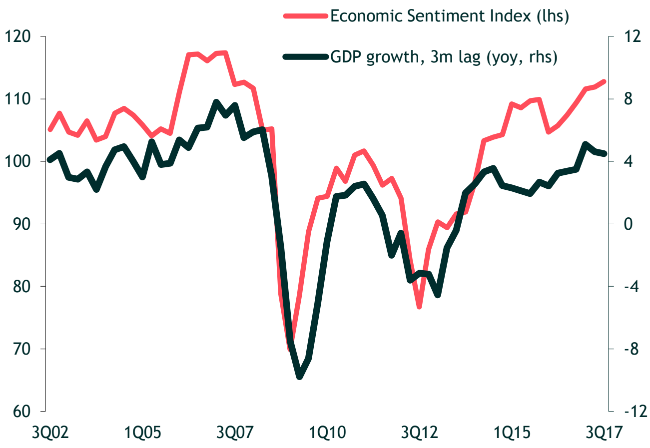
With strong macro data and business sentiment the ECB can fundamentally justify the end of QE purchases, but the interplay of the euro's upward skewness and inflation undershooting still complicates the ECB's exit strategy. This in our view suggests net asset purchases will continue at least until end-2018 and the announced changes in forward guidance on interest rates may be postponed until 2Q18 as long as there is no sign of lasting pickup in inflation. In that vein, we see Slovenian yields trending in line with the expected gradual increase in core yields, but given the ECB still buys more bonds than euro zone countries issue on a net basis, plus reprising of Slovenian growth potential, further interest bill reduction and thus stronger rating prospects, we expect Slovenian spreads to remain stably lower. That said, in the event of unpredictable major central bank's policy mistake and/or intensified political risks, Slovenian spreads may though not avoid 30-50 widening during risk-off episodes, in our view. Worth looking ahead are Slovenia's post-election (2H18) reform and privatization prospects to ensure lasting public debt reduction and overheating. Slovenia can also start pre-funding for 2019 without material pressures on rates given the fully funded 2018 and strong cash reserve. As such, positive risks for bond performance include further USD bond buybacks and the euro curve lengthening and possible further rating upgrades that would further lower interest rate outlays. In the medium term, we see Slovenian bonds outperforming on superior macro/fiscal performance and the growing sovereign's recognition as a semi-core story.

Slovenia's data trends

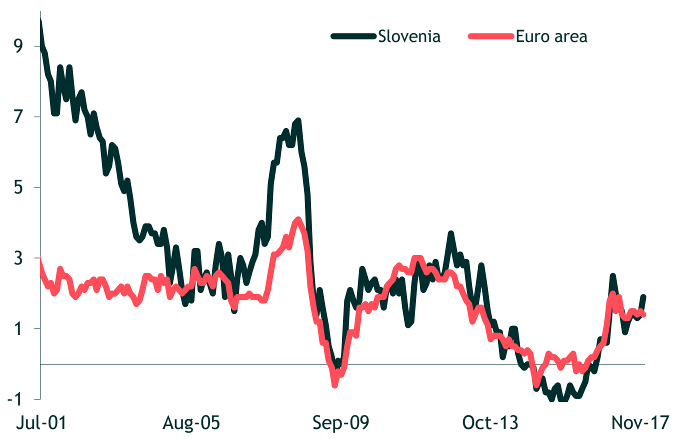
Real GDP growth (% YoY)



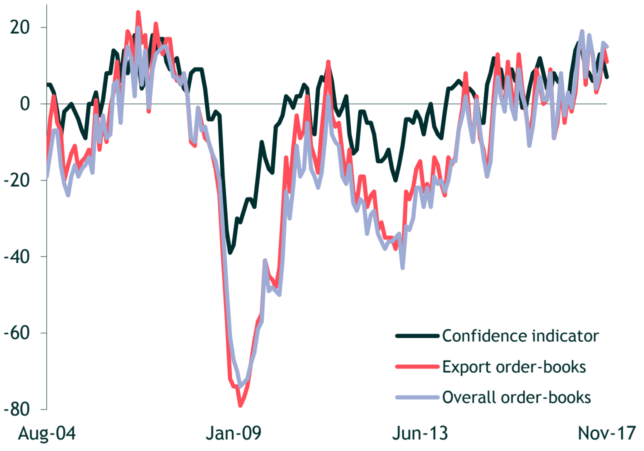
Economic confidence vs. GDP growth



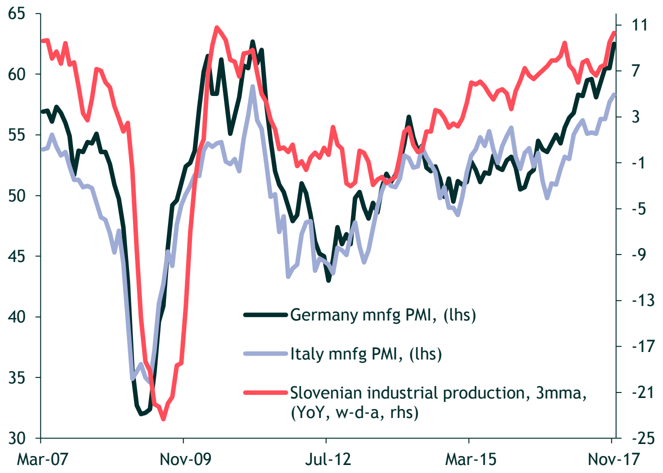
CPI inflation dynamics (% YoY)



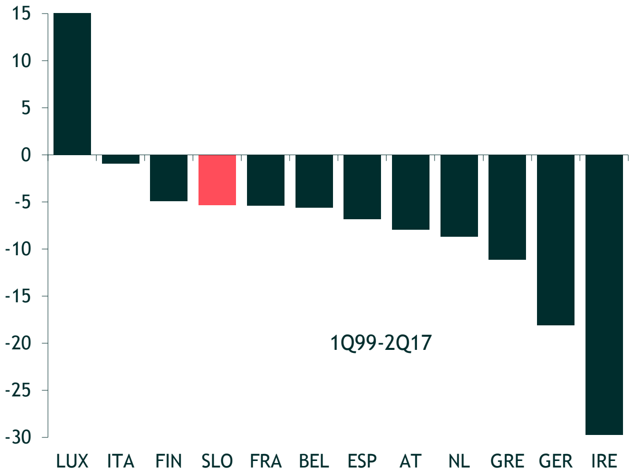
Business sentiment in manufacturing



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	2017F	2018F	2019F
Activity									
Nominal GDP (EURbn, current prices)	36,9	36,1	36,2	37,6	38,8	40,4	42,9	45,5	48,0
Nominal GDP (USDbn)	51,4	46,4	48,1	50,0	43,1	44,8	48,5	51,6	58,6
GDP per capita (EUR)	17.971,9	17.538,2	17.591,8	18.241,9	18.834,4	19.582,4	20.773,7	21.916,4	23.106,6
GDP per capita (USD)	25.027,7	22.554,1	23.363,7	24.234,4	20.889,4	21.685,3	23.455,6	24.875,1	28.190,1
Real GDP (constant prices YoY, %)	0,6	-2,7	-1,1	3,0	2,3	3,1	4,8	4,2	3,7
Private consumption (YoY, %)	0,0	-2,4	-4,2	1,9	2,1	4,3	3,3	3,6	3,1
Fixed investment (YoY, %)	-4,9	-8,8	3,2	1,1	-1,6	-3,6	8,4	7,4	6,5
Industrial production (YoY, %)	1,3	-0,8	-0,9	1,7	5,1	7,8	7,8	7,4	6,2
Unemployment rate (ILO, average %)	8,2	8,9	10,1	9,7	9,0	7,9	6,5	6,0	5,5
Prices									
CPI inflation (average % YoY)	1,8	2,6	1,8	0,2	-0,5	-0,1	1,4	1,7	1,8
CPI inflation (end-year % YoY)	2,3	2,7	0,7	0,1	-0,5	0,5	1,7	1,5	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	2,6	3,0
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,7	-4,1	-15,1	-5,4	-2,9	-1,8	-0,6	0,0	0,5
Public debt	46,6	53,9	71,0	80,3	82,6	78,5	74,2	70,5	67,1
Gross public funding needs	10,5	8,2	19,3	14,5	6,4	9,6	6,7	5,1	4,7
External balance									
Export of goods and services (EURbn)	25,948	26,363	27,010	28,520	29,905	31,401	35,756	38,687	41,396
Import of goods and services (EURbn)	25,516	24,934	24,569	25,641	26,569	27,690	31,472	34,304	37,014
Merchandise trade balance (EURbn)	-0,974	-0,081	0,708	1,181	1,476	1,537	1,734	1,833	1,831
Merchandise trade balance (% of GDP)	-2,6	-0,2	2,0	3,1	3,8	3,8	4,0	4,0	3,8
Tourism receipts (EURbn)	1,975	2,008	2,043	2,060	2,098	2,190	2,385	2,525	2,645
Current account balance (EURbn)	0,068	0,930	1,732	2,179	1,698	2,108	2,833	2,864	2,784
Current account balance (% of GDP)	0,2	2,6	4,8	5,8	4,4	5,2	6,6	6,3	5,8
Net FDI (EURbn)	0,6	0,5	0,0	0,6	1,3	0,9	0,4	0,6	1,1
FDI (% of GDP)	1,7	1,3	0,1	1,6	3,3	2,2	1,0	1,2	2,3
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	44,455	44,205	44,005
Government (EURbn)	8,748	11,092	15,459	22,416	24,824	22,953	23,253	23,703	24,953
Private (EURbn)	28,534	25,709	23,457	21,815	19,587	18,395	17,702	17,202	17,852
Gross external debt (% of GDP)	112,9	118,8	115,0	123,1	120,1	110,9	103,6	97,3	91,7
Gross external debt (% of exports)	160,6	162,6	154,2	162,4	155,9	142,7	124,3	114,3	106,3
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,19	1,18	1,24
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,13	1,14	1,22
Money supply M1 (% YoY)*	1,5	4,4	0,1	18,5	24,9	17,1	15,0	12,1	10,3
Broad money M3 (% YoY)*	3,5	-1,4	-1,3	6,1	4,6	7,1	7,2	5,7	5,8
Domestic credit (% YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	3,6	4,0	3,9
ECB reference rate (end-year %)	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,20
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,15
SLO 5Y yield (average %)	3,96	4,55	4,35	2,14	0,84	0,20	-0,10	0,10	0,40
SLO 10Y yield (average %)	4,98	6,01	5,87	3,28	1,67	0,82	1,14	1,27	1,55

* 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	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	48.748	46.125	40.344	38.714	37.383	37.050	37.975	38.299	38.797
Assets (%, YoY)	-3,1	-5,4	-12,5	-4,0	-3,4	-0,9	2,5	0,9	1,3
Assets (% of GDP)	132,1	127,9	111,3	102,9	96,3	91,7	88,5	84,3	80,8
Net loans (EURm)	32.875	30.964	24.338	21.540	20.275	20.534	21.282	22.136	22.989
Net loans (%, YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	3,6	4,0	3,9
Net loans (% of GDP)	89,1	85,8	67,2	57,3	52,2	50,8	49,6	48,7	47,9
Deposits (EURm)	24.170	23.856	22.550	24.426	25.140	26.133	27.449	28.550	29.567
Deposits (%, YoY)	2,8	-1,3	-5,5	8,3	2,9	3,9	5,0	4,0	3,6
Deposits (% of GDP)	65,5	66,1	62,2	64,9	64,7	64,7	64,0	62,8	61,6
Loan-to-deposit ratio (%)	136,0	129,8	107,9	88,2	80,6	78,6	77,5	77,5	77,8
Capital adequacy ratio (%)	11,6	11,9	14,0	19,2	20,8	20,8	19,6	19,8	20,3
Performance									
Net interest income (EURm)	1.018	886	708	832	746	670	646	647	656
Net interest income (%, YoY)	-2,0	-12,9	-20,1	17,5	-10,4	-10,1	-3,7	0,3	1,3
Total operating income (EURm)	1.447	1.566	1.091	1.231	1.158	1.128	1.107	1.109	1.118
Total operating income (%, YoY)	-1,9	8,2	-30,3	12,8	-6,0	-2,6	-1,9	0,2	0,9
Pre-provision profit (EURm)	670	823	370	544	472	464	449	454	454
Pre-provision profit (%, YoY)	-5,4	22,8	-55,0	47,0	-13,3	-1,5	-3,4	1,1	0,1
Provision charges (EURm)	1.207	1.599	3.809	650	313	85	19	15	12
Profitability and efficiency									
Net interest margin (%)	2,1	1,9	1,6	2,1	2,0	1,8	1,7	1,7	1,8
Pre-tax ROAA (%)	-1,1	-1,6	-8,0	-0,3	0,4	1,0	1,1	1,1	1,1
Pre-tax ROAE (%)	-13,3	-20,3	-92,9	-2,7	3,7	8,4	9,2	8,9	8,6
Cost-to-income ratio (%)	53,7	47,4	66,1	55,8	59,3	58,8	59,5	59,1	59,4
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	4,4	4,2	4,0
NPL coverage (%)	37,8	42,7	56,8	60,8	65,0	65,2	68,3	68,8	69,7
Provision charges (% of loans)	2,4	3,4	8,8	1,6	0,8	0,2	0,1	0,0	0,0
Provision charges (% of PPP)	180,1	194,3	1.029,2	119,5	66,4	18,3	4,2	3,4	2,5

Source: BSI, Addiko research

Retail loans drive credit activity

November results show acceleration of credit re-leveraging with 2.3% ytd growth (vs. +1.3% yoy in 2016) driven by loans to private sector. Strongest contribution came from retail loans which increased 6.3% ytd, mostly due to rise in consumer loans amid improved situation on labour market, strong consumer sentiment and active marketing by certain banks. Corporate sector loans rose 2.5% ytd mostly on the back of intensified lending to SMEs. On the other hand, public sector de-leveraging continued (-27.5% ytd) due to successful debt restructuring. As ytd performance was somewhat under our expectations, we downgrade our credit growth forecast for 2017 to 3.6% yoy. In 2018 we see credit growth accelerate 4.0% yoy, thanks to low interest rates, with strongest positive contribution coming from the private sector given easier financial conditions, extensive replacing of debt securities with bank financing, private capex, strong consumer sentiment and relatively low private sector indebtedness. NPL ratio declined to 4.4% in October (vs. 5.5% at YE2016), with corporate NPL still accounting for more than half of total bad loans. Due to SME NPL resolution, NPL sales and higher write-offs we expect ratio to decline further to 4.2% in 2018.

Solid deposit growth despite low interest environment

Deposit collection also picked-up, with 4.4% ytd growth in November. Household deposits rose 4.6% ytd due to rising employment and wages, as well as entrenched propensity to save. Corporate deposit intake increased by 9.6% ytd on higher firms' revenues. Following the expected 5.0% deposit growth in 2017, we see deposit collection decelerate to 4.0% yoy in 2018 due to slower deposit growth in the private sector, amid high-base effect, low interest rate environment and stronger capex needs. Concerning profits, NII decreased by 3.7% yoy in 11M2017 as strong decline of interest expenses did not manage to neutralize lower interest income. However, stagnating opex and lower impairments managed to increase pre-tax profit by 10.3% yoy to EUR424m. Same trend is likely to continue in 2018. Despite expected increase of credit activity, low interest rates environment will keep NII around 2017 level. Along with continued NPL resolution and consequently lower provisioning, we expect 2.6% yoy pre-tax profit growth in 2018.

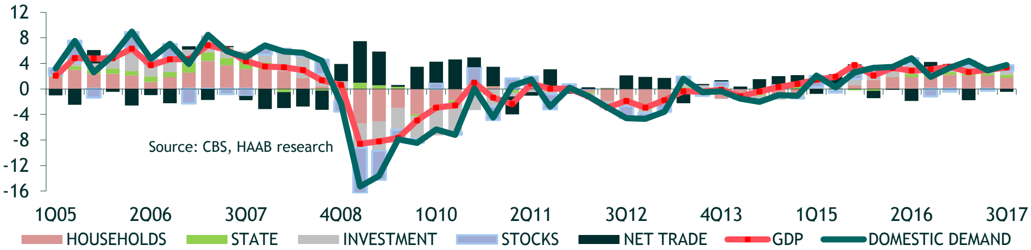
Getting Present it's been Dreaming About

Despite the moment of truth for Agrokor, we keep above-consensus 3% GDP grow call for 2018 on above-trend and EU demand, deeper trade inroads, tourism, steady consumption, stronger capex and policy-led optimism. Encouragingly, macro/fiscal over performance, stronger local reforms activism and stronger structural fiscal adjustment prospects under EC-enabled fast-track for the euro adoption and viable Agrokor restructuring support rating upgrade(s). This alongside potential delay in the ECB QEs exit, hunt for carry in low volatility environment and EM resilience may well trigger a positive market response in the form of further Croatian risk tightening in the near term.

The upside prevails

The economy has grown its way out of Agrokor-related uncertainty thanks to almighty tourist season ensuing private consumption spree, robust EU trade partners' demand and easy funding conditions. Notably, private consumption growth accelerated in H2, driven by tourist-related spending, strong 6% net wage growth and rising employment, lower savings rate and resurgent consumer credit. Despite strong business optimism, higher firms' profits, price competitiveness gains and low cost of capital, investments surprised on the downside, reflecting halted capex by Agrokor and economically intertwined firms, associated uncertainty and some EU funding under-execution. The expected 3.5%+ GDP growth in Q4 on stronger consumption, robust exports and resurgent capex leaves the FY17 growth forecast structurally healthy and tracking 3.2%, with slight upside risks from the record euro zone conjuncture and construction investments. Record tourism earnings, rising disposable income and cheaper funding combine in their support of the upward trend in most confidence gauges around 10Y highs.

Croatia: contributions to GDP (in pps)



We stay above-consensus for 2018, productivity growth needed

Many factors underpin our above-consensus 3.0% GDP call for 2018: (i) persistent above-trend EU demand (ii) decent consumption, (iii) better investment outlook and (iv) newly found space for fiscal easing after years of strong consolidation. The latter importantly involves a cumulative ~1% of GDP in tax cuts for 0.5-1pp attribution to the growth potential. On top of another record tourist season, increasingly diversified and strong outlook facing goods exports will again outgrow that of services in support of transition from the consumption-driven growth model. In parallel, private consumption is driven by new HRK1.1bn tax cuts, generally faster wage growth due to labour shortage, public wage and minimum wage hikes, higher pensions, foreign tourist receipts, job creation and foreign remittances, despite fading effects of wage tax cuts. We also expect stronger investments in response to rising firm's profits, ever lower cost of funding and faster pace of EU funding in support of re-leveraging, price competitiveness gains amid (initial HRK1.5bn) parafiscal burden cuts, and ample replacement capex needs. While the risks to our baseline are balanced, faster euro interest rate re-pricing, idiosyncratic risks around Agrokor, labour shortages (in tourism and construction), significant corporate de-leveraging needs and bank unfriendly policy-making, including bigger negative impact of consumer credit market regulation, are the main risks to the downside. As ever upside risks stem from stronger external backdrop, another unthinkable tourism record, stronger EU funding and FDI, plus fiscal expansion.

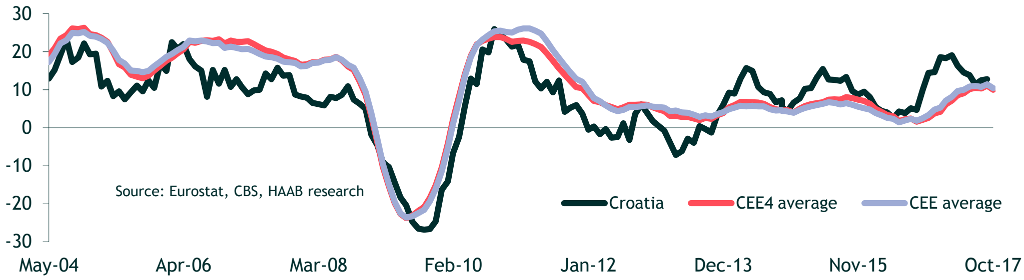
Inflation still week, for now

Despite the recent strong wage growth and rising prices, we still expect price wars for Agrokor's retail space, structural changes in retailing and negative base effects in the energy component in Q1 subdue inflation around 1% in early 2018, before progressively moving higher to ~2% in the rest of the year. As we can see, imported inflation is turning north on the heels of upstream price pressures and frictions from above-trend and broad-based recovery. Moreover, core prices pressures appear to be related to the improvement in the local labour market whereby the expected closing of the output gap will further add to wage growth (3-4% yoy) revival at about 10-year high. In 2018, we see the average CPI at 1.5%, with risks mainly tilted to the upside in the event of even stronger-than-expected consumer demand, even tighter labour markets, stronger upstream pressures and domestic fiscal easing. Still, inflationary developments do not pose a headwind to otherwise very supportive factors for citizens' purchasing power.

C/A surplus surges on Agrokor issues and tourism, external position improves further

With the euro zone (manufacturing/services) PMIs approaching all-time highs, driven by strong gains in the output and new orders components, points to ongoing high single-digit goods export growth in 1H18. Steady EU/global demand, Croatia's deeper integration into global value chains and both price and non-price competitiveness gains (resilient to rising labour costs) continue to drive exports in 2018-2019 and outperformance of most CESSEE peers. Nevertheless, strong consumer demand, private capex, broader private credit recovery and higher commodity prices lead to stronger imports as well, higher goods trade deficit and C/A surplus moderation relative to 2017 when it was inflated by much lower income deficit due to foreign-owned banks' losses upon Agrokor-related provisioning (1%+ of GDP). Still, we see record FC tourism receipts and EU transfers, and C/A surplus just above 2.5% of GDP. Foreign debt slump owing to record firms' profits used to reduce debt and Agrokor-related write-offs, record banks' net foreign assets, and higher portfolio/FDI flows lead to further improvement in net international investment position.

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



CNB easing bias more conditional?

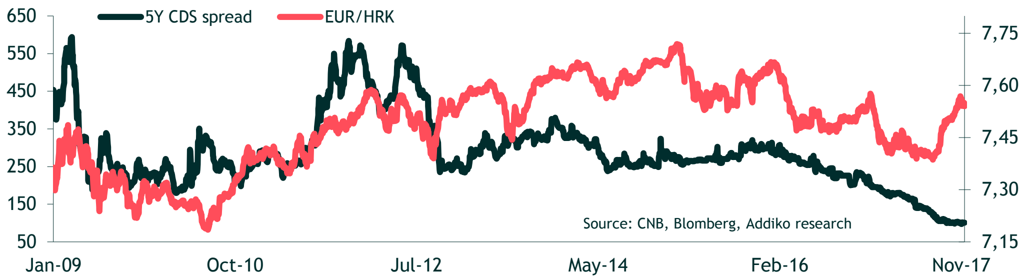
Despite the ECB QE tapering in 2018, we expect the CNB to keep record kuna excess liquidity (4-5% of GDP) in its ongoing support to bank lending. Beyond creating billions of kuna out of heavy tourism FC supply, we expect the CNB to beef up REPO (size/maturity) capacity as to anchor bank liquidity costs and flatten the kuna yield curve close to their trough. While mandatory reserve cuts also fit into early EMU entry strategy, the CNB is in our view increasingly aware the (global) monetary arsenal has hit limits and should therefore make liquidity provision conditional on real demand. With an insistence on firms' investment intentions since household loan market will be hit by tighter regulation for debt capacity. With floating retail interest rate sensitivity under increased CNB's scrutiny and pent-up demand for kuna credit, stronger shift to fixed rate kuna lending rests on ample long-term kuna funding via long-term FX swaps, NDF instruments, longer REPO or interest rate swaps. Thankfully, the ECB is far away from rate hikes, and the CNB's collateral pooling gives a sense of augmented policy space, both consistent with our long held view of a slow exit thereafter and low rates for longer. From a risk perspective, stronger private-sector external positions, steady FX outlook and low fiscal risk allow the CNB's easing. Still, the banking system needs unambiguous criteria for automatic NPL write-offs, specific tax treatment, new platforms for SME capital hikes, regulatory incentives for asset management firms and strong insolvency framework in order to dampen cost of risk and improve transmission.

EURHRK moving in tight band, appreciation pressures in sight

The EUR/HRK peaked around 7.55 on local banks' purchases ahead of the newest Eurobond issue, sporadic Agrokor-related provisioning and banks' structural bid amid stronger FX-linked loan backflow relative to new kuna disbursement. The cross sank below 7.45 quickly once the CNB stopped buying, and strong exports, EU funding, tourist season prolongation and hoteliers' hefty FX supply came to the fore again. Short-end rates stay record low due to record interbank liquidity after early repayment of state road firms' loans, accommodative CNB and stronger kuna. Still-supportive global monetary policy and dovish Fed, late-cycle rotation to riskier assets and strong inflows into EM fixed income funds have supported EM/CESEE debt, notwithstanding the growing uneasiness that valuations are compelling. Croatian bonds outperformed on strong macro and fiscal over-performance, cheaper (quasi)sovereign (re)financing operations and extended duration, little sensitivity to Agrokor issues and the Fitch one-notch rating upgrade.

Despite further Agrokor-related provisioning and short-covering potential after refinancing of state road firms in 1Q18, we see the EUR/HRK within 7.20-7.50 in 1H18, depending on seasonal factors. Namely, record C/A surplus and banks' net foreign assets, positive fiscal news flow and robust exporters' FX cash positions leave FX supply skewed to the upside. Given sharply higher CNB FX reserve this year, interest rate differential, new Eurobond prospects in 1Q18, and traditionally little sensitivity to global risk volatility, we'd not expect stronger FX volatility for the time being. Bearing in mind the recent ERM-2 2020 entry aspirations, positive news on associated structural reforms and sovereign rating upgrade(s) might intensify inflows into local assets and in turn appreciation pressures on the kuna. While the Eurostrategy document appears comfortable with the average EUR/HRK since 2001 of 7.45 as a likely central parity rate, such discussions look premature given yet-to-be assessed REER fair valuation in light of high unit labour costs and real convergence capacity.

Croatia: 5Y CDS spreads and EUR/HRK



Another year of smooth sailing for Croatian spreads?

Given the CNB's hefty liquidity provision and subdued new bank lending, we see short-end rates at record lows. Namely, despite pent-up demand for kuna credit, new disbursement is insufficient (partly due to Agrokor-inflicted corporate demand) to push MM rates up. With debt supply in 1H18 substantially lower after quite active Q4 issuance, sound (re)financing options and favourable conditions for the ongoing cheaper ~EUR3bn refinancing of state road firms in 1Q18, good euro debt issuance prospects, strong EM inflows, Croatian spreads may tighten further. Our persistently bullish near-term outlook assumes a track record of macro/fiscal (over)performance, 9pp/GDP lower funding needs in 2018, stronger reform/structural adjustment outlook and the overall risk profile under Fiscal compact and accelerated ERM II bid process, viable Agrokor restructuring and thus enhanced (investment-grade) rating prospects. All mentioned alongside slow and steady ECB/Fed policy framework, unfinished hunt for yield (amid rising growth differential between EM and developed economies) and ensuing EM resilience makes way for additional 30bp 5Y CDS spread compression in 1H18, before the coming normalization of the central banks' balance sheets leads to a bout of the yield curve steepening. The major risks to our benign baseline include volatility in the event of Agrokor disorderly solutions (100-150bp), plus an unpredictable major central bank's policy mistake.

Fiscal overperformance continues

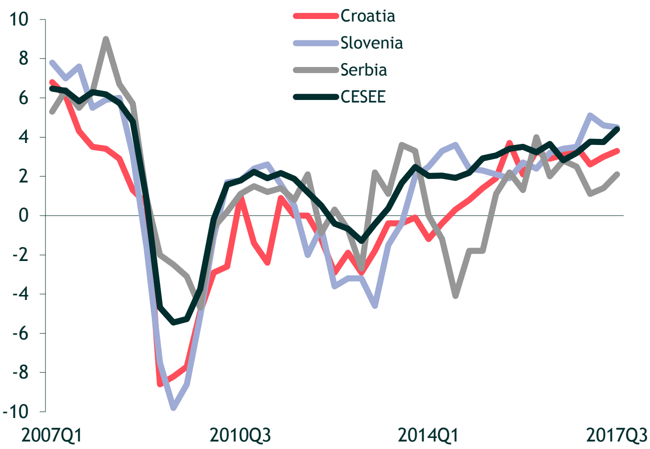
Fiscal ledgers eked out somewhat surprising consolidated budget surplus just above 0.5% of GDP on cyclically 4% higher tax revenues, positive impact from tax reform, current spending restraint and capex under-execution. While 2018 may see a balanced budget and stable 2%+ primary surplus, fiscal consolidation is driven by ~10% interest cost cuts, as the government's political consolidation and NATO standards required higher public wage bill, entitlement and defence spending. Consequently, structural deficit may hit 1-1.5% of GDP (as the output gap also turns positive), albeit still within the MTO of -1.75% of GDP. While the planned HRK2.5bn higher tax intake could be underestimated as in the past years (to help fiscal consolidation) given stronger, tax-rich local demand and the record tourist season, despite HRK1.3bn tax cuts in 2018 (cumulatively ~1% of GDP in 2017-2018), the main challenges lie in public consumption. Namely, as long as the budget lacks substantial reform on the expenditure side, we'd not be surprised by spending overruns in healthcare, war veteran transfers and other entitlements, potentially accompanied by one-offs in Agrokor restructuring. At first lower CIT reflecting banks' and Agrokor-affected firms' profit slump and later on contingent liabilities upon a number of court cases for anti-market practices in Agrokor and other cases. That said, while MoF eyes new tax cuts in 2019 (including VAT) on the heels of front-loaded fiscal consolidation, it would be more prudent to tie-up tax cuts to non-discretionary spending containment. Given stronger nominal GDP growth, strong kuna, ever lower interest cost and consolidation of agencies holding sovereign debt, we see public debt cut to 73% of GDP in 2018 and 71% in 2019, which together with brighter reform prospects under Fiscal Compact is credit positive.

... as stronger reform momentum is needed to grant stability

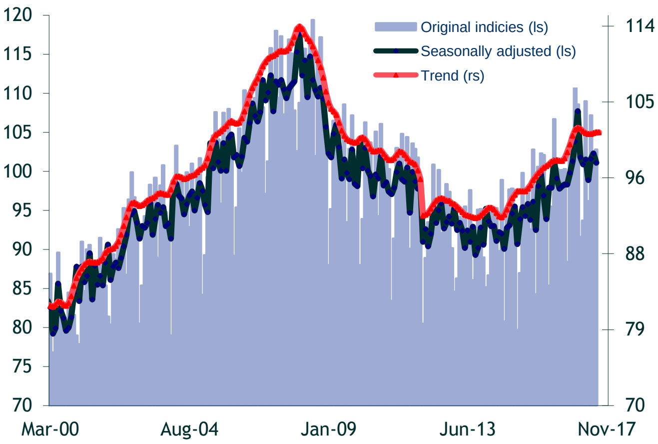
Given the growing pressure on non-discretionary spending (salaries, transfers), imperatives to reduce (one of the EU's highest) tax burden and the imminent interest rates normalization in the medium term, we deem public finance sustainability dependent on public sector and entitlement reforms, primarily in healthcare and pension system. The last attempt to cut public employee fringe benefits accompanied by reform of the public wage system (to set complexity/work efficiency criteria) in our view boosts the cabinet's leverage in the forthcoming collective bargaining, durable public wage containment and comprehensive public administration reforms ahead. That said, spending rationing will have to be accompanied by the 'mother-of-all-reforms': well-though Agrokor resolution, plus convincing growth-enhancing reforms: liberalization of the labour, product and services markets, parafiscal levy cuts, moving fiscal pressure away from labour to real estate, idle assets and consumption, and strengthening the credit channel via permanent incentives for NPL workouts, equity capital raising and faster insolvency model. Last but not least, better sovereign asset-liability management does not only pertain to cheaper (re)financing operations and privatization, but also SOEs' restructuring and efficiency gains within industry standards, with stronger profits and cost flexibility of utmost importance in the state guarantee-free capex financing. The final aim should be a 3-4%/GDP primary surplus in the medium term as long as Croatia spends ~1pp/GDP on interest payments above EU average, wants to anchor risk premium lower and ensure durable public debt reduction to 60% of GDP by 2022 when the country targets its euro zone entry.

Croatia's data trends

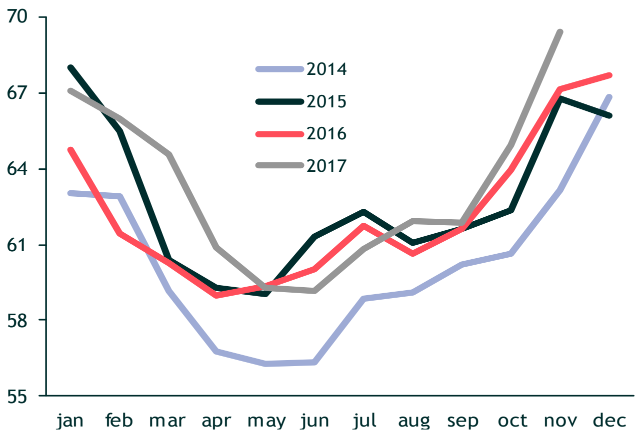
CRO growth in line with CESEE



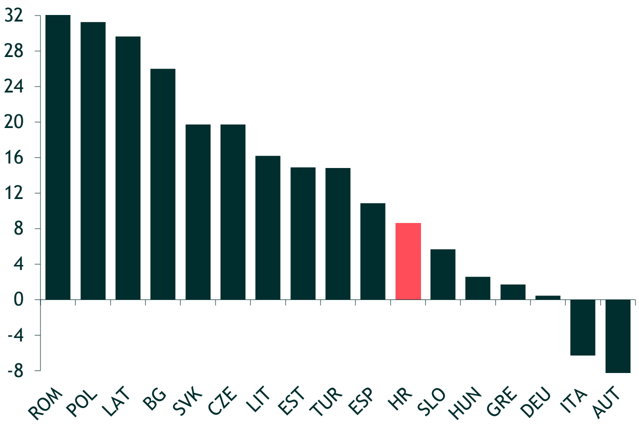
Industrial production, 2010=100



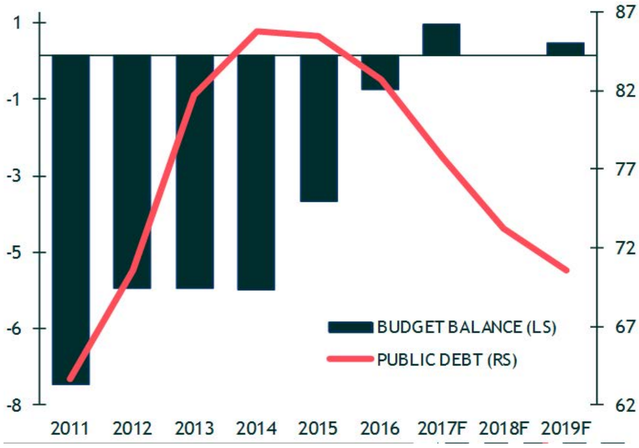
Merchandise import cover (% 3mma)



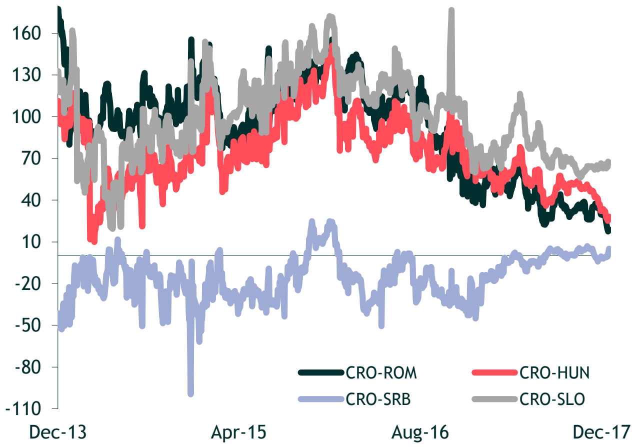
Change in export shares vs EU countries, 2017-2008,(%)



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	2017F	2018F	2019F
Activity									
Nominal GDP (HRKbn, current prices)	333,3	330,9	331,4	331,3	339,0	349,4	366,6	385,9	406,1
Nominal GDP (EURbn)	44,7	44,0	43,8	43,4	44,5	46,4	49,1	52,2	55,0
Nominal GDP (USDbn)	62,2	56,5	58,1	57,7	49,4	51,4	55,4	59,2	67,1
GDP per capita (EUR)	10.453	10.300	10.281	10.245	10.511	10.945	11.590	12.300	12.977
GDP per capita (USD)	14.542	13.233	13.646	13.604	11.656	12.112	13.060	13.960	15.832
Real GDP (constant prices YoY, %)	-0,3	-2,2	-0,1	-0,1	2,3	3,2	3,2	3,0	3,0
Private consumption (YoY, %)	0,3	-3,0	-1,9	-1,6	1,0	3,5	3,6	3,0	2,8
Fixed investment (YoY, %)	-2,7	-3,3	1,4	-2,8	3,8	5,3	4,3	6,5	6,5
Industrial production (YoY, %)	-1,2	-5,5	-1,7	1,4	2,5	5,1	2,0	3,4	3,5
Unemployment rate (ILO, average %)	13,7	15,9	17,3	17,3	16,3	13,1	11,5	10,5	9,7
Prices									
CPI inflation (average % YoY)	2,3	3,4	2,2	-0,2	-0,5	-1,1	1,2	1,7	1,7
CPI inflation (end-year % YoY)	2,1	4,7	0,3	-0,5	-0,6	0,2	1,2	1,5	1,7
PPI inflation (average % YoY)	6,4	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,2	2,2
Net wage rates (% YoY, nom., €)	-0,2	-0,4	-0,1	-0,4	1,5	2,9	5,0	3,7	3,6
Fiscal balance (% of GDP)									
State budget balance	-7,5	-5,3	-5,3	-5,4	-3,3	-0,8	0,7	0,0	0,3
Public debt	63,7	70,6	81,7	85,8	85,4	82,7	77,8	73,3	70,5
Gross public funding needs	15,5	17,8	24,8	18,2	19,9	16,3	20,3	11,4	14,5
External balance									
Export of goods and services (EURbn)	18,128	18,319	18,768	19,677	21,472	22,780	25,437	27,253	28,637
Import of goods and services (EURbn)	18,314	18,125	18,599	18,852	20,442	21,434	24,291	26,433	28,154
Merchandise trade balance (EURbn)	-6,382	-6,296	-6,587	-6,512	-6,974	-7,338	-8,168	-8,942	-9,714
Merchandise trade balance (% of GDP)	-14,3	-14,3	-15,1	-15,0	-15,7	-15,8	-16,6	-17,1	-17,7
Tourism receipts (EURbn)	6,617	6,859	7,203	7,402	7,962	8,635	9,481	10,003	10,403
Current account balance (EURbn)	-0,313	-0,051	0,415	0,858	2,019	1,172	1,858	1,422	1,197
Current account balance (% of GDP)	-0,7	-0,1	0,9	2,0	4,5	2,5	3,8	2,7	2,2
Net FDI (EURbn)	1,1	1,2	0,8	0,7	0,2	1,9	0,9	1,6	1,8
FDI (% of GDP)	2,5	2,8	1,9	1,6	0,5	4,0	1,9	3,1	3,3
FDI cover (%)	357,7	2.453,4	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	14,494	15,764	16,964
Import cover (months of imports)	7,3	7,4	8,3	8,1	8,0	7,6	7,2	7,2	7,2
Debt indicators									
Gross external debt (EURbn)	46,397	45,297	45,803	46,416	45,384	41,668	39,773	39,460	41,007
Government (EURbn)	11,449	12,705	14,647	15,841	18,049	16,230	16,709	17,459	18,059
Private (EURbn)	34,949	32,592	31,157	30,575	27,335	25,438	23,064	22,001	22,948
Gross external debt (% of GDP)	103,7	103,0	104,7	106,9	101,9	89,8	80,9	75,7	74,5
Gross external debt (% of exports)	255,9	247,3	244,1	235,9	211,4	182,9	156,4	144,8	143,2
Exchange rates and money growth									
USD/HRK (end-year)	5,82	5,47	5,55	6,30	6,99	7,17	6,34	6,31	5,98
USD/HRK (average)	5,34	5,85	5,71	5,75	6,86	6,80	6,62	6,52	6,05
EUR/HRK (end-year)	7,53	7,55	7,64	7,66	7,64	7,56	7,54	7,45	7,42
EUR/HRK (average)	7,43	7,52	7,57	7,63	7,61	7,53	7,46	7,40	7,38
Money supply M1 (% YoY)	7,3	0,9	11,5	9,6	11,3	18,2	20,2	9,9	10,3
Broad money M4 (% YoY)	5,7	3,6	4,0	3,2	5,1	4,7	2,6	3,7	3,9
Domestic credit (% YoY, euros)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	-1,0	1,2	2,4
ZIBOR 3M interest rate (average %)	3,19	3,55	1,54	0,99	1,27	0,90	0,65	0,30	0,30
HRK 1Y yield (average %)	3,72	3,93	2,54	1,86	1,50	0,96	0,43	0,10	0,20
HRK 10Y yield (average %)	6,63	6,26	4,30	4,00	4,09	3,60	2,68	2,36	2,50

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	55.342	54.395	54.338	54.719	54.536	54.689	54.870	55.760	56.892
Assets (%, YoY)	3,7	-1,7	-0,1	0,7	-0,3	0,3	0,3	1,6	2,0
Assets (% of GDP)	123,7	123,7	124,2	126,0	122,4	117,8	111,7	106,9	103,4
Gross loans (EURm)	38.665	37.678	37.543	36.561	35.941	34.125	33.767	34.173	34.996
Gross loans (%, YoY)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	-1,0	1,2	2,4
Gross loans (% of GDP)	86,4	85,7	85,8	84,2	80,7	73,5	68,7	65,5	63,6
Deposits (EURm)	29.293	30.087	30.959	31.874	33.660	35.237	36.279	37.364	38.436
Deposits (%, YoY)	0,3	2,7	2,9	3,0	5,6	4,7	3,0	3,0	2,9
Deposits (% of GDP)	65,5	68,4	70,8	73,4	75,6	75,9	73,8	71,6	69,9
Loan-to-deposit ratio (%)	132,0	125,2	121,3	114,7	106,8	96,8	93,1	91,5	91,1
Capital adequacy ratio (%)	19,6	20,9	21,0	21,8	20,9	23,0	22,5	22,0	21,7
Performance									
Net interest income (EURm)	1.540	1.449	1.360	1.366	1.401	1.457	1.471	1.478	1.525
Net interest income (%, YoY)	3,7	-5,9	-6,2	0,5	2,5	4,0	0,9	0,5	3,2
Total operating income (EURm)	2.249	2.015	1.923	1.922	1.904	2.150	2.183	2.208	2.268
Total operating income (%, YoY)	2,0	-10,4	-4,5	0,0	-1,0	12,9	1,5	1,2	2,7
Pre-provision profit (EURm)	1.127	972	920	934	915	1.178	1.173	1.210	1.255
Pre-provision profit (%, YoY)	3,1	-13,7	-5,4	1,6	-2,0	28,7	-0,5	3,2	3,8
Provision charges (EURm)	500	501	780	645	1.529	380	645	425	398
Profitability and efficiency									
Net interest margin (%)	2,8	2,6	2,5	2,5	2,6	2,7	2,7	2,6	2,6
Pre-tax ROAA (%)	1,2	0,9	0,3	0,5	-1,1	1,5	1,0	1,4	1,5
Pre-tax ROAE (%)	8,4	6,2	1,9	3,9	-8,7	11,4	7,0	10,0	10,8
Cost-to-income ratio (%)	49,9	51,7	52,2	51,4	51,9	45,2	46,3	45,2	44,7
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	12,1	11,3	10,8
NPL coverage (%)	41,4	42,6	46,2	51,3	56,9	63,7	64,2	60,2	60,0
Provision charges (% of loans)	1,3	1,3	2,1	1,7	4,2	1,1	1,9	1,3	1,2
Provision charges (% of PPP)	44,4	51,5	84,8	69,0	167,0	32,2	55,0	35,1	31,7

Source: CNB, Addiko research

Credit activity still in decline

Although being positive for most of the year, November results show that credit activity weakened (-1.0% ytd), with public sector as the main drag after cheaper refinancing operations (notably that of state road companies). At the same time retail re-leveraging accelerated 1.7% ytd as stronger labour market and consumer sentiment drive demand for cash loans, while state-subsidised schemes propelled housing loans since August. Corporate lending was driven by improving business optimism and easier access to lending and EU funding (SME). However, these effects were basically offset by NPL sales (EUR519m in 9M17) and write-offs, leaving corporate credit growth unchanged on ytd level. In 2018 we expect credit activity to enter positive territory and increase by 1.2% yoy on the back of further economic recovery, better labour market outlook, stronger household consumption and record low interest rates, thanks to higher competitiveness among banks and lower risk premium. Downside risks stem from still hard-to-quantify Agrokor problem and new CNB regulation leading to tightening of credit standards for retail lending (housing). Regarding credit quality, we expect further decline of NPL ratio to 12.1% in 2017 (vs. 12.5% in 9M17), down to 11.3% in 2018 amid expansion phase of the business cycle, higher recovery rate and further NPL sales and write offs.

Solid deposit growth set to continue

Deposit growth slowed down to 2.3% in year to November. The strongest positive contribution came from 6.4% ytd higher corporate intake due to stellar tourist season and strong firms' profits. Household deposits saw modest 0.8% ytd increase as record low interest rates are motivating migration to alternative savings channels (AuM). That said, we lowered our expectations for 2017 deposit growth to 3.0% yoy. In 2018 we expect deposits to stagnate around the same level mainly due to persisting low interest rates environment and increasing households' consumption propensity. Regarding profits, NII recorded weak 0.4% yoy growth in 9M17 supported by low funding costs which entirely offset the -11.0% yoy lower interest income. Agrokor related financial restructuring forced higher bank provisioning (HRK1.8bn yoy), resulting in strong pre-tax profit deterioration (-46.2% yoy). In 2018 we expect recovery of profitability due to lower provisioning, while NIM will stay under pressure of low interest rates.

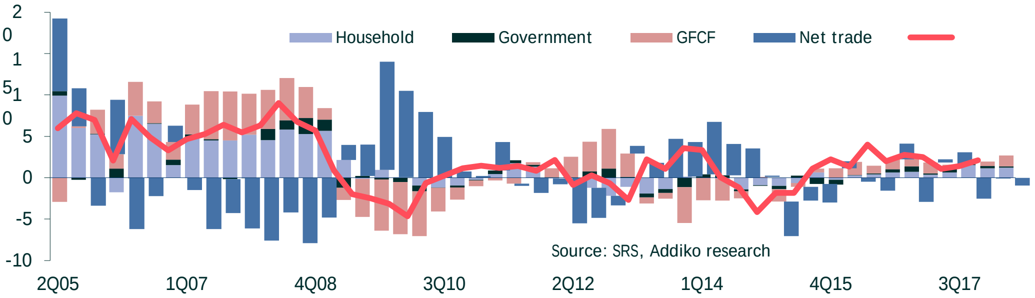
GDP Growth Normalizing Higher

We raise our 2018 GDP forecast to 3.5% on stronger domestic demand, external demand bonanza, FDI/capex, unwinding of negative one-offs from 2017 and more supportive fiscal stance. While inflation will pick up gradually and require the NBS policy rate normaliaztion only in 1H19, this does not stop the central bank from further easing, including rate cuts, during 1H18. We see further spreads tightening through 2018 thanks to significant public/external debt cuts, ongoing IMF co-operation and stable politics before dinar rates grind higher in 2019 amid stronger bank lending and monetary policy normalization.

Growth near prior expectations, moderate upward

GDP growth picked up to 2.1% yoy in Q3 on private consumption, stronger manufacturing and goods exports. The growth would be stronger had it not been for drought-inflicted agriculture output slump, 3-week outages in Fiat and sub-optimal energy output. The key driver, household consumption is driven by private job creation, strong wage hikes and re-leveraging. Investment also gathered pace on the back of resurgent FDIs, mirroring progress in the key competitivness rankings, and substantial reversal in public capex under-execution after dismal 1H17. While stronger 11%+ goods export growth reflects robust euro zone demand and market share gains, import-intensive demand leaves net trade contribution negative. With faster manufacturing recovery, stronger consumers, investment bonanza and goods exports growth steadily in double digits, we see Q4 GDP growth above 2.5% yoy. Despite a poor 1H17 and ~2pp negative effect from supply shocks due to one of the harshest winterest in decades, the underlying recovery in H2 brings the FY17 GDP growth closer to 2%, yet only about a half of the CESEE average.

Serbia: contributions to GDP (pps, %)



Growth accelerates 3.5% in 2018 on stronger domestic demand and steady external backdrop

We lift 2018 growth forecast to 3.5% mainly thanks to a pick-up in domestic demand, external demand bonanza, unwinding of negative one-offs from 2017 and more supportive fiscal stance. For starters, sustained increase in private consumption contribution has legs, in our view, on ongoing 6%+ disposable income growth amid wage/pension hikes (notably in private sector), higher social transfers and cheaper debt service, employment gains and re-leveraging. Furthermore, we see stronger investment growth thanks to improved business climate (in the WB Doing Business, DTF rose by 0.26pp to 73.1, above peers like Croatia, Hungary, Bulgaria), strong capacity-enhancing FDI accumulation, continued state-sponsored EUR2.5bn railway/road construction and better financing conditions. Buoyant exports growth is set to continue, in our view, driven by capacity expansion in tradable sectors and persistent above-trend euro zone growth, which despite stronger import demand will see less negative net trade contribution (-0.5pp) compared to 2017. Competitiveness reforms, including wage tax cuts, SOE restructuring, privatization and public administration reform, alongside progress on the EU 2025 entry agenda and infrastructure capex pose upside risks. Downside risks stem from public capex under-execution and political/reform stalemate in case of another snap elections should President Vucic try to cement the SNS party and his own position.

Subdued inflation set to pick up gradually

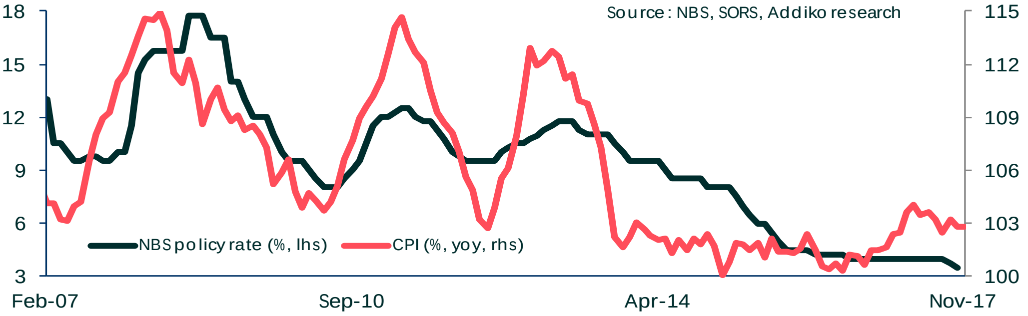
Headline CPI inflation came in lower than expected due to subdued import prices (partly due to stronger dinar) and weaker-than-expected food prices, despite weather-induced damages. Inflation pressures appear low, with core inflation around the lower end of the 3%+/-1.5pp NBS' target interval, and inflation expectations of both financial and corporate sectors anchored within the inflation target bands. High petroleum- and food-related base effects and strong dinar will lower inflation below 2.5% in 1Q18, while agricultural commodity prices and resurgent aggregate domestic demand supported by slightly expansionary fiscal backdrop will help CPI converge towards 3% yoy by this summer. Upside risks to inflation mainly stem from the global commodity market, stronger-than-expected administered price hikes and ongoing strong domestic wage growth, while the stronger dinar and finally one normal agricultural season may exert downside pressure on food prices. We again expect the average 2018 CPI around 3% in 2018 in the absence of siginicant food prices supply-side shocks.

C/A deficit widens on stronger import demand

The C/A deficit surged 64.2% yoy in 10M17 as wider goods trade and primary income deficits dwarfed higher secondary income surplus. That said, goods trade gap rose 20.3% yoy as 11.6% export growth could not offset 13.3% higher imports amid stronger domestic consumption, capital goods imports and generally high import content of exports. Looking ahead, robust external demand, capacity upgrades and higher importance of technology goods in total imports bode well for exports and competitiveness this year and next one. Stronger consumer demand, private capex, and ongoing credit recovery will see import growth accelerate as well, leading to higher goods trade as well as C/A defcits to about 11% and 5% of GDP, respectively. The net external debt slump and contained borrowing needs, ongoing private-sector de-leveraging and FDI overfinancing (see down) of C/A gap and stronger banks' net external positions and external de-leveraging (as part of balance sheet restructuring, banking NPL sales) all support further improvement in net international investment position.

Net FDIs rose 12.6% yoy in 9M17, which coupled with much smaller net portfolio outflow resulted in higher surplus in the financial account. Having hit almost 6.5% of GDP for the FY17 (above the EU average ~5% of GDP), we see similar FDI inflow in 2018 thanks to improvement in investment climate, stronger privatization pipeline (including Komercijalna Banka, chemical maker MSK and copper smelter RTB Bor) as well as firmer foreign investors' perception of long-term investment and growth prospects. That said, FDI allocation is increasingly diversified, with the strongest interest for various manufacturing capacity, financial sector, industrial real estate, etc. Following a sharp decline in portfolio flows upon a USD750m bond repayment partly through a strong MinFin's cash reserve, we we se those stably higher as long as slow flattening US rate cycle and contained external imbalances continue to fuel flows into EM assets, Serbian included.

Serbia CPI inflation and NBS policy rate



Further NBS easing ahead amid subdued inflation, reduced fiscal risks and strong dinar

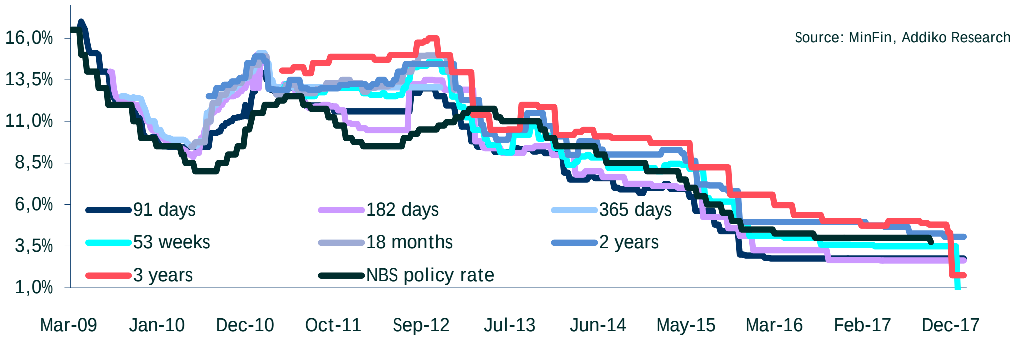
Having cut the key policy rate by 50bp last autumn on short-term inflation undershooting and medium-term (18M) expectations, the NBS in our view also used a genuine maneuvering space provided by the dinar 'overboughtness' thanks to strong fiscal overperformance, record low sovereign risk and ample foreign inflows in the local debt, soaring dinar bank lending and (yet) unharmful Fed tightening. While inflation has defied expectations through a good part of 2H17, CPI gauge is still well above inflation of the main trading partners, which alongside stronger dinar hits price competitiveness. The downward trajectory of short-end rates has been supported by monetary easing and stronger MinFin's bargaining power given its hefty cash reserve and high interbank excess liquidity, which the NBS continued to dillute via 1W REPO instrument to stabilize short-end dinar rates.

Despite the expected smooth global monetary transition and, hence, appealing EM risk appetite, we expect modest global reflation on recently adopted US fiscal stimulus, Fed tightening (four rate hikes in 2018, in our view) and gradual rate hikes in CESEE economies reduce chances for the NBS rate cuts. However, given the tighter monetary conditions amid further dinar rally, subdued inflation and reduced fiscal risks, we see further NBS easing, including FX spot interventions, plus policy rate cut(s) given that due to high excess liquidity, market rates are already closer to the NBS deposit facility than to the repo rate, and real rates are even slightly negative. In our base case, we see two 25bp NBS rate cuts in 1H18 to 3.0% - unchanged in the rest of 2018 and 1H19 - before the first rate hikes in 2H19 amid highert inflation (outlook). One of the slowest Fed tightening cycle on record (15bp/month so far) won't have too strong impact on Serbian assets, in our view, thanks to the recent Fitch rating upgrade, record low sovereign risk premium, and further downside potential thanks to significant public/external debt cuts, ongoing IMF co-operation and stable politics. The mix of improving sovereign risk profile and muted domestic inflation pressures allow the NBS to keep monetary policy loose amidst external monetary normalization. What's more, despite louder calls to end the ECB QE programme in September this year, we do not not expect the ECB to hike rates until 2019 given subdued inflation outlook in the euro zone.

How low can EUR/RSD go?

Despite stronger corporate FC demand as implied by soaring total trade deficit, the EUR/RSD dipped below 118.50, with appreciation pressures in check only upon multiple NBS FX interventions as even seasonally strong pre-holiday/energy imports have barely had an impact. Sporadic seasonal depreciation episodes aside, there are grounds for the RSD strength to persist in 2018 on stronger macro and risk profile amid further fiscal healing (i.e. public debt reduction outlook), stronger country's external position, inclusion in the JP Morgan EM index and in turn strong non-residents' appetite for Serbian assets. Moreover, from a short-term flows perspective, stronger RSD bank lending lends further support to the RSD since the NBS continues to withdraw liquidity through REPO, which in case of soaring clients' demand for RSD loans may force banks to sell euros. Last but not least, stronger dinar has not only helped in inflation targeting and incentivizing deposit dinarization, but it also bodes well for improvement in closely-watched public debt metrics where the authorities have had a lot of interest. With occasional depreciation influences from soaring import-intensive demand and rumours about new snap elections contained, we see the EUR/RSD inside 117-120 steered by the NBS' heavy two-way management on both ends (ignoring IMF recommendations for more flexibility).

Serbia: T-bill/notes yields



Strong fiscal consolidation likely to be reversed slightly

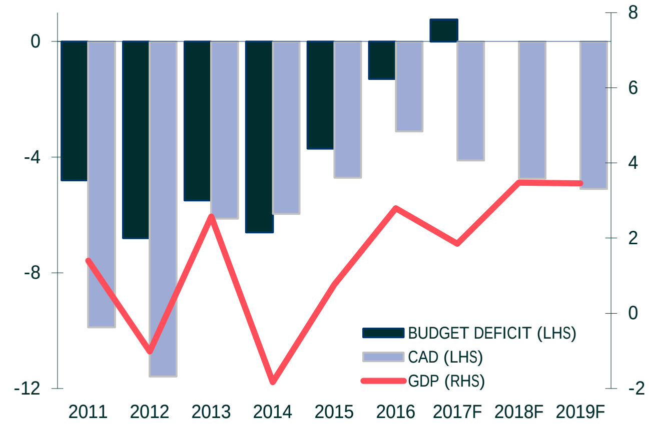
In 2017, Serbia eked out budgetary surplus of 0.8% of GDP (against the planned -1.7% FY17 deficit) thanks to persistent tax revenue (notably VAT and CIT) overshooting (+8% yoy), SOE dividend payments, stronger tax compliance, plus lower social transfers as well as interest payments, and public capex under-execution. While stronger tax-rich domestic demand this year will likely ensure a further 8%-alike tax growth and interest rate spending falls further, we still expect the budget to return to a balance in 2018 on public capex acceleration, wages and pension hikes and higher non-taxable income treshold. From a competitiveness point of view, it would have been if labour tax cuts were stronger and public wage hikes milder. 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 the near term though, the main fiscal risks include vulnerabilities from the large non-restructured SOE sector via higher payment arrears (EPS, Srbijagas?) and/or subsidy activation. In our view, the current 2018 budget plan looks reasonable given faster GDP growth, steady euro zone outlook and ever lower interest rates. With frontloaded fiscal consolidation, GDP growth rebounding, sustained primary surplus and stronger dinar to enable further drop in public debt from the last year's 65% of GDP to about 63% of GDP in 2018, which is below the 'BB' median.

… as stronger reform momentum is needed to grant stability

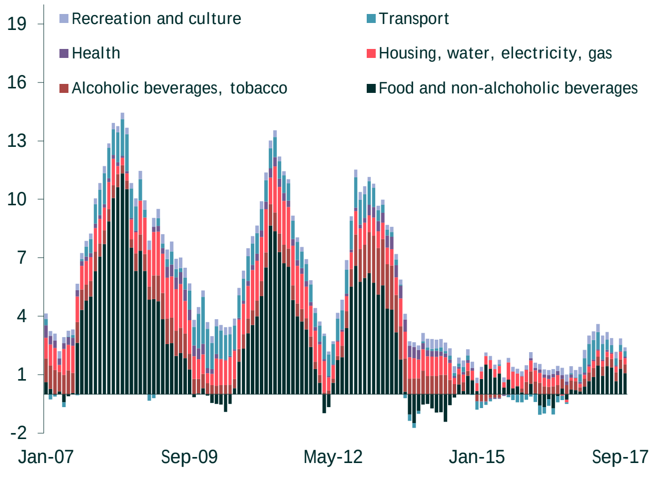
While the MinFin continued lengthening its local debt stock through Q4 at bid-to-cover above 2x and lower costs, the main event is the first ever sizeable one-off repayment of USD750m bond in November from a hefty fiscal reserve. Following a cumulative 50bp decline over 2-3Q17, Serbian risk premium fell another 30bp in Q4 to a record low just above 110bp. Besides ongoing strong global EM risk appetite for high-yielders, Serbia remains the IMF poster child for front-loading strong fiscal deficit containment and improved external metrics, rating agencies (e.g. Fitch) are positive on further fiscal healing prospects, and JP Morgan is set to include Serbian papers in its EM index. Downside potential on spreads may still come from the continued co-operation with the IMF, stronger macro outlook and structural reform agenda under new PM Ana Brnabic. While large benchmark Eurobond in 1Q18 would help rebuild FX reserves after November's USD bond redemption and prompt a drop in FC local issuance and/or buy-back auctions, we see the MinFin focused on (re)financing via longer 5&10Y dinar maturities on the assumed high interbank liquidity and decent activity from non-resident investors after inclusion into JP Morgan index, which may boost liquidity and help in further local yield compression. Early repayment of expensive EUR183m London Club debt will also help cut interes rate costs. After some further spread tightening potential during 2018 as explained before, we see gradual dinar rates normalization in 2019 onwards in line with stronger bank lending flows and the NBS policy normalization.

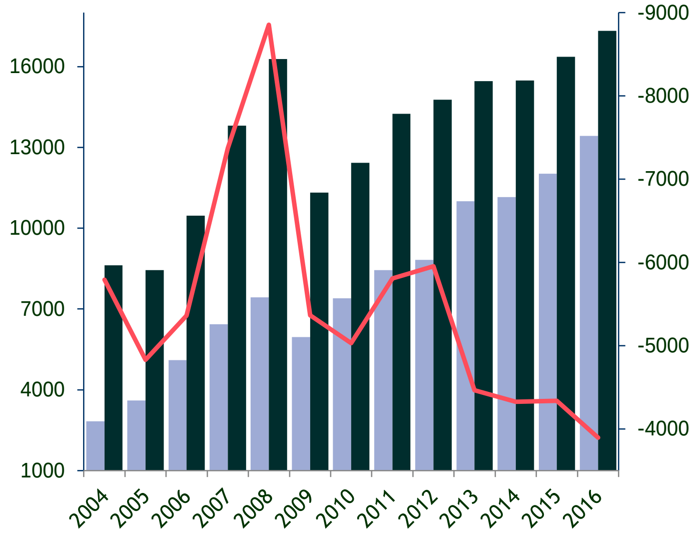
Serbia's data trends

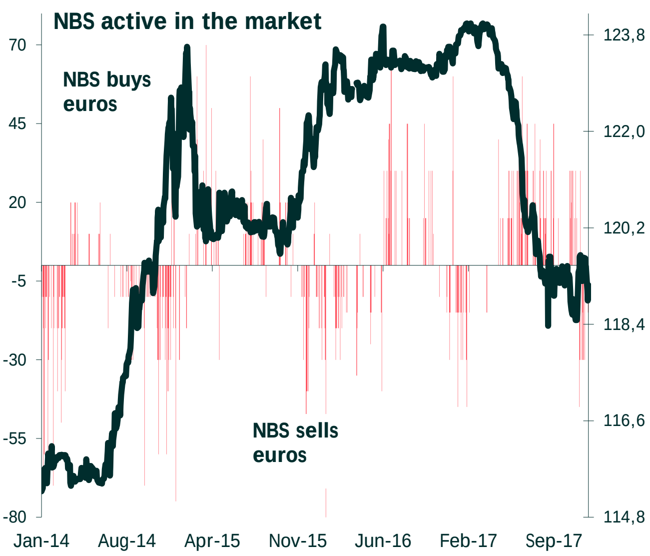
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



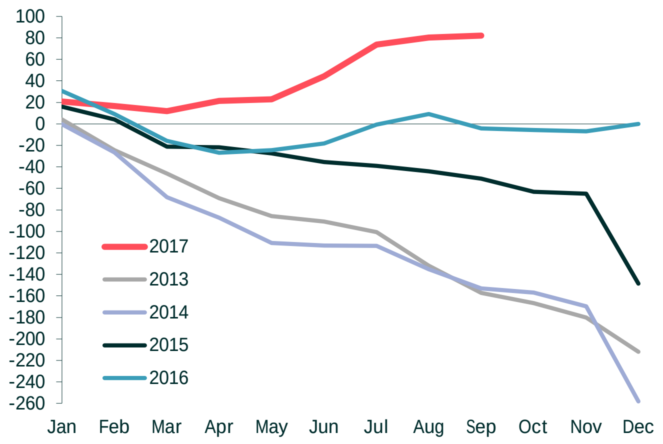
CPI contribution - key categories (pps)



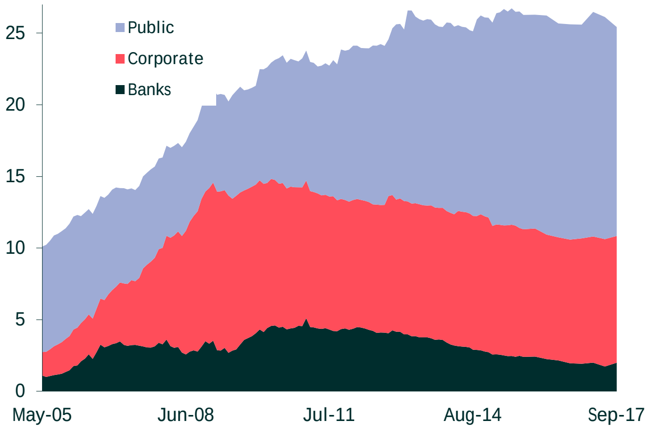




Consolidated government budget balance (RSDbn)



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	2017F	2018F	2019F
Activity									
Nominal GDP (RSDbn,current prices)	3.408	3.584	3.876	3.908	4.043	4.262	4.474	4.765	5.135
Nominal GDP (EURbn)	33,4	31,7	34,3	33,3	33,5	34,6	36,8	40,3	43,2
Nominal GDP (USDbn)	46,5	40,7	45,5	44,1	37,1	38,3	41,6	45,8	52,6
GDP per capita (EUR)	4.620	4.401	4.783	4.662	4.720	4.904	5.234	5.726	6.129
GDP per capita (USD)	6.423	5.650	6.353	6.177	5.234	5.432	5.910	6.499	7.393
Real GDP (constant prices YoY, %)	1,4	-1,0	2,6	-1,8	0,8	2,8	1,9	3,5	3,5
Private consumption (YoY, %)	0,9	-2,1	-0,4	-1,3	0,4	0,8	1,9	2,9	3,2
Fixed investment (YoY, %)	4,6	13,2	-12,0	-3,6	5,6	5,1	4,4	6,7	7,0
Industrial production (YoY, %)	2,5	-2,2	5,4	-6,4	8,4	4,8	3,4	4,3	4,2
Unemployment rate (ILO, average %)	23,0	23,9	22,1	19,2	17,7	15,3	13,0	12,0	11,4
Prices									
CPI inflation (average % YoY)	11,0	7,8	7,8	2,1	1,4	1,1	3,1	2,8	4,2
CPI inflation (end-year % YoY)	7,0	12,2	2,2	1,7	1,5	1,6	3,0	3,3	4,4
PPI inflation (average % YoY)	14,2	5,6	3,6	0,7	0,2	-0,4	3,0	3,4	4,1
Net wage rates (% YoY, nominal, euros)	1,1	-1,8	-1,8	-4,3	-3,3	1,8	6,2	6,4	3,4
Fiscal balance (% of GDP)									
State budget balance	-4,8	-6,8	-5,5	-6,6	-3,7	-1,3	0,8	0,0	0,0
Public debt	45,4	56,2	59,6	70,4	74,7	71,9	64,0	61,5	59,6
Gross public funding needs	13,3	15,4	16,1	17,6	16,7	13,9	14,6	12,8	11,3
External balance									
Export of goods and services (EURbn)	n/a	11,469	13,937	14,451	15,631	17,385	19,654	21,254	22,730
Import of goods and services (EURbn)	n/a	16,992	17,782	18,096	18,899	19,597	22,330	24,506	26,161
Merchandise trade balance (EURbn)	n/a	-5,634	-4,159	-4,111	-3,993	-3,119	-3,684	-4,225	-4,354
Merchandise trade balance (% of GDP)	n/a	-17,8	-12,1	-12,3	-11,9	-9,0	-10,0	-10,5	-10,1
Remittances, net (EURbn)	n/a	1,989	2,217	1,931	2,155	1,953	2,109	2,215	2,325
Current account balance (EURbn)	-3,305	-3,671	-2,098	-1,985	-1,577	-1,075	-1,518	-1,911	-2,199
Current account balance (% of GDP)	-9,9	-11,6	-6,1	-6,0	-4,7	-3,1	-4,1	-4,7	-5,1
Net FDI (EURbn)	n/a	0,8	1,3	1,2	1,8	1,9	2,4	2,5	2,7
FDI (% of GDP)	n/a	2,4	3,8	3,7	5,4	5,5	6,4	6,3	6,3
FDI cover (%)	n/a	20,5	61,9	62,3	114,4	176,7	156,4	133,4	123,0
Gross international reserves (EURbn)	12,058	10,915	11,189	9,907	10,378	10,205	10,261	9,811	9,611
Import cover (months of imports)	n/a	7,7	7,6	6,6	6,6	6,2	5,5	4,8	4,4
Debt indicators									
Gross external debt (EURbn)	24,125	25,645	25,644	25,679	26,234	26,488	25,718	25,488	25,972
Government (EURbn)	10,773	12,185	13,120	14,145	15,295	15,680	14,970	14,820	15,020
Private (EURbn)	13,352	13,460	12,525	11,534	10,939	10,808	10,748	10,668	10,952
Gross external debt (% of GDP)	72,2	80,9	74,8	77,1	78,3	76,5	69,8	63,2	60,2
Gross external debt (% of exports)	n/a	223,6	184,0	177,7	167,8	152,4	130,9	119,9	114,3
Exchange rates and money									
USD/RSD (end-year)	80,87	86,18	83,13	99,46	111,64	117,93	99,30	99,15	95,48
USD/RSD (average)	73,34	88,12	85,17	88,54	108,88	111,17	107,55	104,14	97,54
EUR/RSD (end-year)	104,6	113,7	114,6	121,5	121,8	123,5	118,5	117,0	118,4
EUR/RSD (average)	102,0	113,1	113,1	117,3	120,7	123,1	121,4	118,2	119,0
Money supply M1 (% YoY)	16,9	-3,3	24,8	5,2	16,4	18,7	6,7	6,0	5,0
Broad money M3 (% YoY)	11,2	0,7	3,7	3,0	5,0	9,9	6,4	3,9	3,6
Domestic credit (% YoY, euros)	8,9	0,8	-5,2	-2,3	2,4	1,0	6,0	6,3	6,3
NBS policy rate (average %)	11,54	10,14	11,00	8,79	6,08	4,15	3,85	3,10	3,17
NBS policy rate (end-year %)	9,75	11,25	9,50	8,00	4,50	4,00	3,50	3,00	3,50
6M BELIBOR interest rate (average %)	13,13	12,00	10,40	8,53	6,43	3,65	3,60	2,96	3,15

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	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	25.325	25.326	24.825	24.546	25.060	26.257	27.570	28.535	29.534
Assets (%, YoY)	5,5	0,0	-2,0	-1,1	2,1	4,8	5,0	3,5	3,5
Assets (% of GDP)	75,8	79,9	72,5	73,7	74,8	75,9	74,8	70,8	68,4
Gross loans (EURm)	17.013	17.148	16.255	15.879	16.253	16.412	17.398	18.500	19.657
Gross loans (%, YoY)	8,9	0,8	-5,2	-2,3	2,4	1,0	6,0	6,3	6,3
Gross loans (% of GDP)	50,9	54,1	47,4	47,7	48,5	47,4	47,2	45,9	45,6
Deposits (EURm)	13.099	13.310	13.634	13.967	14.728	16.159	17.166	17.950	18.594
Deposits (%, YoY)	10,1	1,6	2,4	2,4	5,4	9,7	6,2	4,6	3,6
Deposits (% of GDP)	39,2	42,0	39,8	41,9	44,0	46,7	46,6	44,5	43,1
Loan-to-deposit ratio (%)	129,9	128,8	119,2	113,7	110,4	101,6	101,4	103,1	105,7
Capital adequacy ratio (%)	19,1	19,9	20,9	20,0	20,9	21,8	22,5	22,8	22,9
Performance									
Net interest income (EURm)	1.131	1.025	1.044	1.063	1.075	1.006	1.026	1.056	1.093
Net interest income (%, YoY)	7,6	-9,4	1,9	1,8	1,1	-6,4	1,9	2,9	3,5
Total operating income (EURm)	1.590	1.484	1.435	1.489	1.520	1.393	1.537	1.575	1.601
Total operating income (%, YoY)	3,2	-6,7	-3,3	3,8	2,1	-8,4	10,4	2,5	1,7
Pre-provision profit (EURm)	617	571	504	529	574	467	607	630	642
Pre-provision profit (%, YoY)	9,6	-7,5	-11,6	4,8	8,6	-18,7	29,9	3,9	1,9
Provision charges (EURm)	313	339	510	490	494	294	30	45	57
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	2,0
Pre-tax ROAE (%)	5,9	4,3	-0,3	0,6	1,6	3,5	11,0	10,1	9,3
Cost-to-income ratio (%)	61,8	66,1	65,3	64,7	62,2	66,5	60,5	60,0	59,9
Operating expense (% of assets)	3,9	3,6	3,7	3,9	3,8	3,6	3,5	3,4	3,3
Credit quality and provisioning									
NPL ratio (%)	19,0	18,6	21,4	21,5	21,6	17,0	11,7	11,0	10,2
NPL coverage (%)	51,0	50,0	50,9	54,9	62,3	67,8	61,8	61,5	60,3
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	5,0	7,1	8,9

Source: NBS, Addiko research

Private sector remains the key driver of credit growth

Credit growth accelerated to 5.9% in year to November (vs. 1.0% yoy in 2016) with the strongest positive contribution coming from the retail sector. Retail lending increased 11.9% ytd driven mostly by cash loans, amid private employment and wage gains as well as record low interest rates. Considering that around 97% of all cash loans were disbursed in RSD, growth in retail cash loans also increased the RSD share of retail portfolio to 51%. At the same, demand for liquidity and working capital loans resulted with 3.1% ytd increase of corporate lending, despite strong NPL write-offs and sales in that segment particularly. Public deleveraging continued given more favourable debt management and cross-border loans. That said, we revised our 2017 credit growth forecast upwards to 6.0% yoy. In 2018 we expect credit growth to accelerate to 6.3%, again driven by private sector lending and supported by cleaner banks' balance sheets, low interest rates, private consumption and investment intensification. Cleaning of banks' portfolios was specifically intensified during 2017 and further enhanced in September with the implementation of new law that forces the banks to write-off all the NPLs that are fully provisioned. Overall, this resulted with RSD94bn ytd NPLs reduction, consequently lowering the NPL ratio to 12.2% in 9M2017 (vs. 17.0% in 2016). Looking ahead, we expect this trend to continue with further decrease of NPL ratio in 2018 to 11.0% level.

Profitability recovered amid NPL sales and lower provisioning

Deposit growth decelerated to 6.0% ytd (vs. 9.7% in 2016) influenced by both slower public and private sector deposit collection amid high-base effect, lower propensity to save and stronger investment appetite. Thus, we estimate deposit collection to reach solid 6.2% growth in 2017, while looking ahead we expect further deposit collection deceleration towards 4.6% in 2018 on the back of low interest rates and fairly high base. Regarding profits, strong non-interest income and lower provisioning led to 63.1% higher yoy pre-tax profit in 9M2017 and we expect similar performance to continue till year end. In 2018 we expect pre-tax income slightly above 2017 level, thanks to solid growth of NII (increasing credit portfolio and lower passive interest rates) along with stable provisioning and opex.

Resilient to Political Wrangling

We lifted 2017 GDP growth forecast to 3.0% amid stronger domestic demand and favourable external environment. As for 2018, we keep 3.1% growth forecast on stronger external demand, fiscal expansion and domestic investments. Meanwhile, we expect inflation to gather pace in 2018 supported by private consumption, while C/A deficit is expected to re-widen.

GDP growth revised upward for 2017 to 3.0%

The Q3 GDP growth came at 2.9% yoy, shaping up somewhat stronger-than-expected 3.0% yoy expansion in 9M17, and the Q4 data suggest similar growth dynamics. Namely, buoyant private consumption growth is set to continue as retail sales rose 4.9% yoy in October/November on strong remittances, improving labour market and re-leveraging, despite slower wage growth. Industrial output rose 4% yoy in October/November (3.6% yoy in 9M17), driven by manufacturing of intermediates and non-durables. Very strong goods export growth continued at 18% yoy pace in October/November on the heels of stronger EU demand. Still, despite record tourist season and surging goods exports, we see net trade contribution to growth negative given import-intensive local demand. That said, our upgrade of 2017 GDP growth forecast to 3.0% may not reflect just stronger activity in 2H17, but may also come from lower base after recently downwardly revised 2016 GDP growth to 2% (prev. 3.1%). Once we've got new 2016 GDP breakdown complete, we may consider fine-tuning GDP forecasts for 2017-2018.

Growth pace set to continue

We see GDP growth at 3.1% this year since the economic activity has proved resilient to political wrangling and the absence of the IMF tranche, enjoying cyclical recovery. Private consumption growth is expected to continue at around 2.5% on rising remittances, stronger employment and wage growth, re-leveraging and lower debt service costs. Moreover, strong EU demand will push exports, but given stronger domestic demand, we see net trade contribution in 2018 negative. Accelerating investments will boost growth largely thanks to long-overdue EUR70m EBRD funding of the Vc highway corridor construction only after the passage of laws on road tolls and excise taxes, as well as somewhat stronger FDIs. However, FDI inflows stay below 3% of GDP, among the lowest in SEE amid poor business climate and political uncertainty. According to the World Bank's 'Doing Business 2018', B-H fell 5 places to 86th, much worse than the countries in the region. Although B-H saw small improvements in categories such as dealing with construction permits, starting a business and paying taxes, it still underperformed strongly in the same areas compared to neighbouring countries. The risks to growth are mainly on the downside, stemming from complex institutional set-up, general elections in October 2018, stronger emigration and long-term unemployment.

IMF deal still on hold

IMF visited B-H in December to discuss the progress on reforms to unlock further payouts to help boost economic growth and job creation. Although B-H authorities have met several conditions over the last few months, including fuel excise hike, there is more political pro-activeness to be shown. To unblock the IMF loan deal, Federation B-H must adopt the 2018 budget in line with IMF staff recommendations (as the RS entity did it in December last year) and the government has to amend Deposit Insurance Act and start due diligence of the incumbent telecoms - BH Telecom and HT Mostar – which may prove politically sensitive ahead of the next year's elections.

We expect budget deficit at -0.5%

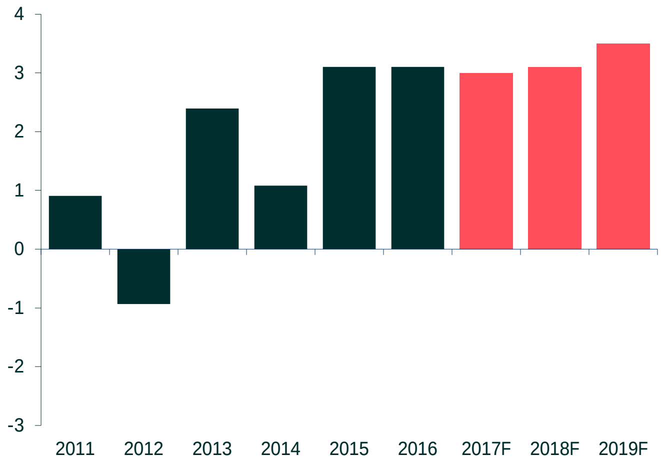
According to the RS and Federation B-H budget drafts, both entities plan to increase spending by 1.5%-5% and project budget surplus. While both governments are eyeing stronger infrastructure investment, the main risk here is that complex decision-making causes delays and the government stays focused on maintenance of wage bill and entitlement rights as well as debt service. We expect consolidated budget balance to turn into the red at -0.5% of GDP. Our expectations of tax revenues are lower than projected by the authorities, while public spending will be under pressure amid general elections in October 2018.

Inflation to gather pace in 2018

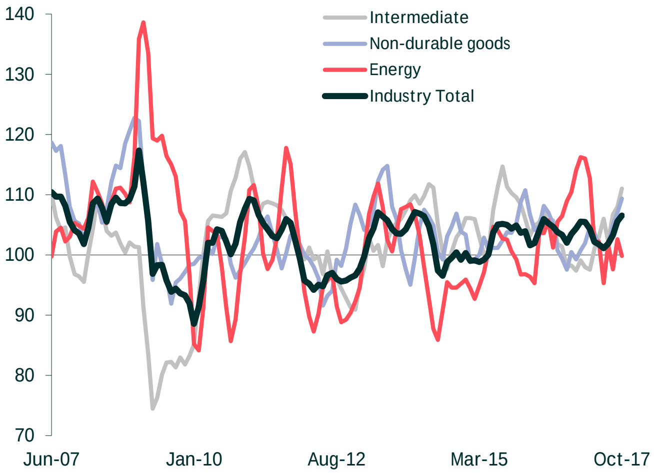
The C/A deficit narrowed 4.5% yoy to EUR541m in 9M17 on the back of improved service balance (+10.8% yoy) amid stronger tourism intake and 8.0% yoy higher remittances. Meanwhile, goods deficit rose 5.7% yoy as 12.3% yoy stronger imports offset 18.5% yoy higher exports. We see C/A deficit at 5.4% of GDP in 2017 due to goods trade deficit re-widening on stronger domestic demand that will outpace record tourist FC revenues and remittances. In 2018, we see further C/A widening to 5.6% of GDP on stronger import demand. Severe winter led to increasing prices at the beginning of the year, peaking at 2.2% in May. CPI eased since then to 1.2% yoy on average in June/November period. Given somewhat lower inflation since the middle of the year, we slightly downgrade our forecast to 1.3% for 2017, while in 2018 we expect inflation to gather pace supported by further acceleration in private consumption.

Bosnia and Herzegovina's data trends

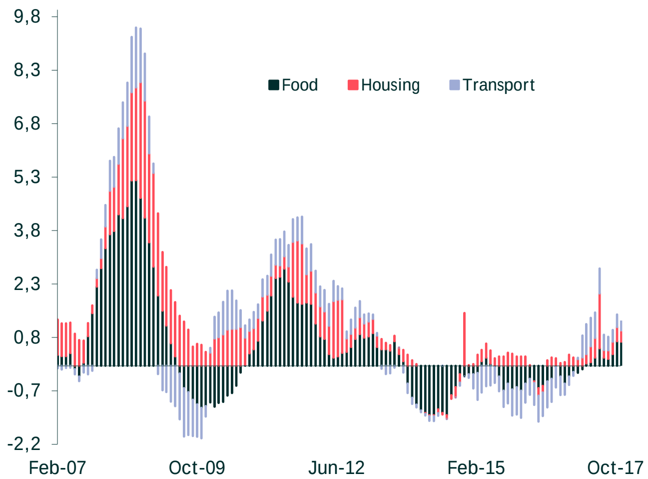
Real GDP growth (% YoY)



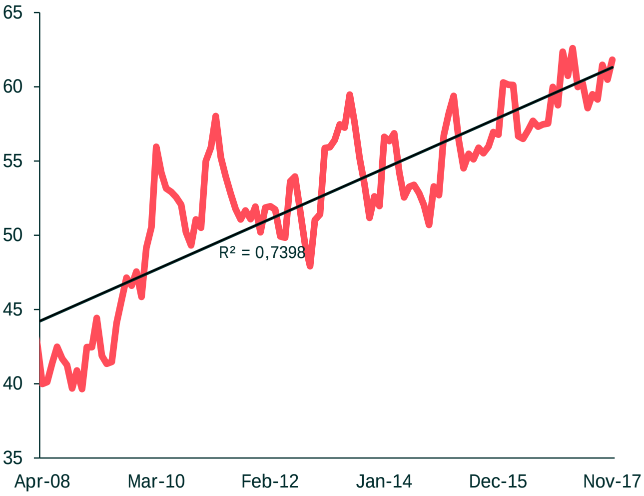
Industrial production (%, yoy, s-a, 3mma)



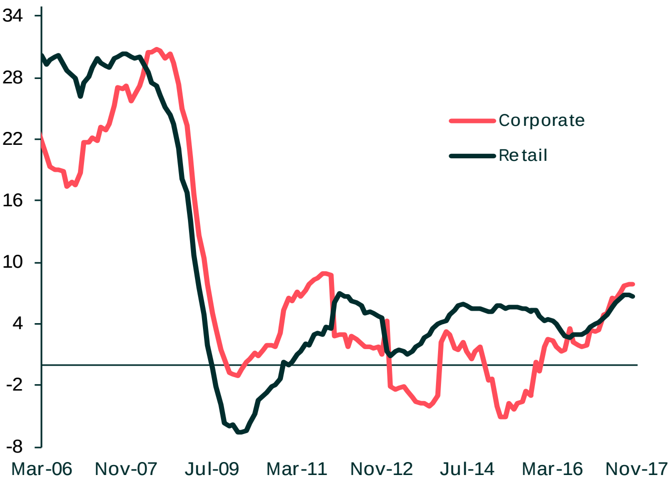
Key CPI contributions (pp)



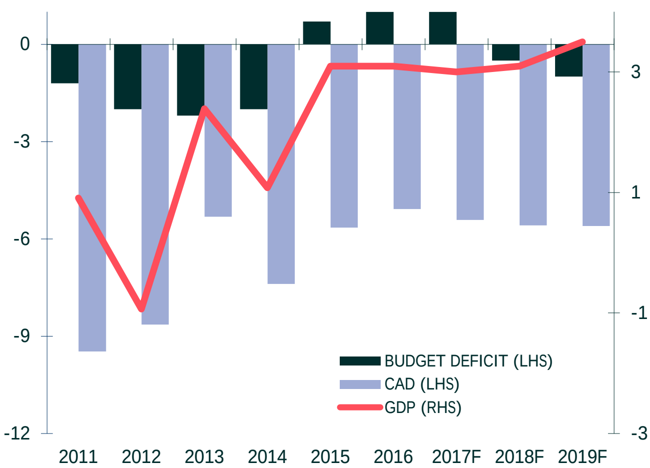
Merchandise import cover (%, 3mma)



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	2017F	2018F	2019F
Activity									
Nominal GDP (BAMbn, current prices)	26,2	26,2	26,8	27,4	28,6	29,9	31,2	32,9	34,9
Nominal GDP (EURbn)	13,4	13,4	13,7	14,0	14,6	15,3	16,0	16,8	17,8
Nominal GDP (USDbn)	18,7	17,2	18,2	18,6	16,2	16,9	18,0	19,1	21,8
GDP per capita (EUR)	3.635,6	3.675,4	3.798,1	3.922,8	4.133,5	4.346,7	4.536,0	4.779,5	5.070,5
GDP per capita (USD)	5.063,0	4.726,5	5.044,2	5.211,4	4.584,5	4.813,5	5.121,6	5.424,8	6.186,0
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	0,0	1,9	1,8	1,7	2,0	2,5	2,3
Fixed investment (YoY, %)	14,1	4,0	-3,0	8,2	2,9	10,8	3,0	4,5	8,0
Industrial production (YoY, %)	5,9	-5,2	6,7	0,1	2,6	4,5	3,7	4,5	5,0
Unemployment rate (ILO, average, %)	27,6	28,0	27,4	27,5	27,7	25,4	20,5	18,6	16,4
Prices									
CPI inflation (average % YoY)	3,7	2,1	-0,1	-0,9	-1,0	-1,1	1,3	2,2	2,5
CPI inflation (end-year % YoY)	3,1	1,8	-1,4	-0,4	-1,3	-0,2	1,8	2,0	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	2,1	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	-0,5	-1,0
Public debt	43,1	43,4	44,5	45,0	45,6	44,7	43,5	42,8	42,0
External balance									
Export of goods and services (EURbn)	4,297	4,337	4,620	4,754	5,056	5,372	6,190	6,614	6,945
Import of goods and services (EURbn)	-7,484	-7,481	-7,419	-7,927	-7,801	-7,993	-8,995	-9,528	-9,813
Merchandise trade balance (EURbn)	-4,131	-3,977	-3,630	-4,026	-3,677	-3,600	-3,891	-4,032	-4,068
Merchandise trade balance (% of GDP)	-30,8	-29,7	-26,5	-28,8	-25,2	-23,5	-24,4	-24,0	-22,8
Remittances (EURbn)	1,027	1,070	1,111	1,181	1,216	1,247	1,347	1,374	1,401
Current account balance (EURbn)	-1,270	-1,159	-0,728	-1,033	-0,826	-0,776	-0,864	-0,938	-0,999
Current account balance (% of GDP)	-9,5	-8,6	-5,3	-7,4	-5,7	-5,1	-5,4	-5,6	-5,6
Net FDI (EURbn)	0,3	0,3	0,2	0,4	0,2	0,2	0,4	0,5	0,5
FDI (% of GDP)	2,6	1,9	1,3	2,9	1,7	1,6	2,2	2,9	2,9
FDI cover (%)	27,1	22,3	24,0	38,8	30,1	31,0	41,3	52,4	52,7
Gross international reserves (EURbn)	3,285	3,328	3,614	4,001	4,400	4,873	5,096	4,940	4,758
Import cover (months of imports)	5,3	5,3	5,8	6,1	6,8	7,3	6,8	6,2	5,8
Debt indicators									
Gross external debt (EURbn)	6,558	6,985	7,134	7,232	7,805	8,316	8,746	8,736	8,726
Government (EURbn)	3,407	3,687	3,867	4,316	4,444	4,536	4,456	4,416	4,386
Private (EURbn)	3,152	3,298	3,267	2,916	3,360	3,780	4,290	4,320	4,340
Gross external debt (% of GDP)	48,9	52,1	52,1	51,7	53,4	54,4	54,8	52,0	48,9
Gross external debt (% of exports)	152,6	161,1	154,4	152,1	154,4	154,8	141,3	132,1	125,6
Exchange rates and money growth									
USD/BAM (end-year)	1,51	1,48	1,42	1,61	1,79	1,87	1,64	1,66	1,58
USD/BAM (average)	1,40	1,52	1,47	1,47	1,76	1,77	1,73	1,72	1,60
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	13,9	9,1	7,2
Broad money M2 (% YoY)	5,8	3,4	7,9	7,3	8,0	8,3	10,0	7,4	6,7
Domestic credit (% YoY)	5,3	4,1	0,5	2,8	2,4	2,0	6,2	6,2	6,6
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,15

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	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	11.196	11.414	11.794	12.299	12.756	13.279	14.038	14.590	15.250
Assets (%, YoY)	3,4	1,9	3,3	4,3	3,7	4,1	5,7	3,9	4,5
Assets (% of GDP)	83,5	85,1	86,1	87,9	87,3	86,9	88,0	86,8	85,5
Gross loans (EURm)	7.828	8.151	8.194	8.423	8.624	8.795	9.339	9.917	10.571
Gross loans (%, YoY)	5,3	4,1	0,5	2,8	2,4	2,0	6,2	6,2	6,6
Gross loans (% of GDP)	58,4	60,8	59,8	60,2	59,0	57,5	58,5	59,0	59,3
Deposits (EURm)	6.643	6.814	7.285	7.861	8.452	9.077	10.148	10.859	11.476
Deposits (%, YoY)	3,7	2,6	6,9	7,9	7,5	7,4	11,8	7,0	5,7
Deposits (% of GDP)	49,5	50,8	53,2	56,2	57,8	59,4	63,6	64,6	64,4
Loan-to-deposit ratio (%)	117,8	119,6	112,5	107,1	102,0	96,9	92,0	91,3	92,1
Capital adequacy ratio (%)	17,1	17,0	17,8	16,3	14,9	15,8	16,3	16,6	17,0
Performance									
Net interest income (EURm)	396	389	385	383	398	411	430	448	486
Net interest income (%, YoY)	8,2	-1,8	-1,0	-0,5	3,9	3,3	4,7	4,1	8,6
Total operating income (EURm)	620	610	618	623	642	680	757	777	830
Total operating income (%, YoY)	1,8	-1,5	1,2	0,8	3,1	6,0	11,2	2,7	6,7
Pre-provision profit (EURm)	209	207	184	213	206	222	293	304	339
Pre-provision profit (%, YoY)	-5,1	-0,8	-11,1	15,8	-3,6	8,1	31,9	3,5	11,7
Provision charges (EURm)	125	130	192	117	171	91	93	94	92
Profitability and efficiency									
Net interest margin (%)	3,6	3,4	3,3	3,2	3,2	3,2	3,2	3,1	3,3
Pre-tax ROAA (%)	0,8	0,7	-0,1	0,8	0,3	1,0	1,5	1,5	1,7
Pre-tax ROAE (%)	5,9	4,8	-0,5	5,6	1,9	6,9	9,8	9,4	10,2
Cost-to-income ratio (%)	66,3	66,0	70,2	65,7	67,9	67,3	61,2	60,9	59,1
Operating expense (% of assets)	3,7	3,6	3,7	3,4	3,5	3,5	3,4	3,3	3,3
Credit quality and provisioning									
NPL ratio (%)	11,8	13,5	15,1	14,2	13,7	11,8	10,4	9,6	9,2
NPL coverage (%)	66,3	65,9	66,7	69,7	71,2	74,4	75,8	76,3	77,0
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	-31,8	-31,1	-27,2

Source: CBBH, banking agencies, Addiko research

We upgraded our 2017 and 2018 credit growth forecast

Overall credit growth in October accelerated to 5.8% ytd (vs. 2.0% yoy in 2016) on the back of stronger lending to the private sector. Namely, retail lending rose 6.1% ytd driven by non-purpose cash loans which make up more than 75% of retail loans, while corporate credit rose 5.6% ytd amid cyclical recovery. Public loans also performed positively with a 2.8% ytd growth given the absence of the IMF tranche, although their impact was less significant due to small share in total loans. Given better than expected credit activity, we upgrade our 2017 growth forecast by 0.3pp to 6.1% yoy amid record low interest rates, rising employment and wages and record tourist season. In 2018 we see similar growth pace at 6.2% yoy on the back of economic growth, further decline in interest rates and improving labour market outlook. NPL ratio fell to 10.8% in September (vs. 11.8% at YE2016), which is in line with the expected 2017 NPL ratio of 10.5%. For 2018 we expect a further reduction of NPL ratio to 9.6% supported by NPL sales, write-offs, recovery and better debt collection.

Deposit collection outperforming 2017 expectations and keeping strong pace in 2018

Deposit collection increased by 10.2% ytd in October (vs. 7.4% yoy in 2016) with positive contribution coming from all sectors. Corporate deposits surged 15.6% ytd thanks to stellar tourist season, while public deposits soared 35.9% ytd, mainly driven by payment of the Russian clearing debt to the BH authorities. Retail deposit growth decelerated to 3.9% ytd influenced by high base. With deposit numbers beyond our expectations, we upgrade our deposit collection forecast for 2017 by 4.0pp to 11.6% yoy. In 2018 we see a deceleration towards 7.0% yoy given high base, intensifying private capex and higher consumption propensity due to low passive interest rates. Regarding profitability, the BH banking sector saw record pre-tax profit of EUR167m for 9M2017 (vs. EUR113m 9M2016, 47.8% yoy) on the back of higher operating income (9.4% yoy) due to strong growth of non-interest income. Considering record profits alongside better than expected credit activity, we expect 2017 pre-tax profit around EUR200m. In 2018 we see profits on similar levels driven by stronger disbursements and steady provisioning.

Decent Growth despite Fiscal Consolidation

For 2018, we keep 3.5% GDP growth forecast, with tourism, public capex (Bar-Boljare highway) and FDIs in energy and tourism the main growth drivers. Fiscal consolidation will be the main drag as higher taxes and excise duties will limit household consumption. Fiscal metrics still remain a cause of concern as highway construction should keep the budget deficit elevated around 5% of GDP in 2018. Inflation is expected to pick up in 2018 on higher excise taxes and stronger demand.

GDP set to increase by 4.4% in 2017

GDP growth accelerated to 4.3% yoy in 9M17 (on average) thanks to intensified road construction and plethora of projects in tourism and energy, as well as private consumption thanks to rising employment and re-leveraging. High frequency data suggest the strong growth pace continued in Q4 on industrial expansion (+3.1% yoy in October/November vs. -6.5% yoy in 9M17), retail trade (+5.6% yoy in October/November vs. 4.9% yoy in 9M17), improving labour market, cash flows from EUR1bn-alike tourism industry (foreign tourist nights +11% in 2017) and higher remittances. On the downside, goods exports fell 1.6% yoy in October/November after soaring 18.2% in 9M17, which alongside import growth acceleration from 16.9% yoy from 8.2% in 9M17 forebodes a strong goods deficit widening to EUR1.8bn in 2017, and goods import coverage hit just 17%. In summary, we lifted 2017 GDP forecast by 1.2pp to 4.4% mainly on account of stellar tourist season and soaring local demand.

Growth driven by tourism and investments in 2018

Despite better-than-expected 2017 outcome, we keep 2018 GDP growth forecast at 3.5%, with the planned fiscal consolidation the main drag on household consumption. The growth will be again driven by tourism, infrastructure projects (Bar-Boljare highway), FDI projects in tourism and energy (wind power) and renewed goods exports strength. Notwithstanding another record tourist season and the newest tobacco factory, net trade will contribute negatively given strong imports of construction and other investment-related equipment. Short-term outlook is subject mainly to downside domestic risks as fiscal adjustment could have larger-than-expected negative impact on private consumption, while delays in investment projects would also undermine economic growth. As ever stronger-than-expected global demand for travel is the main risk to the upside.

Fiscal package to offset highway-related expenditure?

In the year to November, budget deficit rose more than three-fold to EUR152m, albeit still lower than EUR260m plan. While tax collection surged 21.5% yoy on cyclical recovery, record tourist season and better tax compliance, expenditures rose 12.4% yoy largely on more than quadrupled public capex, despite the apparent under-execution of the FY17 plan. In the light of the latter and stronger GDP growth, we see 2017 deficit somewhat lower at 5.2% of GDP, down from 6% projected last fall. Cognizant of the strains of highway construction on public finances, Montenegro is eyeing a number of correction measures in the 2018 budget; 2pp VAT hike (21%), higher excise duty on tobacco, alcohol, sugar drinks, employment ban, senior staff wage as well as childcare support cuts, which may produce fiscal surplus, excluding capex budget. The official budget gap target (2.6% of GDP) is still only a half way to our 5% forecast as we expect the announced (tax) measures to cool tax-rich local demand, and public capex stays elevated. The actual execution of the cabinet's slim majority is the main downside risk if the loss of political support slows consolidation efforts. A negative risk for public debt is the EUR250m buy-back of 41.7% in the electricity board EPCG from Italy's A2A who activated put option in mid-2017 over disagreements on EPCG capex plan. The burden on public finances should however prove temporary as the government is actively seeking alternative strategic investor.

Inflation picking up

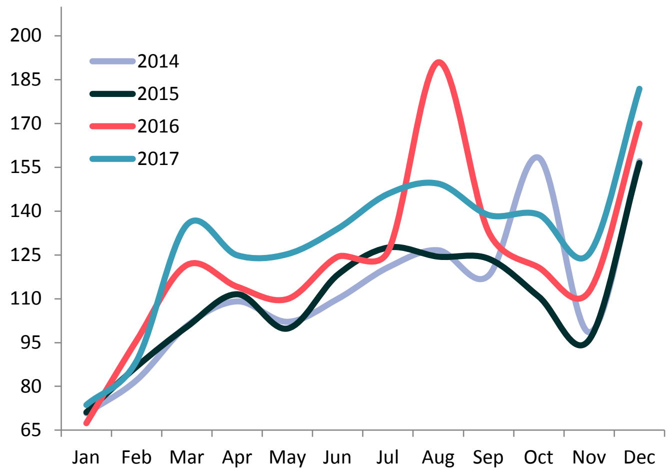
After the average -0.3% in 2016, inflation picked up considerably on higher alcohol and tobacco excises and rising fuel prices, while strong tourist demand pushed up hotel and catering prices. In 2018, VAT, excise duty hikes will add 0.8-1.0pp to the average 2018 inflation to which subdued imported inflation will act as a partial offset. All in all, we expect 2018 inflation to average around 3%, up from 2.4% in 2017.

C/A gap decreasing slightly

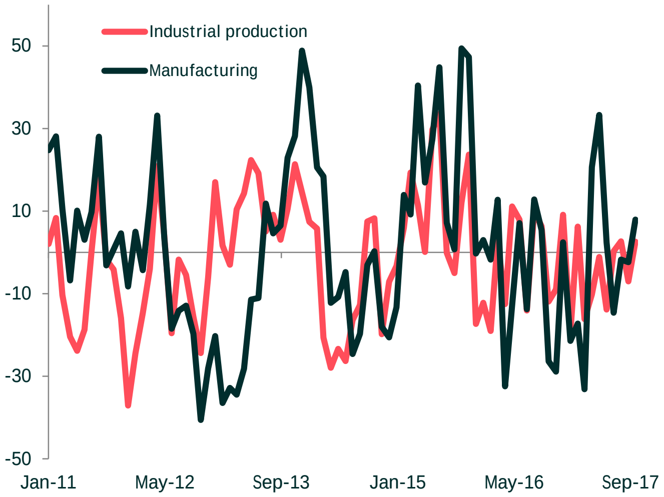
In 9M17, C/A deficit fell 9.2% yoy to EUR386m thanks to stronger services surplus as well as higher primary and secondary incomes, despite further goods trade gap widening. That said, goods trade gap rose 6.9% yoy amid capex-related imports, while services surplus increased by 8.8% yoy on the back of the record tourist season. Looking into capital and financial accounts, net FDI rose 10.6% to EUR0.3bn, which lends support to the expected 68% FDI cover in 2017. Despite highway construction and import-intensive local demand, we lower 2017 C/A gap forecast slightly to 16.6% of GDP amid stellar tourist season and soaring primary income. In 2018-2019, we see C/A gap around similar, slightly lower levels as the record tourist season and stronger goods exports will offset stronger import demand. Meanwhile, FDIs at 11-12% of GDP plan an important stabilizing role for C/A, albeit export base needs to be diversified to ensure sustainable improvement in C/A accounts.

Montenegrin data trends

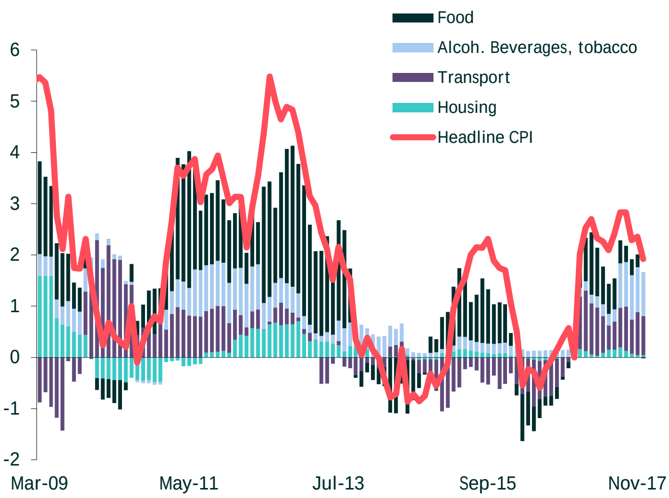
Budget revenue movements (EURm)



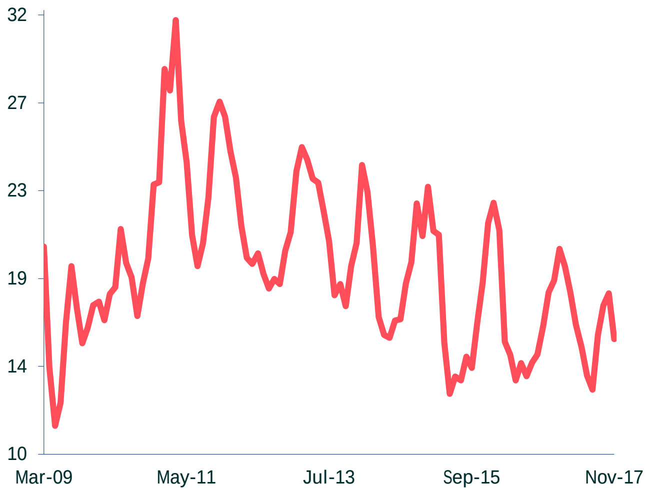
Industrial production (%, yoy)



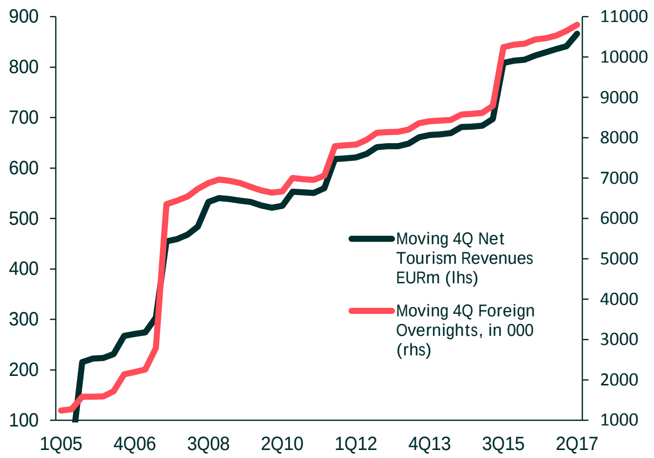
CPI by key contributions (pps)



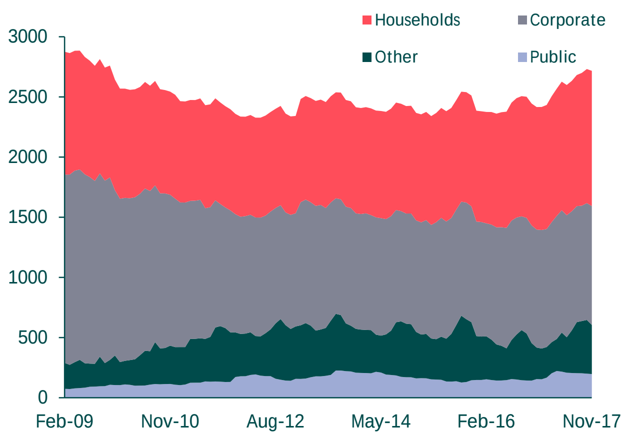
Merchandise import cover (%, 3mma)



Tourism



Gross loans by sector in EURm



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017F	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	5,1	5,8
GDP per capita (EUR)	5.261	5.114	5.415	5.564	5.875	6.355	6.790	7.245	7.662
GDP per capita (USD)	7.327	6.577	7.191	7.391	6.516	7.037	7.667	8.223	9.347
Real GDP (constant prices YoY, %)	3,2	-2,7	3,5	1,8	3,4	2,9	4,4	3,5	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, %)	-9,6	-2,4	10,7	-2,5	11,9	27,5	12,0	11,0	7,2
Industrial production (YoY, %)	-8,7	-6,2	10,7	-10,5	9,2	-3,3	-3,9	4,5	3,2
Unemployment rate (ILO, average %)	19,9	19,9	19,5	17,9	17,8	18,0	17,3	16,8	16,0
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	2,3	2,2
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	2,6	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	-5,2	-5,0	-3,5
Public debt	45,6	53,4	57,5	59,9	66,7	67,5	69,4	72,6	73,9
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	1,600	1,744	1,891	2,027
Import of goods and services (EURbn)	-2,082	-2,109	-2,066	-2,074	-2,214	-2,488	-2,693	-2,906	-3,084
Merchandise trade balance (EURbn)	-1,303	-1,384	-1,329	-1,376	-1,464	-1,657	-1,783	-1,928	-2,040
Merchandise trade balance (% of GDP)	-39,9	-43,5	-39,5	-39,8	-40,0	-41,9	-42,2	-42,8	-42,8
Tourism receipts (EURbn)	0,619	0,643	0,666	0,682	0,813	0,836	0,895	0,958	1,013
Current account balance (EURbn)	-0,573	-0,588	-0,487	-0,526	-0,483	-0,715	-0,701	-0,743	-0,762
Current account balance (% of GDP)	-17,6	-18,5	-14,5	-15,2	-13,2	-18,1	-16,6	-16,5	-16,0
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	11,3	11,6	11,9
FDI cover (%)	67,9	78,6	66,6	67,3	128,3	52,0	68,2	70,7	74,5
Gross international reserves (EURbn)	0,273	0,318	0,395	0,514	0,641	0,780	1,055	1,460	1,730
Import cover (months of imports)	1,6	1,8	2,3	3,0	3,5	3,8	4,7	6,0	6,7
Debt indicators									
Gross external debt (EURbn)	4,734	4,959	5,093	5,353	5,559	6,121	6,618	7,241	7,706
Government (EURbn)	1,460	1,295	1,352	1,646	2,061	2,187	2,351	2,520	2,646
Private (EURbn)	3,275	3,665	3,742	3,707	3,498	3,934	4,267	4,721	5,060
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	382,6	379,5	382,9	380,1
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,19	1,18	1,24
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,13	1,14	1,22
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	11,2	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	0,20
EURIBOR 3M interest rate (average, %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,15

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	2.810	2.808	2.959	3.136	3.472	3.790	4.417	4.897	5.303
Assets (%, YoY)	-4,5	-0,1	5,4	6,0	10,7	9,2	16,5	10,9	8,3
Assets (% of GDP)	86,1	88,3	88,0	90,7	95,0	95,9	104,5	108,6	111,2
Gross loans (EURm)	2.359	2.342	2.414	2.367	2.386	2.416	2.687	2.877	3.026
Gross loans (%, YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	11,2	7,1	5,2
Gross loans (% of GDP)	72,3	73,6	71,8	68,5	65,3	61,1	63,6	63,8	63,5
Deposits (EURm)	1.817	1.981	2.098	2.308	2.625	2.871	3.195	3.435	3.664
Deposits (%, YoY)	1,5	9,0	5,9	10,0	13,7	9,4	11,3	7,5	6,7
Deposits (% of GDP)	55,7	62,3	62,4	66,7	71,8	72,6	75,6	76,2	76,8
Loan-to-deposit ratio (%)	129,8	118,2	115,1	102,6	90,9	84,1	84,1	83,8	82,6
Capital adequacy ratio (%)	16,5	14,7	14,4	16,2	15,5	16,1	16,5	16,9	17,1
Performance									
Net interest income (EURm)	106	106	104	111	117	122	131	137	144
Net interest income (%, YoY)	-4,8	-0,1	-1,6	6,6	5,3	4,2	7,7	4,6	4,7
Total operating income (EURm)	221	178	156	158	171	175	197	209	220
Total operating income (%, YoY)	42,6	-19,5	-12,0	1,2	8,3	1,9	12,8	6,2	5,1
Pre-provision profit (EURm)	114	65	48	46	52	53	73	84	94
Pre-provision profit (%, YoY)	114,7	-43,2	-26,7	-2,6	11,5	2,6	37,4	14,8	12,8
Provision charges (EURm)	124	121	44	21	53	44	46	47	49
Profitability and efficiency									
Net interest margin (%)	3,7	3,8	3,6	3,6	3,5	3,4	3,2	3,0	2,8
Pre-tax ROAA (%)	-0,3	-2,0	0,1	0,8	-0,1	0,3	0,7	0,8	0,9
Pre-tax ROAE (%)	-3,2	-18,7	1,0	6,0	-0,4	2,0	5,4	7,0	8,7
Cost-to-income ratio (%)	48,2	63,5	69,6	70,7	69,8	69,6	63,0	60,0	57,1
Operating expense (% of assets)	3,7	4,0	3,8	3,7	3,6	3,3	3,0	2,7	2,5
Credit quality and provisioning									
NPL ratio (%)	15,5	17,6	18,4	16,8	12,6	10,3	6,9	6,1	5,8
NPL coverage (%)	33,0	40,0	39,1	39,5	39,5	41,3	42,8	48,9	52,1
Provision charges (% of loans)	5,1	5,1	1,9	0,9	2,2	1,8	1,8	1,7	1,7
Provision charges (% of PPP)	108,5	185,7	92,5	45,6	103,2	82,2	63,0	56,5	51,6

Source: CBCG, Addiko research

Credit growth in 2018 decelerating to 7.1%

Overall loan growth soared to 12.4% ytd in 11M17 after 1.3% in 2016, with the volatile 'other' loans (mostly financial institutions) as the main driver (+55.5% ytd). Retail loans also had a positive effect rising 10.4% ytd amid higher employment and wages, as did public loans (+27.0% ytd) driven by highway construction. Corporate lending rose only 0.7% ytd (vs. 3.0% yoy in 2016), albeit solely due to one-off working capital credit slump in July. That said, we adjusted our credit growth forecast for 2017 by 3.9pp to 11.2% given stronger-than-expected rise in 'other' loans. In 2018, we expect credit activity to slow down to around 7% due to high base of 'other' loans, slower growth in retail loans given public employment ban and senior staff wage cuts, and higher tax burden eating into disposable income. Given clearer bank balance sheets, we expect corporate credit to accelerate amid generally stronger private capex, notably in tourism and energy. NPL ratio continued its way down to 7.1% at end-October as banks resorted to selling their non-performing portfolios or transferring them to the factoring companies. We therefore downgrade our NPL ratio forecast to 6.9% at end-2017, followed by a decline towards 6.1% by end-2018.

Deposits rising on yet another record tourist season

On funding, deposit collection increased by 11.0% ytd in 11M17 with positive contribution coming from all sectors. Bearing in mind stellar tourist season and higher profits, corporate deposit collection soared 17% ytd. Household deposits rose 7.3% ytd given higher employment and wages as well as tourism earnings. Given better than expected deposit collection growth, we upgrade our forecast for 2017 by 4.4pp to 11.3%, while in 2018 we see deposit growth slowing down to 7,5% due to high base effect and abovementioned fiscal consolidation that will have a negative impact on retail deposits. L/D ratio increased slightly to 85.2% at end-November (vs 84.1% YE16) and we expect the ratio to stay on a similar level in 2018 given balanced growth of credit and deposits. Finally, pre-tax profit rose to EUR31m in 9M17 (+26.1% yoy) on 5.9% higher operating income and lower impairments. Looking ahead, we see further pre-tax growth in 2018 on rising operating income and stable provisioning and opex.

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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