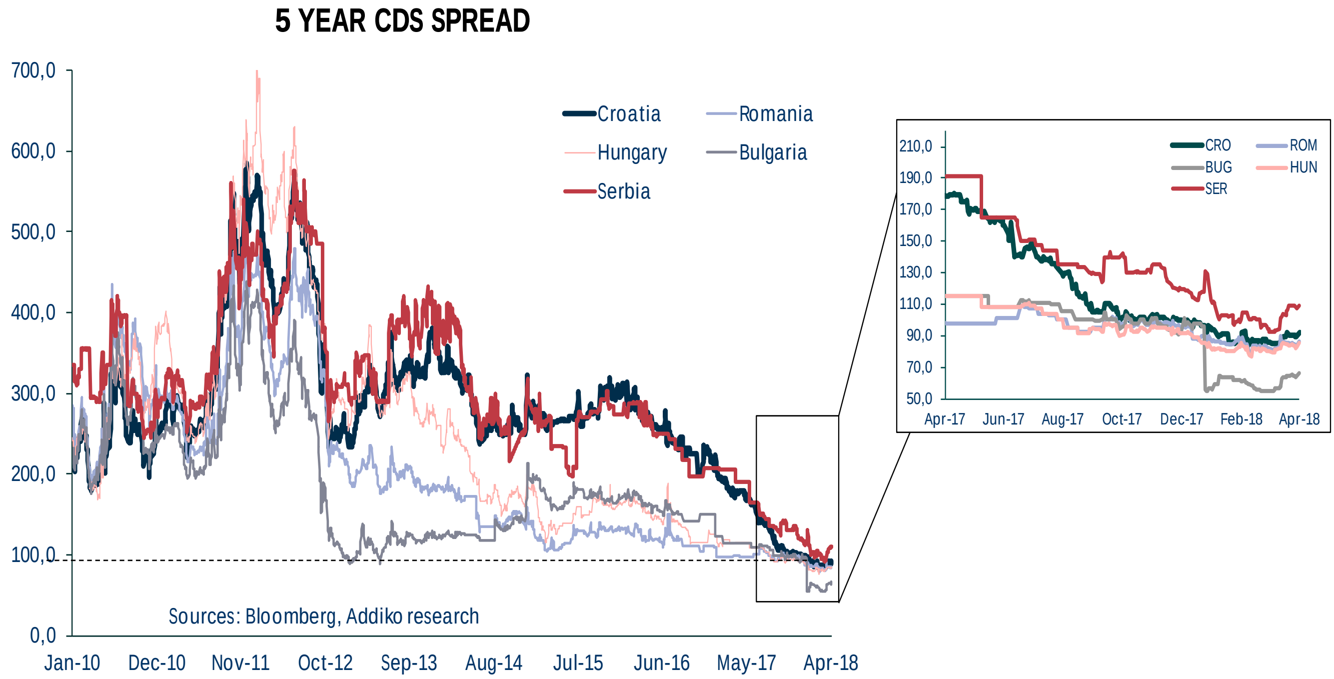
SEE Quarterly

Addiko Bank

10 April 2018

BRACE FOR FASTER GROWTH IN 1H18



EXECUTIVE SUMMARY

Bottom LINE: We keep GDP growth forecasts intact in all economies except for Slovenia, where we lifted 2018 growth forecast to 4.7% on stronger domestic and EU demand, investment acceleration and hefty carry-over. In Croatia we kept 3.0% growth forecast on robust external demand, another tourism record, fiscal easing, stronger consumption and investments. GDP growth in Serbia is set to accelerate to 3.5% driven by stronger domestic demand, exports and unwinding of supply shocks. Inflation will pick up moderately across the region driven by stronger consumer demand, except in Serbia, where inflation pressures will be subdued by the strong dinar, subdued food prices and base effects.

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:

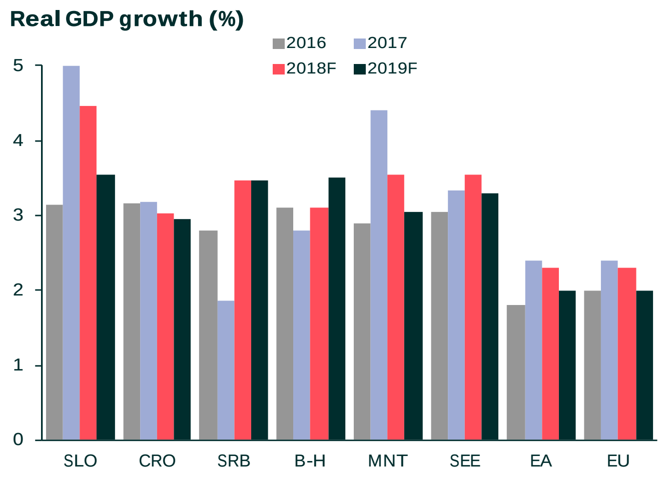
1. In Slovenia, we lifted our 2018 GDP growth forecast to 4.7% on hefty carry-over, above-potential growth in the euro zone, stronger consumption outlook and investment demand acceleration. In Croatia, we keep our above consensus 3.0% GDP growth forecast based on robust EU demand, strong consumption, better investment outlook, another record tourist season and fiscal easing. The growth also remains supported by lower cost of credit and stronger EU funding. In Serbia, we see above consensus 3.5% growth driven by stronger domestic demand, export market share gains, fiscal impulse and unwinding of negative (~2pp of GDP) one-offs from 2017 supply shocks. In Bosnia-Herzegovina, we keep 3.1% growth expectations, thanks to stronger private consumption, robust external demand and faster public capex execution. In Montenegro, we keep 3.5% growth forecast driven by tourism, highway construction and FDI in tourism and energy.

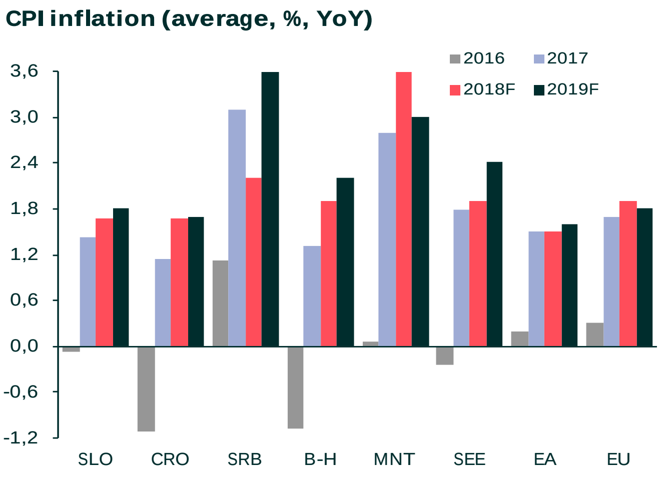
2. As for fiscal performance, in Slovenia we see a small budget surplus in 2018 as tax-rich demand growth, interest rates savings and BAMC will offset wage/transfer hikes, extraordinary pension indexation and higher EU-sponsored public capex. In Croatia, we expect the budget to return to balance on higher EU-sponsored capex, defence and entitlement spending, with potential risks hidden in healthcare overruns and Agrokor. Similarly, in Serbia we see a balanced budget in 2018 after a high surplus in 2017 amid stronger public capex, wages and pension hikes and higher non-taxable income threshold, as well as childcare support.

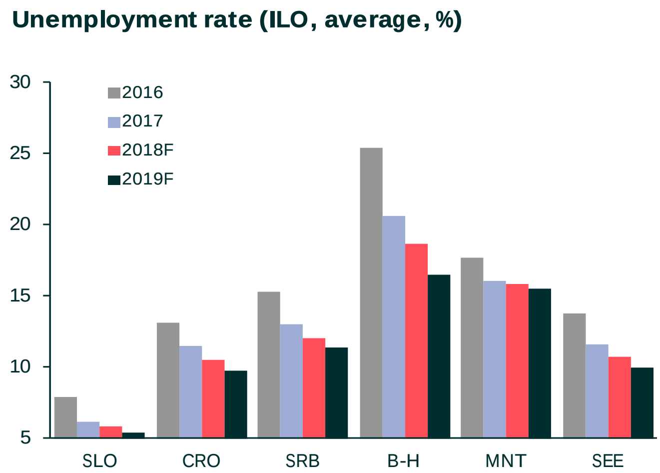
3. Looking to inflation, in Slovenia we see average 2018 CPI at 1.4%, picking-up slightly as robust consumer demand, higher wages and rising capacity utilization help underlying inflation to recover gradually and base effects and subdued imported energy prices from 1Q fade away. While Croatia will see higher 2018 inflation amid above-trend and broad-based recovery, tighter labour market and wage growth, the lower starting point in 1Q18 has required CPI forecast downgrade to 1.4%. In Serbia, we expect average CPI at 2.1% in 2018, balancing between base effects and strong dinar as downside forces, and resurgent domestic demand and generally higher commodity prices as upward-pulling factors.

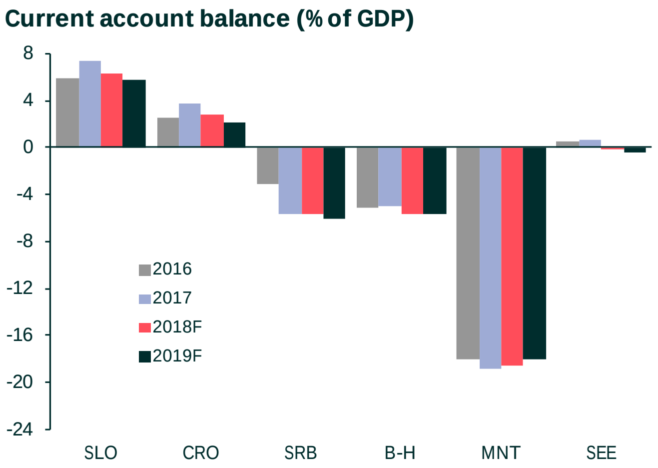
4. For Slovenia, strong macro and fiscal performance alongside additional interest spending cuts make Slovenian long-term yields attractive again. Positive risks for bond performance include further sovereign debt restructuring, revisiting the long overdue privatization projects and rating upgrades that would ensure faster public debt reduction closer to sub-50% single-'A' median. In Croatia, we expect short-end rates at record low amid CNB's hefty liquidity position and further easing, with still insufficient new disbursements growth. Assuming persistent and patient ECB policy, Fed gradualism and EM appetite, Croatian exposure entry could regain interest in the case of sustained macro/fiscal performance, more ambitious structural adjustment agenda given early euro adoption ambitions and, hence, investment grade status. In Serbia, we expect NBS easing to continue given persistent dinar strength, subdued inflation outlook and reduced fiscal risks. The impact of slow FED tightening cycle and ECB tapering on Serbian assets should not be strong given record low Serbian risk premium, a result of the ongoing macro/fiscal and external balances improvement, new IMF reform program, lower state gross funding needs, stable domestic politics and improved rating prospects.

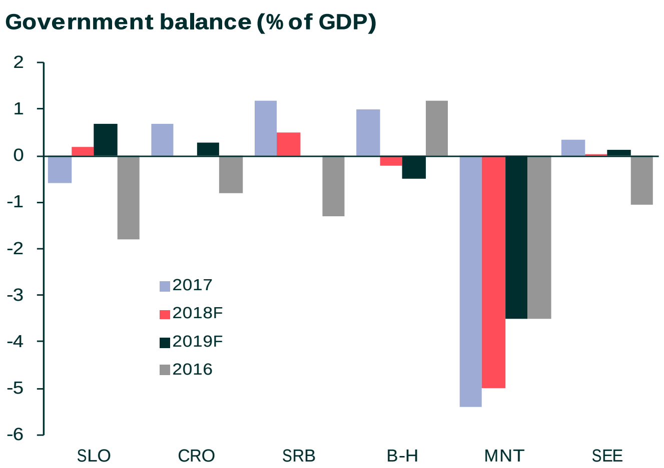
SEE data trends

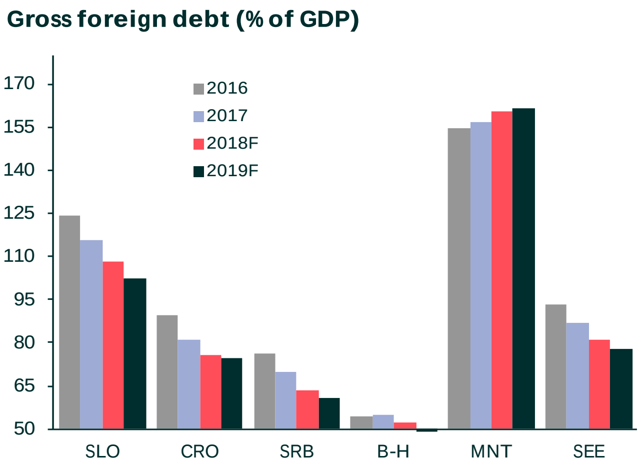








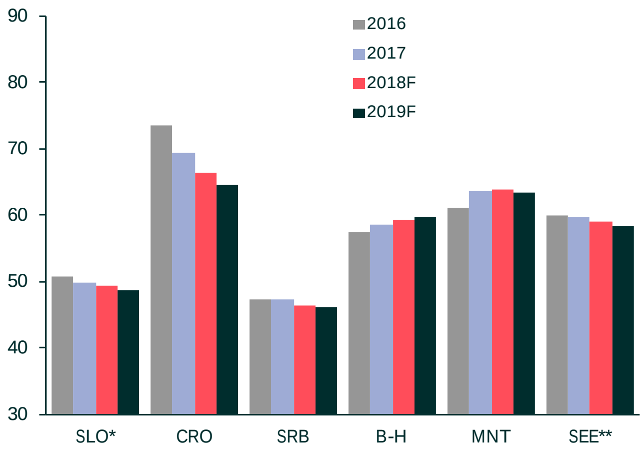




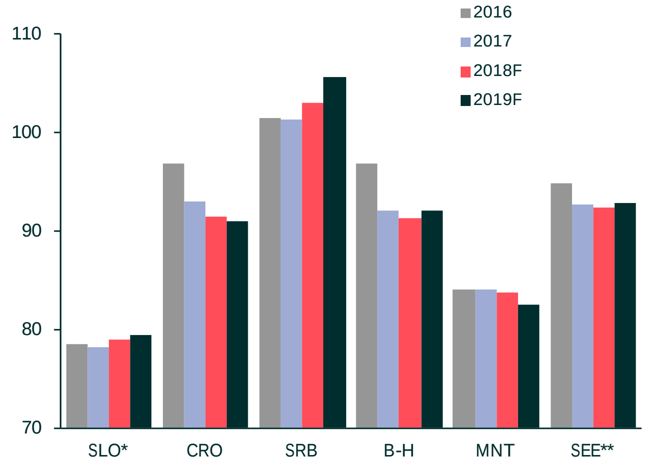
Source: National sources, Addiko research

SEE banking sector trends

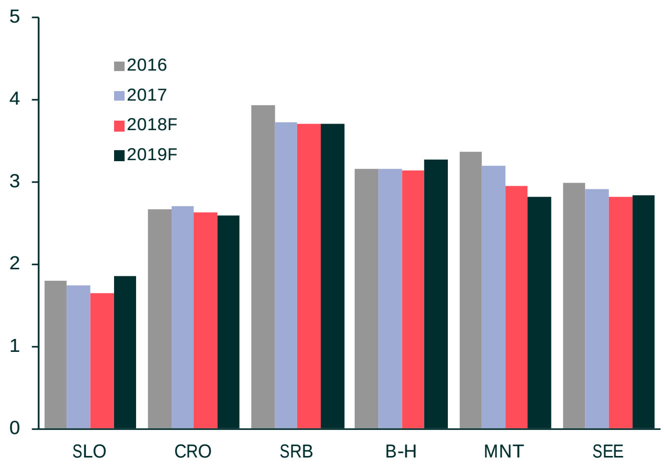
Gross loans (% of GDP)



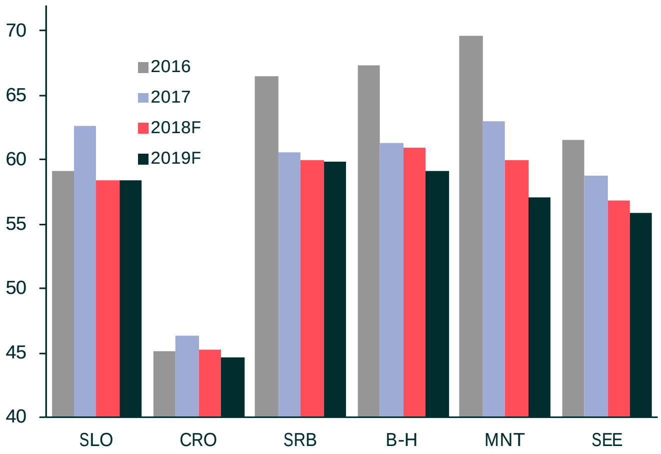
Loan-to-deposit ratio (%)



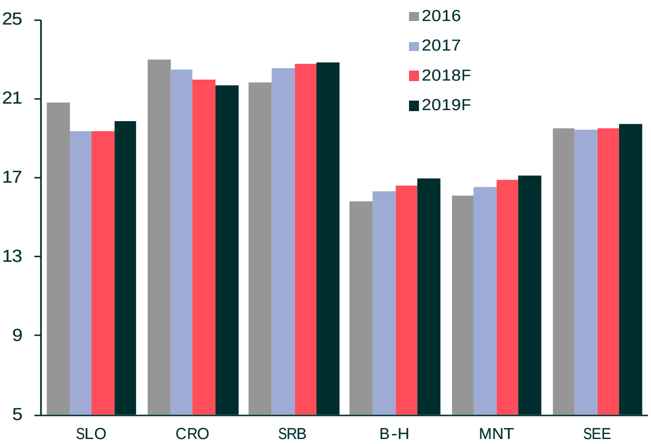
Net interest margin (%)



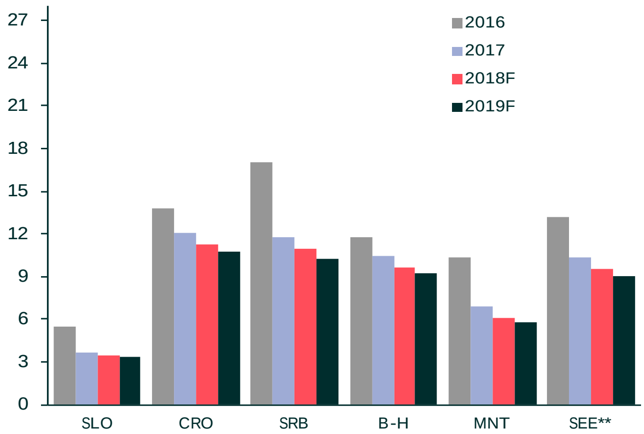
Cost-to-income ratio (%)



Capital adequacy ratio (%)



NPL ratio (%)



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

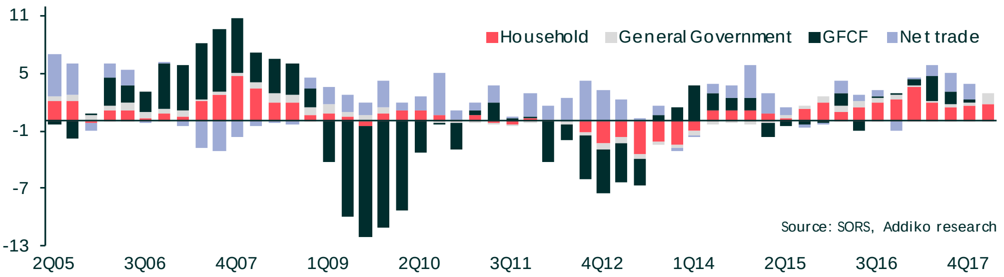
As Good As It Gets

Our above-consensus GDP call for 2018 reflects strong external as well as domestic demand, private sector re-leveraging and booming investment. While fiscal metrics improve further, another heterogeneous coalition government is unlikely to speed up reforms and privatization, both needed to sustain potential growth higher and ensure long-lasting public debt cuts. Both macro and fiscal overperformance over the euro zone peers, and further interest spending cuts in support of rating upgrades, alongside ongoing ECB (net) purchases make Slovenian long-term yields attractive again.

Growth has peaked, but remains above potential

The 4Q17 GDP (+2.0% qoq, +6.2% yoy seasonally adjusted) once again outdid expectations. Despite demand-driven imports acceleration, exports (+12.3% yoy) and industry (+10.5% yoy) are still the growth engines as the euro zone growth sweet spot persists, alongside low inflation and policy accommodation. Investment surged thanks to the evolving infrastructure and real estate boom (house price growth double the EU average), while equipment capex kept steady pace alongside robust exports. Private spending was led by record sentiment, a manifestation of improving labour market, income expectations, re-leveraging, cheaper credit and household market recovery. The FY17 GDP grew 5.0%, double than the last five year's average, lending support to our thesis that export capacity build-up has pushed potential growth rate higher. Our GDP model suggests the growth will continue at 1% qoq pace in 1H18 on stronger investment- and exports-led growth in the euro zone, domestic capex and private consumption.

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



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

We perked our 2018 GDP call to above-consensus 4.7% on the wings of hefty carry-over, strong above-potential growth in the euro zone, very easy financial conditions and, in turn, stronger local labour market and overall local demand. In particular, given the tighter labour market, strong firms' profits and, hence, faster real wage growth, re-leveraging, lower debt service and tourist spending - private consumption is set to accelerate at 4%-alike clip. We also expect business investment to accelerate in response to stronger companies' balance sheets, including EUR1bn higher retained profits for 2017, record capacity utilization, strong export outlook, improved take-up of EU funds and the continued strength of bank lending at longer maturities. Despite strong import-intensive domestic demand, robust exports secure positive net trade contribution in 2018, in line with our suspicion new export capacity has helped reprice potential growth higher perhaps around 3%. The risks to our forecasts are still skewed to the upside on stronger foreign demand, fiscal easing in this election cycle and soaring capex. While rising protectionism is a risk, we expect - at present - it won't imperil directly the euro zone since there are high chances of constructive trade negotiations between the US and China. The latter turning into full-blown global trade wars, faster ECB/Fed tightening, sustained financial market sell-off, sentiment-driven tightening in financial conditions, EU politics (Brexit/Italy) and the growing lack of labour at home are the main risks on the downside.

Inflation remains around low euro zone average

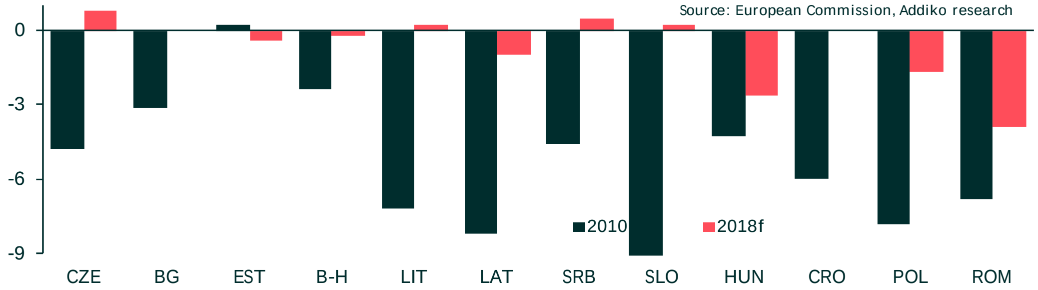
CPI bottomed in 1Q18 on large base effects from weather-inflicted food/utility prices as well as subdued imported energy prices. Looking ahead, we expect inflation to climb gradually due to stronger consumer demand, higher retailers' selling price intentions, improving labour market, rapidly absorbing slack in the face of strong economic growth. That said, upside risks stem from higher-than-expected wage growth, increasingly driven by public sector, as well as firms' profit margins, which in turn might become a key ingredient in their ability to sanction long-delayed capex programmes that might also allow them to make productivity gains. At the same time, downside risks mainly stem from the 'amazonization' of traditional retail trade channels. Marking the weak entry into 2018 to market, we lower 2018 inflation forecast to 1.4%, close to the euro zone's average and with neutral effect on competitiveness. As the euro zone inflation stays subdued, we do not expect the ECB to change its monetary stance significantly until a more sustained convergence to targeted inflation rate.

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

We see similar C/A surplus in 2018-2019 to that in 2017 as robust export growth and EU transfers counterbalance stronger import-intensive domestic demand and the global commodity price stabilization. While the net external debt dropped to about 22% of GDP (down from a peak of 46% in 2103) is still almost two times higher than the A-rated median, the ongoing hefty CA/ surplus support further decline in external liabilities. Lower indebtedness together with ample banks' liquidity likewise supports further improvement in the net international investment position towards -25% of GDP and lower in the next years.

Given sizable C/A surplus and the recent sovereign debt restructuring activities, including a EUR0.5bn in new issuance, funding position remains on very strong footing, with the average debt duration also materially extended. With 2018 funding needs already met, we expect Slovenia's proactive debt management to result in further (re)financing activities later this year as long as the ECB does not deviate significantly from persistent dovishness. FDIs remain scarce with the authorities reluctant in letting foreign investors buy controlling stakes in 'strategic' companies especially during election cycles. Changing the approach to 'strategic asset criteria, including the final solution for NLB bank after June elections, incentives for bank consolidation and more far-reaching product market reforms are of utmost importance to boost FDI flows still so far below the euro zone's average of 5.5% of GDP.

Slovenia: fiscal deficits (% of GDP)



Fiscal consolidation exhibits a marked improvement

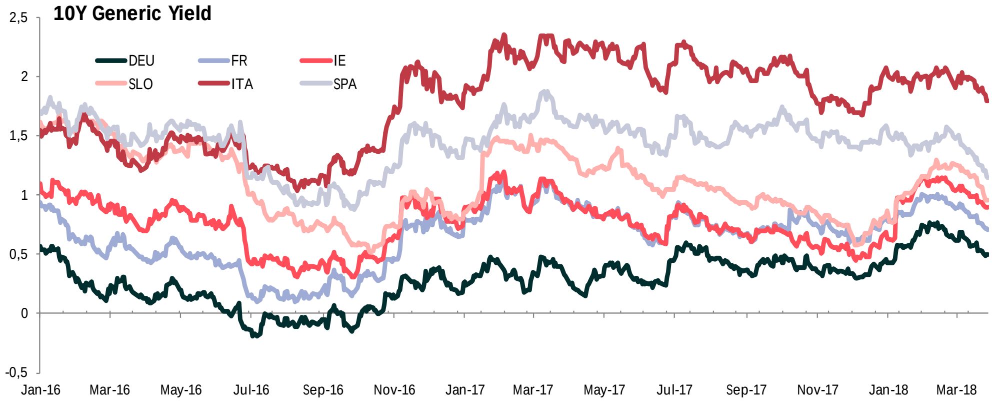
The FY17 budget gap fell to -0.6% of GDP on the back of higher tax revenue (+7.0% yoy), sharply lower interest bill, higher SOE dividends and positive impact from BAMC, despite public wage, pensions and social transfer hikes. In 2018, we see a small budget surplus as the ever stronger tax-rich demand growth (tax revenue projected 6% higher), interest rate savings and BAMC positive effect offset wage/transfer hikes, extraordinary pension indexation and higher EU-sponsored public capex. Negative risks include even stronger capex ahead of elections, higher entitlement spending and lower dividend income. The latter is due to delayed NLB privatization, as the EC might request a freeze on dividend payouts due to ongoing negotiations. While the persistent economic upswing has raised spending appetite of various interest group and spending reforms the major taboo topic during the election cycle, the risks of excessive spending are to some extent contained as PM Cerar's resignation left technical cabinet in place. In the absence of reforms, Slovenia still needs to deal with about 1.5%/GDP structural budget deficit, which leaves the EC keen on 0.5pp and 1pp structural effort in 2018 and 2019, respectively. Another hung parliament, with anti-establishment party temporarily leading the polls, may just add to the complacency on policy front, with the property valuation act making it easier to implement real estate tax by 2020 rather than curtail entitlement (healthcare/pension) spending.

… but public and interest costs stay on a firm downward trend

After the last year's decline below 75% of GDP on strong nominal GDP growth and strong deficit cuts, we expect public debt to fall towards 67% of GDP in 2019 on further GDP growth surprises, attained budget surplus, record low interest bill and hefty fiscal reserve (~8% of GDP) rundown. Namely, as mentioned above, further pre-funding operations for 2019 will be likely combined by remaining USD bond buybacks (and lengthening of the euro curve), which will result in interest spending slump below 4% of general budget revenues from 5% in 2017 and 7.3% in a peak year 2014. This effectively puts public debt net of liquid assets below 60% of GDP and on a declining path through 2019 and thereafter. Importantly, pro-active debt management has not just ameliorated vulnerability to a theoretical interest rate shock, but also brought about a notable reduction in the sovereign debt-banks nexus. Public debt reduction could be faster in the medium term in the event of reinvigorated privatizations (NLB, Telekom Slovenije) and more active sale and stronger recovery in BAMC assets (at the assumed EUR300m p.a. pace) and hopefully broader reform content in further fiscal consolidation. Further bank business model and SOEs' restructuring are equally crucial to anchor the risks in public finance in the medium term.

Risk aversion and inflation undershooting lower yields…

After a roller-coaster performance on robust US data and global trade tensions, the Bund rally of recent weeks on EMU-integration hopes and scarcity spreading beyond Bunds helped Slovenian yields to stabilize as well. Stronger-than-expected macro/fiscal performance, further sovereign debt re-profiling with cheaper and longer Eurobonds as well as Fitch rating affirmation have only supported sentiment. Despite more favourable next months' EGB supply (relative to Q1), US macro factors (inflation!) and monetary policy concerns may again fuel speculation of stronger Fed tightening, which has seen 10Y Bund yields struggling at the 0.50% level despite weak core inflation in the euro zone. Moreover, while EMU peripheral spreads have been resilient during recent risk-off episodes, the multi-year lows against the Bund now limit the scope to decouple, leaving Slovenian longer duration more vulnerable to 10Y UST and Bunds sell-off.

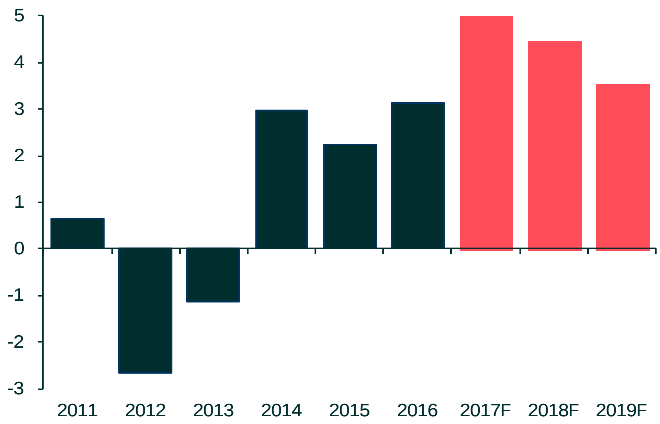


… as ECB is eyeing monetary normalization

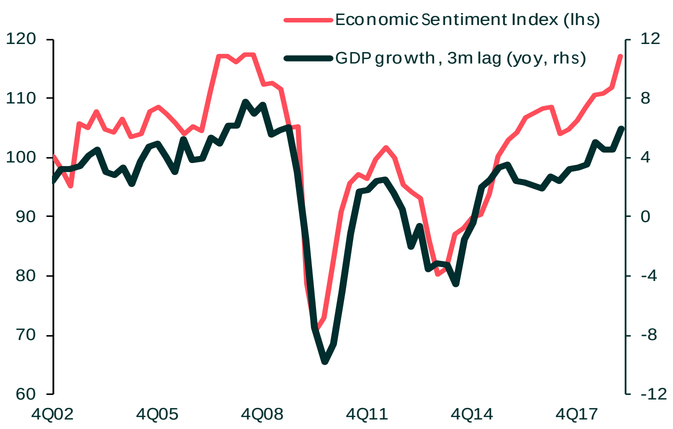
While firm confidence in economic growth and reduced variance in the future inflation path allowed the ECB to drop dovish bias on QE program, we think the strong euro and inflation undershooting still complicate the ECB exit strategy. This suggests net asset purchases continue at least until end-2018, next forwards guidance update in June (or later) and sequencing of no rate hike until 'well past' the end of net asset purchases - i.e. around mid-2019 rather than in early 2019 (according to market pricing). With Slovenian yield repricing from rich valuations completed, ongoing ECB (net) purchases, stronger Slovenian growth potential, further interest spending cuts and firmer rating outlook, we find Slovenian long-end spreads attractive again. That said, in the event of more outspoken Fed/ECB tightening and/or intensified (Italian) political risks, Slovenian yields may though underperform again in about 30bp spread widening from current levels. Worth looking after mid-2018 elections are Slovenian entitlement reform and privatization prospects to pave the way for long-lasting public debt reduction and spending overheating. Slovenia can also use every opportunity for pre-funding for 2019 without material pressures on rates given the fully funded 2018 and strong cash reserve. That said, positive risks for bond performance include further sovereign debt financial restructuring, revisiting the long overdue privatization projects (NLB, Telekom Slovenije) and rating upgrades that would ensure faster public debt reduction closer to sub-50% single-'A' median. In the medium term, we see Slovenian bonds outperforming on superior macro/fiscal performance and stronger sovereign's perception as a semi-core story.

Slovenia's data trends

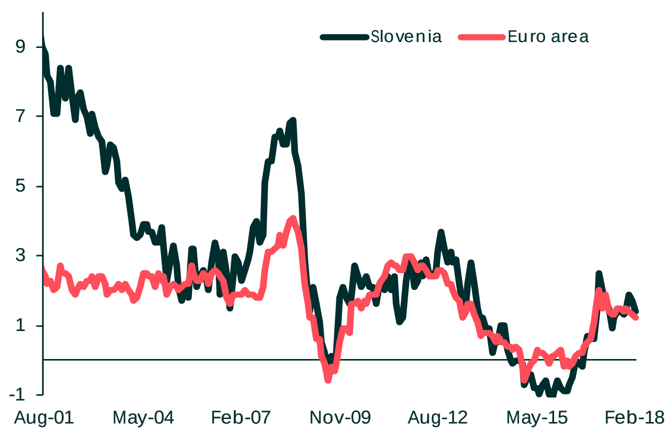
Real GDP growth (% YoY)



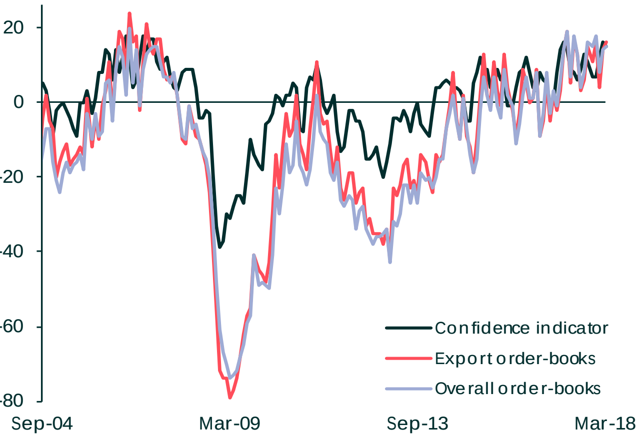
Economic confidence vs. GDP growth



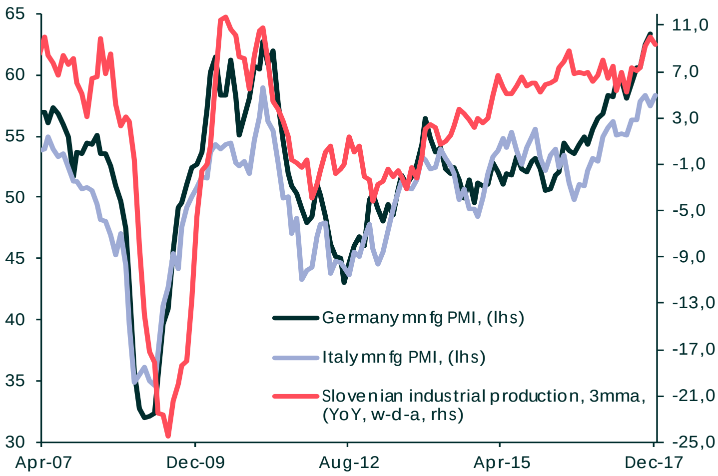
CPI inflation dynamics (% YoY)



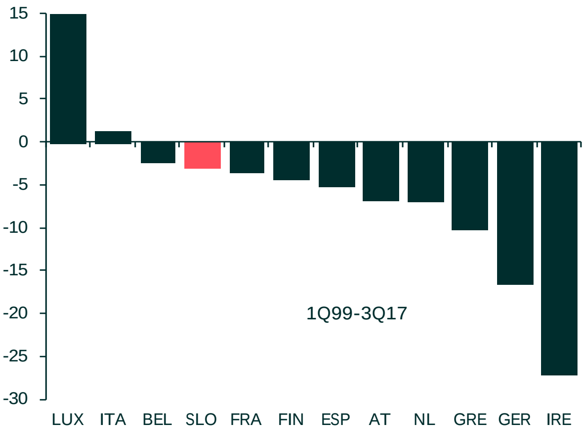
Business sentiment in manufacturing



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	43,3	46,0	48,5
Nominal GDP (USDbn)	51,4	46,4	48,1	50,0	43,1	44,8	48,9	55,0	60,1
GDP per capita (EUR)	17.971,9	17.538,2	17.591,8	18.250,0	617.689,3	19.580,6	20.948,8	22.274,7	23.461,0
GDP per capita (USD)	25.027,7	22.554,1	23.363,7	24.245,2	685.084,4	21.683,3	23.653,3	26.611,7	29.091,7
Real GDP (constant prices YoY, %)	0,6	-2,7	-1,1	3,0	2,3	3,1	5,0	4,7	3,6
Private consumption (YoY, %)	0,0	-2,4	-4,2	1,9	2,1	4,3	3,2	3,9	3,0
Fixed investment (YoY, %)	-4,9	-8,8	3,2	1,1	-1,6	-3,6	10,3	8,6	7,4
Industrial production (YoY, %)	1,3	-0,8	-0,9	1,7	5,1	7,8	8,5	10,4	6,2
Unemployment rate (ILO, average %)	8,2	8,9	10,1	9,7	9,0	8,0	6,8	6,3	5,7
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	3,3	3,0
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,7	-4,1	-15,1	-5,4	-2,9	-1,8	-0,8	0,2	0,7
Public debt	46,6	53,9	71,0	80,3	82,6	78,5	74,2	70,0	66,8
Gross public funding needs	10,5	8,2	19,3	14,5	6,4	9,6	6,8	5,2	4,9
External balance									
Export of goods and services (EURbn)	25,948	26,363	27,010	28,520	29,905	31,401	35,596	38,551	41,311
Import of goods and services (EURbn)	25,516	24,934	24,569	25,641	26,569	27,690	31,406	34,232	36,977
Merchandise trade balance (EURbn)	-0,974	-0,081	0,708	1,181	1,476	1,537	1,626	1,769	1,764
Merchandise trade balance (% of GDP)	-2,6	-0,2	2,0	3,1	3,8	3,8	3,8	3,8	3,6
Tourism receipts (EURbn)	1,975	2,008	2,043	2,060	2,098	2,190	2,386	2,526	2,646
Current account balance (EURbn)	0,068	0,775	1,594	2,179	1,698	2,108	2,813	3,083	3,104
Current account balance (% of GDP)	0,2	2,1	4,4	5,8	4,4	5,2	6,5	6,7	6,4
Net FDI (EURbn)	0,6	0,5	0,0	0,6	1,3	0,9	0,5	0,9	1,2
FDI (% of GDP)	1,7	1,3	0,1	1,6	3,3	2,2	1,2	1,9	2,5
FDI cover (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0,767	0,722	0,669	0,837	0,760	0,700	0,800	0,800	0,800
Import cover (months of imports)	0,4	0,3	0,3	0,4	0,3	0,3	0,3	0,3	0,3
Debt indicators									
Gross external debt (EURbn)	41,669	42,872	41,658	46,314	46,627	44,805	43,456	43,306	43,106
Government (EURbn)	8,748	11,092	15,459	22,416	24,824	22,953	21,773	22,223	23,473
Private (EURbn)	28,534	25,709	23,457	21,815	19,587	18,395	18,033	17,583	16,133
Gross external debt (% of GDP)	112,9	118,8	115,0	123,1	120,1	110,9	100,4	94,1	88,9
Gross external debt (% of exports)	160,6	162,6	154,2	162,4	155,9	142,7	122,1	112,3	104,3
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,19	1,22	1,26
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,13	1,19	1,24
Money supply M1 (% YoY)*	1,5	4,4	0,1	18,5	24,9	17,1	16,0	14,5	12,2
Broad money M3 (% YoY)*	3,5	-1,4	-1,3	6,1	4,6	7,1	7,8	5,1	3,9
Domestic credit (% YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,8	5,4	4,2
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	-0,10
SLO 5Y yield (average %)	3,96	4,55	4,35	2,14	0,84	0,20	-0,12	0,10	0,40
SLO 10Y yield (average %)	4,98	6,01	5,87	3,28	1,67	0,82	1,12	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	2017	2018F	2019F
Balance sheet									
Assets (EURm)	48.748	46.125	40.344	38.714	37.383	37.050	37.948	38.839	39.439
Assets (%, YoY)	-3,1	-5,4	-12,5	-4,0	-3,4	-0,9	2,4	2,3	1,5
Assets (% of GDP)	138,7	121,5	111,6	106,8	101,3	102,7	98,8	95,3	91,9
Net loans (EURm)	32.875	30.964	24.338	21.540	20.275	20.534	21.521	22.680	23.638
Net loans (%, YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,8	5,4	4,2
Net loans (% of GDP)	93,5	81,6	67,3	59,4	55,0	56,9	56,1	55,7	55,1
Deposits (EURm)	24.170	23.856	22.550	24.426	25.140	26.133	27.528	28.717	29.762
Deposits (%, YoY)	2,8	-1,3	-5,5	8,3	2,9	3,9	5,3	4,3	3,6
Deposits (% of GDP)	68,8	62,9	62,4	67,4	68,1	72,4	71,7	70,5	69,3
Loan-to-deposit ratio (%)	136,0	129,8	107,9	88,2	80,6	78,6	78,2	79,0	79,4
Capital adequacy ratio (%)	11,6	11,9	14,0	19,2	20,8	20,8	19,4	19,0	19,4
Performance									
Net interest income (EURm)	1.018	886	708	832	746	670	651	684	694
Net interest income (%, YoY)	-2,0	-12,9	-20,1	17,5	-10,4	-10,2	-2,8	5,0	1,5
Total operating income (EURm)	1.447	1.566	1.091	1.231	1.158	1.127	1.075	1.148	1.164
Total operating income (%, YoY)	-1,9	8,2	-30,3	12,8	-6,0	-2,6	-4,6	6,8	1,4
Pre-provision profit (EURm)	670	823	370	544	472	460	401	478	484
Pre-provision profit (%, YoY)	-5,4	22,8	-55,0	47,0	-13,3	-2,5	-12,8	19,1	1,2
Provision charges (EURm)	1.207	1.599	3.809	650	313	96	-40	15	23
Profitability and efficiency									
Net interest margin (%)	2,1	1,9	1,6	2,1	2,0	1,8	1,7	1,7	1,9
Pre-tax ROAA (%)	-1,1	-1,6	-8,0	-0,3	0,4	1,0	1,2	1,2	1,2
Pre-tax ROAE (%)	-13,3	-20,3	-92,9	-2,7	3,7	8,1	9,5	9,6	9,2
Cost-to-income ratio (%)	53,7	47,4	66,1	55,8	59,3	59,2	62,7	58,4	58,4
Operating expense (% of assets)	1,6	1,6	1,7	1,7	1,8	1,8	1,8	1,7	1,7
Credit quality and provisioning									
NPL ratio (%)	11,2	14,4	13,4	11,9	9,9	5,5	3,7	3,5	3,3
NPL coverage (%)	37,8	42,7	56,8	60,8	65,0	65,2	66,8	67,0	67,5
Provision charges (% of loans)	2,4	3,4	8,8	1,6	0,8	0,3	-0,1	0,0	0,1
Provision charges (% of PPP)	180,1	194,3	1.029,2	119,5	66,4	20,9	-10,0	3,2	4,9

Source: BSI, Addiko research

Retail sector drives credit activity

Credit growth accelerated in 2017 4.8% yoy due to private sector re-leveraging. The strongest contribution came from retail loans which increased 6.8% yoy, as overall economic situation and improved labour market resulted with record-high optimism and increased spending propensity, leading to strong consumer loans growth (12.5% yoy). Following the revival of real estate market, loans for house purchases also increased at a nice pace (4.5% yoy). Corporate sector loans rose 2.2%, finally regaining a growth momentum after a long deleveraging series. On the other hand, loans to public sector decreased mostly as a result of successful debt restructuring. Deposits increased 5.3% yoy despite low interest rates environment. Again, household deposits contributed the most, growing 5.6% yoy due to rising employment and wages, reinforced by traditionally high saving propensity. Corporate deposits grew 10.6% yoy, in line with current economic upswing and higher firms' revenues. Regarding profits, NII decreased by 2.8% as strong decline of funding costs did not manage to compensate for lower interest income. Nonetheless, the banking sector earned EUR 441m pre-tax profit (+21.3% yoy) owing to lower impairments (i.e. release of provisions) and stagnating opex.

Economic outlook supports credit acceleration

In 2018 we expect credit growth continuing at 5.4% rate, with private sector again as the main driver. Strong investment outlook and export activities bode well for corporate loan demand, despite significant size of available own funds, while retail loans growth should continue on the back of improved employment conditions and disposable income growth, supported by high sentiment indicators and still relatively low indebtedness. With NPL ratio reaching low 3.7% level at year end, we expect limited further decline towards 3.5% owing to SME NPL resolution efforts, while new lending cycle could increase pressures on credit quality in the medium term. Deposit collection should decelerate to 4.3% amid high-base effect, persistently low interest rates and stronger capex needs. We see slightly higher level of NII as the effect of expected volume increase should overcome the lower interest rates. Although increased credit activity could result in new provisioning costs, we expect somewhat better 2018 pre-tax profit level compared to previous year.

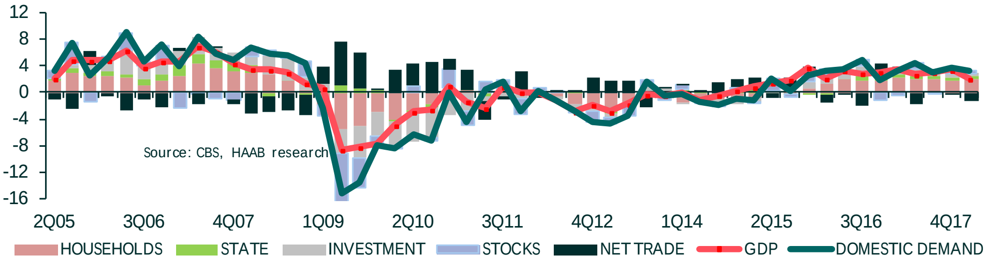
Betting on Investment Grade in 2019

We maintain 3.0% GDP growth forecast for 2018 on strong external demand, another tourism record, steady consumption, accelerated absorption of EU funds and investments as well as fiscal impulse. The key signposts for sustained macro/fiscal performance, competitiveness and investment grade status are further tax and red tape cuts, labour, entitlement and education reforms as well as orderly Agrokor restructuring. This alongside persistent and patient ECB policy, Fed gradualism and EM appetite offers re-entry opportunity in Croatian exposure.

No grounds for scepticism on growth...

The growth slowed in 4Q17 amid EU-funded and Agrokor and intertwined firms' capex under-execution, agriculture output slump, high industry base effect and some impact of quasi-transit adjustment on export, which alongside soaring import-intensive demand saw a 1.2pp negative net trade contribution. Reassuringly, household consumption even exceeded expectations due to faster wage and employment growth, lower saving rate and re-leveraging, despite postponed car sales in 4Q17 for tax reasons. This brought FY17 growth to 2.8%, down slightly from 3.2% in 2016. After a poor Q4, high-frequency data and sentiment gauges suggest broadly-based Q1 GDP growth re-acceleration to 3% yoy including manufacturing activity. Stronger external and local consumer demand, alongside milder winter, are largely behind ~50% higher industrial confidence in 1Q18 on 4Q17 average. Private spending is driven by soaring car sales, recycling of the record tourist receipts, strong labour market and early Easter effect on tourism.

Croatia: contributions to GDP (in pps)



Stronger potential growth needed to shield against future shocks

For 2018, we keep above-consensus 3.0% GDP growth call thanks to: (i) robust EU demand and Croatian exports (ii) strong consumption, (iii) better capex outlook and (iv) some space for fiscal easing after years of strong consolidation. On top of the record tourist season, private consumption is driven by new HRK1.1bn tax cuts, faster wage growth, higher pensions, job creation and remittances. Stronger investment outlook (and similar contribution to growth to that of consumers by 2019) reflects rising firms' profits, cheap credit and soaring EU funding (2-2.5% of GDP) in support of re-leveraging, almost EUR1bn tourism capex and exporters' ample replacement capex. With higher NPL sales (+40.5% in 2017) also in 2018, monetary transmission can be improved. With the cabinet barely halfway through its 4Y term, Agrokor settlement in Q2 in sight and political infighting behind, we expect hitherto quick wins on the fiscal side to give leverage to reforms. The key signpost for business climate and sustained 3% growth are HRK2bn tax cuts in 2019, HRK626m red tape cuts in 2018, labour, entitlement and education reforms, and further rating upgrades. That said, faster euro rates re-pricing, disorderly Agrokor restructuring, labour shortages, corporate de-leveraging and stricter retail credit regulation are the main risks to the downside. As ever, upside risks stem from external demand, another unthinkable tourism record, EU funding and FDI, plus fiscal expansion on soaring public capex (eg. Peljesac bridge, LNG terminal).

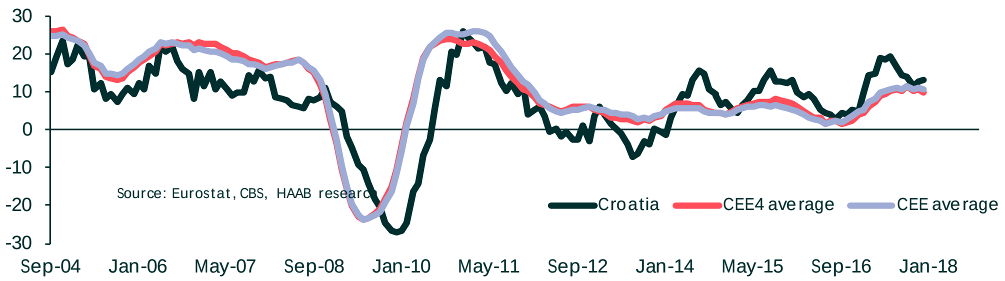
Inflation still weak, for now

Inflation has surprised on the downside on lower food prices on international markets and lower energy inflation, but the Q1 had nevertheless marked the trough (1% yoy), and we see a roughly 1pp increase from here by mid-year. Notwithstanding price wars for Agrokor's retail space and depressing effect of the rise of e-commerce on goods prices and stronger kuna, price pressures will intensify, in our view. That said, CPI inflation will increasingly reflect imported frictions from above-trend and broad-based EU recovery, and domestic demand pull factors since tighter labour markets typically go hand in hand with strong wage growth. Even so, the lower starting point has prompted a downward revision to 2018 average CPI forecast to 1.4%, slightly higher compared to 1.1% in 2017 and with little impact on otherwise strengthening citizens' purchasing power. If any, upside risks stem from imported upstream pressures, but these are comfortably balanced by subdued global energy price outlook.

External position continues to improve on de-leveraging and persistent C/A surpluses

While the euro zone PMIs are likely to fall further, they still signal respectable recovery ahead, which points to high single-digit growth in Croatian goods exports in 2018. Steady EU demand, deeper integration into global value chains and both price and non-price competitiveness gains (resilient to rising labour costs) bode well for Croatian exports' overperformance in 2018-2019 albeit from lower base than CESSEE peers. Nevertheless, strong consumer demand, private capex, private credit recovery and higher commodity prices lead to stronger imports as well as 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 around 3% of GDP. Foreign debt slump owing to record firms' profits used to reduce debt and Agrokor write-offs, record banks' net foreign assets, and higher portfolio/FDI flows lead to improvement in net international investment position towards -55% of GDP in 2018 from -71% in 2016.

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



CNB easing alongside macroprudential tools...

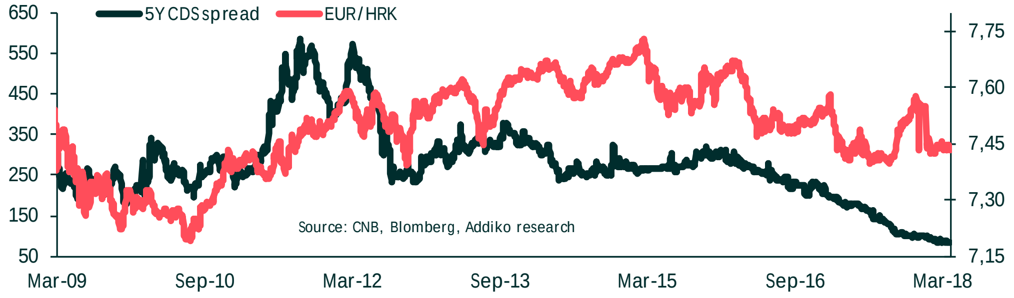
While the ECB sets the scene for gradual policy normalization, we expect the CNB to keep easing bias via record high kuna liquidity provision almost 8% of GDP. It is accompanied by expanded REPO (size and/or maturity) capacity in the CNB's best trying to anchor liquidity costs for banks and flatten the kuna yield curve as it bottoms out. While mandatory reserve rate cuts also fit into early EMU entry agenda, the CNB is well aware of decreasing effectiveness of any liquidity bulge if not meeting real demand. We thus expect the CNB to link liquidity management closer to the assessment of corporate (investment) demand since housing loan market will succumb to tighter and still uncertain regulation. With citizens' sensitivity to floating interest rate volatility in the next years, CNB asking banks to offer fixed-rate loans and pent-up demand for kuna credit, we think stronger fixed-rate kuna lending depends on ample long-term kuna liquidity via long-term FX swaps, longer REPO or even FX interest rate swaps. Thankfully, ECB rate hikes are not expected by mid-2019, and the CNB's collateral pooling leaves a lot of policy flexibility if needed, both consistent with our long-held view of patient and persistent monetary policy in the euro area and low rates for longer. From a risk perspective, strongly improved private-sector external balances, steady FX outlook and ongoing fiscal healing allow the CNB easing. However, the banking system needs unambiguous criteria for automatic NPL resolution, specific tax treatment, broad platform for SME capital hikes, incentives for asset management firms and stronger insolvency framework in a bid to slash cost of risk and improve transmission.

Kuna strengthening to persist

Appreciation pressures on the kuna in Q1 are no longer a surprise, being justified by re-cycling of record tourist receipts, positive trends in the goods import cover, stronger-than-expected C/A surplus and sovereign rating upgrades. Also, with excessive FC liquidity another 5% of GDP, hefty FC reserves build up last year and lower external debt service needs, the CNB is less inclined to lean against the market forces. Short-end kuna rates hit record lows amid record-high interbank liquidity at HRK28bn (+HRK5bn ytd, almost double over 2017 average), monetary easing and steady kuna outlook. Despite volatility in the global markets, monetary uncertainty and escalation in trade-war rhetoric, EM credit spreads have refused to firm up sharply thanks to the Fed policy gradualism and unexpectedly low EM bonds supply. Croatian bonds outperformed CESEE peers thanks to impressive fiscal results for 2017, two rating upgrades in 1Q18, cheaper (quasi)sovereign (re)financing and ample local liquidity, which has limited sensitivity to benchmark jitters and political infighting over Agrokor and other issues.

We see further strength in the kuna since the large EUR1.8bn FX-linked financial restructuring of state road firms' debt requires banks to adjust FX positions downward, early Easter gives a boost to FC tourism inflows, and Agrokor uncertainty is out of the way. Appreciation pressures are partly offset by seasonal dividend outflows (EUR330m announced so far) and banks' structural bid due to substantial FX-linked loan backflow (above new kuna disbursement). We expect real flows including record tourist FC inflows, strong goods exports, absorption of EU funding, workers' remittances, net Eurobond issue in 2Q18 (in our view), and hence further improvement in external position to underpin appreciation pressures going forth. With the kuna traditionally showing little sensitivity to regional FX-risk-off episodes, we see the EUR/HRK inside 7.25-7.45 in Q2-Q3 before stabilizing at 7.40-7.45 thereafter.

Croatia: 5Y CDS spreads and EUR/HRK



Near-term pullback in Croatian spreads offers a re-entry opportunity

Given the CNB's hefty liquidity provision and further easing, still gradual bank lending recovery and firm kuna, we see short-end rates record low. Despite pent-up demand for kuna loans, new disbursement overall is insufficient to have a material impact on MM rates. With domestic debt supply picking up in Q2 after Q1 standstill, potentially bigger euro debt issuance, volatile global environment on tariff concerns, moderating EM inflows and the lack of EM conviction, Croatian spreads should widen somewhat. Given, however, China's willingness to negotiate with the US, the risk of escalation to an all-out trade war is not high, and the major risk aversion can be avoided. Moreover, we stay positive on Croatian credit on further public debt reduction and much better external metrics, ~8pp/GDP lower funding needs in 2018-2019, smooth Agrokor restructuring, stronger reform agenda and structural adjustment appetite under ambitious ERM II and OECD prospects and investment grade rating prospects for 2019. Given all above-mentioned, persistent and patient ECB policy framework, Fed gradualism and ensuing EM resilience, we think the near-term pullback offers a re-entry opportunity, especially in the event of trade war threats de-escalation. The key central banks' policy normalization will eventually lead to the yield curve steepening. The major risks to our benign baseline stem from further escalation in the global trade and political tensions, US curve inversion and what it means for global growth assets, and further rise in US real yields.

Fiscal overperformance continues

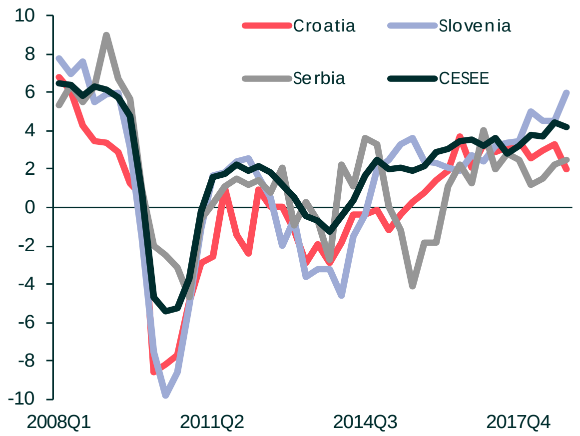
Fiscal accounts surprised again with the first ever consolidated budget surplus above 0.5% of GDP, thanks to cyclically higher tax revenues, positive impact from tax reform, lower interest bill upon financial restructuring (incl. bank loan swaps with bonds) and capex under-execution. These spending cuts nevertheless mask the fact that the composition of non-interest expenditure has deteriorated given relaxed spending constraints on public wages and transfers. While fiscal consolidation in 2018 (primary surplus above 2% of GDP) will again receive support from tax-rich domestic demand and new interest spending cuts, we expect the budget to return to balance since a temporary tax overshooting has given a boost to hard-to-reverse entitlement spending at a time when (partly EU-sponsored) capex and defence outlays are expected to grow on a continuous basis. Hence, 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. Frontloading of fiscal consolidation has left the window opened for a new HRK2bn round of tax cuts in 2019, whereby direct tax (unlike VAT) cuts would better support competitiveness. It would be also prudent to align tax cuts to non-discretionary spending rationing. In our base scenario, with stronger nominal GDP growth and lower interest bill and consolidation of agencies' sovereign debt positions, we see public debt down to 70% of GDP in 2019. This not only puts it at the level of one-notch higher rated Hungary, but one big difference is that Croatian mandatory and fully funded pension funds hold almost 20% of public debt, unlike in Hungary.

...but stronger reform momentum is needed to sustain structural adjustment

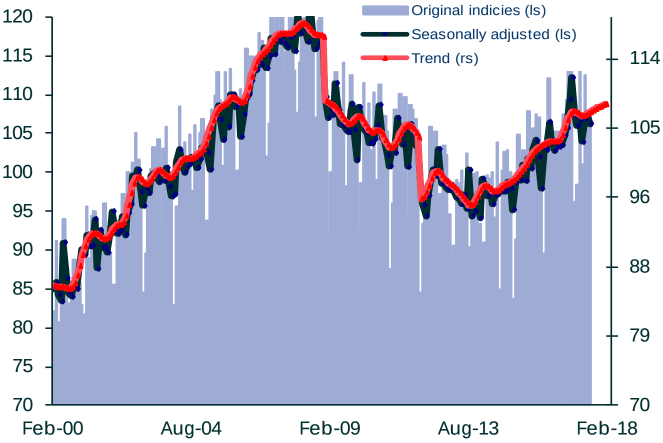
The focus of the EC's assessment of the progress on country-specific recommendations is on wide range of barriers to investment, asking for more action on the recurrent property taxes as well as public sector, entitlement and service markets reforms, which reassure investors of close external monitoring. Cognizant of strong pressure on non-discretionary spending, much-needed transition of fiscal pressure away from labour to real estate, idle assets and consumption, and poor progress in doing business reforms, we think Croatia's exit from the Excessive Imbalances Procedure rests on health and pension system reforms and other entitlement cost containment. As one of the quick wins, public wage bill reforms (to set complexity/work efficiency criteria) raise the authorities' leverage in setting criteria for more flexible social negotiations, durable public wage containment and comprehensive administration restructuring ahead. Spending reforms must be accompanied by well-thought Agrokor reshuffle, creating equal level playing field, plus various growth enablers: red tape cuts, labour mobility reforms, fewer barriers to competition in services, direct tax cuts, and strengthening the credit channel via automatic NPL workouts, equity capital hikes and faster insolvency model. Most effective labour measures to raise total factor productivity are those that reduce dismissal costs and foster active labour market policies. Lastly, sovereign asset-liability management does not only pertain to financial restructuring and privatization, but also SOE operating restructuring (notably in case of road firms), with stronger profits and cost flexibility crucial for state guarantee-free capex financing.

Croatia's data trends

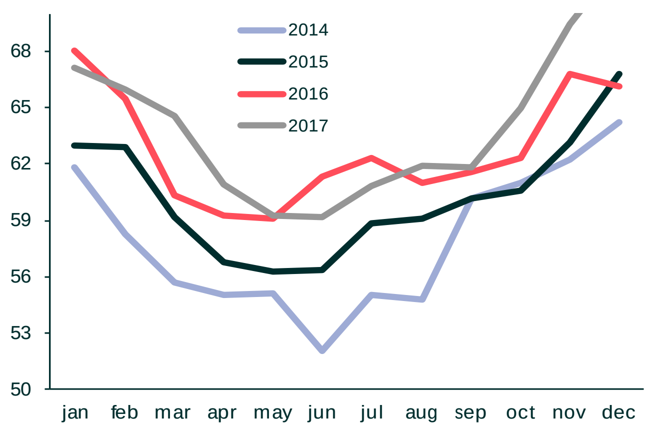
CRO growth in line with CESEE



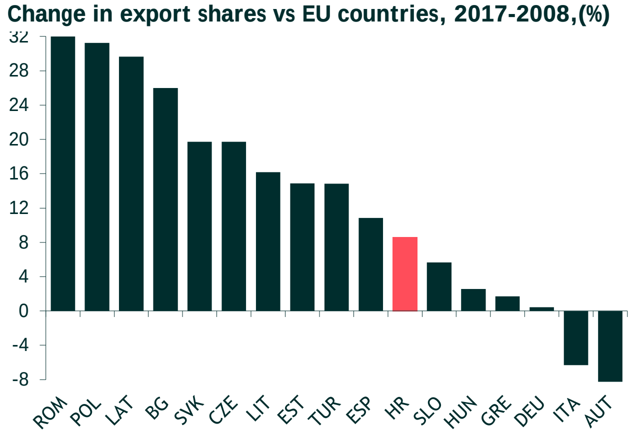
Industrial production, 2010=100



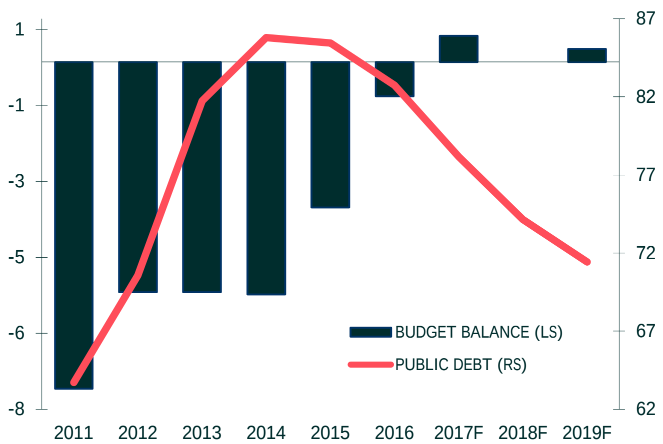
Merchandise import cover (% 3mma)



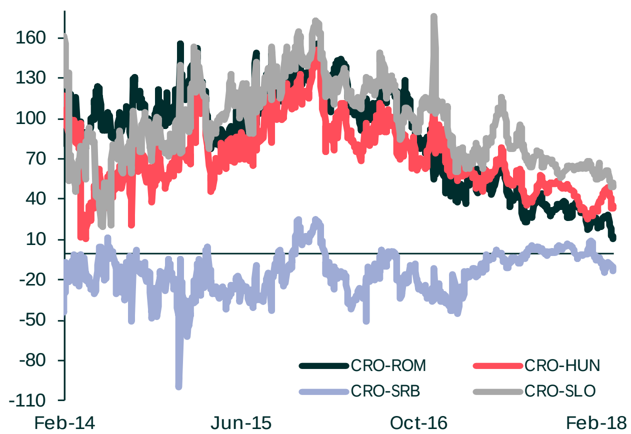
Change in export shares vs EU countries, 2017-2008,(%)



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	363,3	380,6	399,7
Nominal GDP (EURbn)	44,8	44,0	43,8	43,4	44,5	46,4	48,7	51,4	54,2
Nominal GDP (USDbn)	62,2	56,5	58,1	57,7	49,4	51,4	54,9	61,4	67,2
GDP per capita (EUR)	10.476	10.314	10.281	10.245	10.596	11.118	11.806	12.568	13.307
GDP per capita (USD)	14.542	13.233	13.646	13.604	11.750	12.304	13.300	15.015	16.501
Real GDP (constant prices YoY, %)	-0,3	-2,2	-0,1	-0,1	2,3	3,2	2,8	3,0	3,0
Private consumption (YoY, %)	0,3	-3,0	-1,9	-1,6	1,0	3,5	3,6	3,2	2,8
Fixed investment (YoY, %)	-2,7	-3,3	1,4	-2,8	3,8	5,3	3,4	6,0	6,5
Industrial production (YoY, %)	-1,2	-5,5	-1,7	1,4	2,5	5,1	1,9	3,4	3,5
Unemployment rate (ILO, average %)	13,7	15,9	17,3	17,3	16,3	13,1	11,2	10,0	9,0
Prices									
CPI inflation (average % YoY)	2,3	3,4	2,2	-0,2	-0,5	-1,1	1,1	1,4	1,7
CPI inflation (end-year % YoY)	2,1	4,7	0,3	-0,5	-0,6	0,2	1,2	1,3	1,5
PPI inflation (average % YoY)	6,4	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,4	2,5
Net wage rates (% YoY, nom., €)	-0,2	-0,4	-0,1	-0,4	1,5	2,9	5,0	3,9	3,7
Fiscal balance (% of GDP)									
State budget balance	-7,5	-5,3	-5,3	-5,4	-3,3	-0,8	0,6	0,0	0,3
Public debt	63,7	70,6	81,7	85,8	85,4	82,7	78,2	74,2	71,4
Gross public funding needs	15,5	17,8	24,8	18,2	19,9	16,3	20,1	11,0	14,4
External balance									
Export of goods and services (EURbn)	18,127	18,319	18,768	19,677	21,473	22,778	25,081	26,863	28,227
Import of goods and services (EURbn)	18,313	18,125	18,599	18,852	20,442	21,437	23,937	25,968	27,651
Merchandise trade balance (EURbn)	-6,382	-6,296	-6,587	-6,512	-6,974	-7,342	-8,159	-8,807	-9,554
Merchandise trade balance (% of GDP)	-14,2	-14,3	-15,1	-15,0	-15,7	-15,8	-16,8	-17,1	-17,6
Tourism receipts (EURbn)	6,617	6,859	7,203	7,402	7,962	8,635	9,493	9,977	10,376
Current account balance (EURbn)	-0,313	-0,050	0,414	0,858	2,019	1,209	1,904	1,560	1,357
Current account balance (% of GDP)	-0,7	-0,1	0,9	2,0	4,5	2,6	3,9	3,0	2,5
Net FDI (EURbn)	1,1	1,2	0,8	0,7	0,2	1,9	1,3	1,6	1,8
FDI (% of GDP)	2,5	2,8	1,9	1,6	0,5	4,1	2,7	3,1	3,3
FDI cover (%)	358,2	2.469,6	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	11,195	11,236	12,908	12,688	13,707	13,514	15,706	17,156	18,789
Import cover (months of imports)	7,3	7,4	8,3	8,1	8,0	7,6	7,9	7,9	8,2
Debt indicators									
Gross external debt (EURbn)	46,397	45,297	45,803	46,416	45,384	41,668	40,069	40,219	41,766
Government (EURbn)	11,449	12,705	14,647	15,841	18,049	16,230	16,312	16,470	17,070
Private (EURbn)	34,949	32,592	31,157	30,575	27,335	25,438	23,756	23,748	24,695
Gross external debt (% of GDP)	103,5	102,9	104,7	106,9	101,9	89,8	82,3	78,2	77,1
Gross external debt (% of exports)	256,0	247,3	244,1	235,9	211,4	182,9	159,8	149,7	148,0
Exchange rates and money growth									
USD/HRK (end-year)	5,82	5,47	5,55	6,30	6,99	7,17	6,27	6,11	5,89
USD/HRK (average)	5,34	5,85	5,71	5,75	6,86	6,80	6,62	6,19	5,95
EUR/HRK (end-year)	7,53	7,55	7,64	7,66	7,64	7,56	7,51	7,45	7,42
EUR/HRK (average)	7,43	7,52	7,57	7,63	7,61	7,53	7,46	7,40	7,38
Money supply M1 (% YoY)	7,3	0,9	11,5	9,6	11,3	18,2	19,1	9,8	10,2
Broad money M4 (% YoY)	5,6	3,6	4,0	3,2	5,1	4,7	2,1	3,6	3,9
Domestic credit (% YoY, euros)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	1,7	2,5
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	2,25	2,40

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
Balance sheet									
Assets (EURm)	55.342	54.395	54.338	54.719	54.536	54.689	54.416	55.442	56.617
Assets (%, YoY)	3,7	-1,7	-0,1	0,7	-0,3	0,3	-0,5	1,9	2,1
Assets (% of GDP)	123,7	123,7	124,2	126,0	122,4	117,8	110,7	106,3	102,9
Gross loans (EURm)	38.665	37.678	37.543	36.561	35.941	34.125	32.706	33.251	34.091
Gross loans (%, YoY)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	1,7	2,5
Gross loans (% of GDP)	86,4	85,7	85,8	84,2	80,7	73,5	66,6	63,8	62,0
Deposits (EURm)	29.293	30.087	30.959	31.874	33.660	35.237	36.355	37.448	38.561
Deposits (%, YoY)	0,3	2,7	2,9	3,0	5,6	4,7	3,2	3,0	3,0
Deposits (% of GDP)	65,5	68,4	70,8	73,4	75,6	75,9	74,0	71,8	70,1
Loan-to-deposit ratio (%)	132,0	125,2	121,3	114,7	106,8	96,8	90,0	88,8	88,4
Capital adequacy ratio (%)	19,6	20,9	21,0	21,8	20,9	23,0	23,2	23,4	22,5
Performance									
Net interest income (EURm)	1.540	1.449	1.360	1.366	1.401	1.457	1.477	1.486	1.461
Net interest income (%, YoY)	3,7	-5,9	-6,2	0,5	2,5	4,0	1,4	0,6	-1,7
Total operating income (EURm)	2.249	2.015	1.923	1.922	1.904	2.150	2.134	2.156	2.133
Total operating income (%, YoY)	2,0	-10,4	-4,5	0,0	-1,0	12,9	-0,7	1,0	-1,1
Pre-provision profit (EURm)	1.127	972	920	934	915	1.178	1.134	1.164	1.126
Pre-provision profit (%, YoY)	3,1	-13,7	-5,4	1,6	-2,0	28,7	-3,8	2,6	-3,2
Provision charges (EURm)	500	501	780	645	1.529	380	574	412	387
Profitability and efficiency									
Net interest margin (%)	2,8	2,6	2,5	2,5	2,6	2,7	2,7	2,7	2,6
Pre-tax ROAA (%)	1,2	0,9	0,3	0,5	-1,1	1,5	1,0	1,4	1,3
Pre-tax ROAE (%)	8,4	6,2	1,9	3,9	-8,7	11,4	7,3	9,4	9,2
Cost-to-income ratio (%)	49,9	51,7	52,2	51,4	51,9	45,2	46,9	46,0	47,2
Operating expense (% of assets)	2,1	1,9	1,8	1,8	1,8	1,8	1,8	1,8	1,8
Credit quality and provisioning									
NPL ratio (%)	12,4	13,9	15,7	17,1	16,7	13,8	11,4	10,2	9,6
NPL coverage (%)	41,4	42,6	46,2	51,3	56,9	63,7	61,5	60,9	61,1
Provision charges (% of loans)	1,3	1,3	2,1	1,7	4,2	1,1	1,7	1,3	1,2
Provision charges (% of PPP)	44,4	51,5	84,8	69,0	167,0	32,2	50,6	35,4	34,4

Source: CNB, Addiko research

Credit growth under influence of public sector and NPL sales

While new retail disbursements picked-up in 2017, gross loans still decreased by 4.2% in 2017, with public sector (-21.4%) the main drag after state road companies' bank debt swap with much cheaper EUR1.25bn Eurobond. Notwithstanding higher business optimism and easier SME credit standards, corporate loan book fell 1.3%, largely due to NPL sales (EUR715m) but also due to lower disbursements, as a result of Agrokor-related uncertainty along with EUR530m life-line to Agrokor in June that effectively lowered local demand for working capital loans. Retail re-leveraging (+1.8%) owed to stronger labour market, consumer sentiment and in turn demand for non-purpose loans, while housing loans soared in H2 thanks to state subsidies. Private sector lending thus displayed only modest 0.5% yoy growth under strong impact of NPL sales, while excluding that effect the actual private credit growth, i.e. performing portfolio, reached 4.7% yoy. Deposit growth decelerated to 3.2% yoy (vs. 4.7% in 2016). The strongest positive contribution came from corporate deposits (9.0% yoy) due to another record tourist season and stronger firms' profits. Household deposits growth was pretty modest (1.2% yoy), reflecting low interest rates offered on savings. Regarding profits, NII increased 1.4% yoy supported by significant drop in funding costs (-32.6%) which managed to compensate for lower interest income. Agrokor financial restructuring forced higher provisioning costs (51.2% yoy), resulting in strong pre-tax profit deterioration (-29.2% yoy) and higher cost of risk (+63bp yoy).

Recovery of credit activity expected going forward

Looking forward, in 2018 we see 1.7% stronger bank lending on further economic recovery, stronger labour market and household consumption alongside record low interest rates, courtesy of bank competition and lower risk premium. Stronger outlook for fixed investments and EU funding in 2018 also bode well for corporate credit. Downside risks mainly stem from tighter consumer credit market regulation, idiosyncratic risks in Agrokor restructuring and further corporate de-leveraging. Given the expected further NPL sales, we see NPL ratio down to 10.2% (vs. 11.4% in 2017). Concerning deposits, we expect growth level around 3.0% yoy thanks to sustained environment of low interest rates and increasing households' spending propensity. Assuming lower impairments level, in 2018 we expect recovery of banks' profitability, though strong competition will keep NIM under pressure.

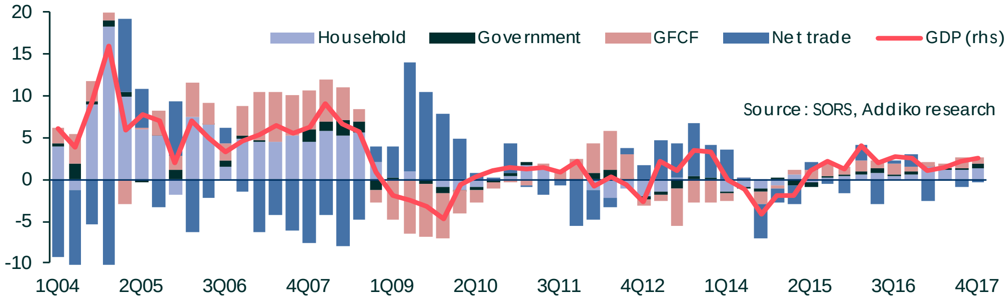
Acceleration Ahead

Unlike in most CEE economies, we expect Serbian GDP growth to accelerate on stronger external and domestic demand, stronger FDI/capex, unwinding of negative one-offs from 2017 and positive fiscal impulse. Given persistent dinar strength, inflation downside surprises and subdued outlook, and lower fiscal risks, we see further NBS easing via FX interventions, rate cut(s) and potentially lower RSD part of the mandatory reserve. We see further spreads tightening thanks to significant public/external debt cuts, new IMF program, stable politics and major EM indices' inclusion before dinar rates grind higher in 2019 amid stronger bank lending and monetary policy normalization.

The underlying growth is picking up

GDP growth accelerated again to 2.5% yoy in Q4 (prev. 2.1%), which alongside small revisions for earlier quarters left the FY17 expansion much below potential at 1.9%. This is only about a half of the CESEE average, partly due to ~2pp/GDP negative effect from supply shocks due to weather-inflicted agriculture and multiple energy/Fiat production outages. While, positively, FDI-related and public capex was the key driver of growth in Q4 (total investment +12.4% yoy), which will boost export capacity, the silver lining is that investment activity is very much import-intensive. The ensuing import surge (+12.0% yoy) left net trade contribution deeply negative (-4.1pp) as exports saw a bit of a downward volatility. Private spending has been driven by strong household income and employment growth, cheaper debt service and re-leveraging. While strong demand continues leaking into imports, we still expect much stronger industrial output, exports and retail trade footing early this year, normalizing energy output and low base ensure further GDP growth acceleration to about 3.5% yoy through 1H18.

Serbia: contributions to GDP (pps, %)



Growth accelerates to 3.5% in 2018 on external demand, fiscal impulse and base effects

We keep above-consensus 3.5% GDP growth call for 2018 intact for a number of reasons. The expected economic growth will be driven by stronger domestic demand, booming EU trade partners' demand and Serbian export market share gains, unwinding of negative (~2pp of GDP) one-offs from 2017 and positive fiscal impulse. Stronger local demand shall mirror accelerating private consumption amid further disposable income and employment gains and re-leveraging, plus similarly robust investment growth amid improved business climate, strong manufacturing FDIs, continued state-sponsored EUR2.5bn railway/road construction and easier financing conditions. Notwithstanding a high import-intensity of stronger domestic demand, buoyant export growth will in our view halve negative net trade contribution to about -1pp of GDP. Risks to our forecasts are skewed to the upside when it comes to even stronger foreign demand and extra fiscal stimulus (i.e. further entitlement spending hikes), supply shock-free agricultural season and policy-induced optimism. Namely, while structural reforms fell short of expectations, we think the expected successor IMF program and the EU 2025 entry prospects may act as catalysts for reforms and institutional convergence to EU standards. Downside risks include global trade wars and resurgent EU political risks in their impact on EU activity, public capex under-execution and slow reform process in case unsuccessful government reshuffle and in case of domestic political risks.

Inflation pressures taking more time to build up

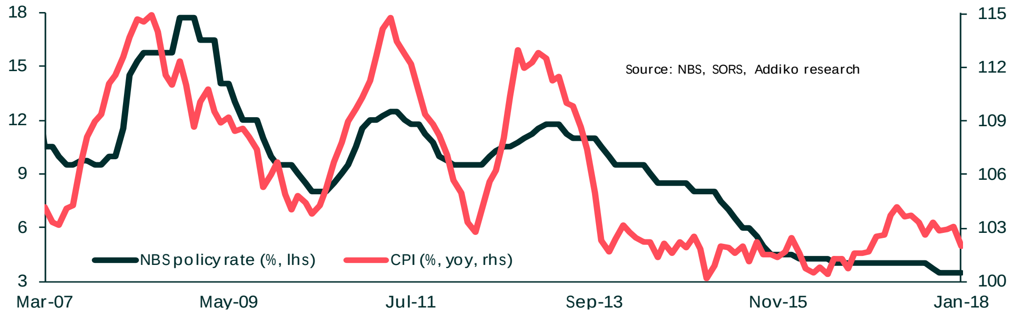
Headline inflation more than halved relative to YE17 and fell below the lower end of the NBS' target range (3%+/-1.5pp) in April largely thanks to high base effects, plus subdued food and energy prices due to mild winter weather and strong RSD (partly due to weak USD). Seasonally-adjusted trend inflation (3mma, annualized) not only hit its two-year low in 1Q18, but core inflation is close to record lows just above 1%. Inflation will nevertheless pick up towards the mid-point of the NBS target band in H2 on generally higher commodity prices and resurgent domestic demand supported by stronger labour market, moderate fiscal expansion and private-sector re-leveraging, as well as faster closing of the negative output gap. Upside risks to inflation mainly stem from commodity prices and strong domestic wage growth, while reduced fiscal needs for regulated price hikes, stronger dinar and the long overdue standard agricultural season may well act on the downside. In all, we lowered the average 2018 inflation forecast to 2.4% in the absence of food prices supply-side shocks, down from the average 3.0% in 2017.

C/A deficit widens trade and primary income deficits…

The C/A deficit soared 174.3% yoy in 4Q17 to EUR678m, sending the FY17 C/A gap to EUR2.1bn or -5.7% of GDP from -3.1% in 2016. The goods trade gap surged 27.8% as 10.0% export growth failed to offset 13.4% import growth acceleration, largely investment-driven (capital goods, technology, intermediates) and reflecting high import content of export and high energy import. Only secondary income saw improvement among else owing to higher remittances (EUR2.2bn, 5.8% of GDP). We see lower goods trade as well as C/A deficit in 2018 around 10.5% and 4.5% of GDP (respectively) as export growth exceeds slightly that of imports amid stabilizing capital goods imports while the temporary widening in 2017 due to energy disruptions and weather-inflicted agricultural exports wane. The net external debt slump, FDI overfinancing of C/A gap and strong banks' net external positions and external de-leveraging (as part of balance sheet restructuring, NPL sales) support further improvement in net international investment position.

Net FDI surged 27.1% to EUR2.4bn in 2017 (6.6% of GDP after 5.5% in 2016) on better business climate and macro/political stability. The strongest EU investment demand since the financial crisis and the growing business process outsourcing is driving FDIs in the CEE region and Serbia. We see net FDI above 7% of GDP in 2018 led by manufacturing additions, higher non-resident banks' profit, real estate projects and privatization (Airport Nikola Tesla, copper smelter RTB Bor, Komercijalna Banka) and stronger long-term growth and efficiency gains (Serbian private NFCs' ROA just 2.0% vs. 3.8% in CESEE). Large FDIs will over time help in significant expansion of the export industry and improve trade balance. We also expect higher non-residential flows into local debt given the attractiveness of Serbian long-term bonds (see down). This in combination with frontloaded fiscal consolidation (next page) reduces the need for external borrowing.

Serbia: CPI inflation and NBS policy rate



Better risk profile, stronger dinar and low inflation support NBS easing

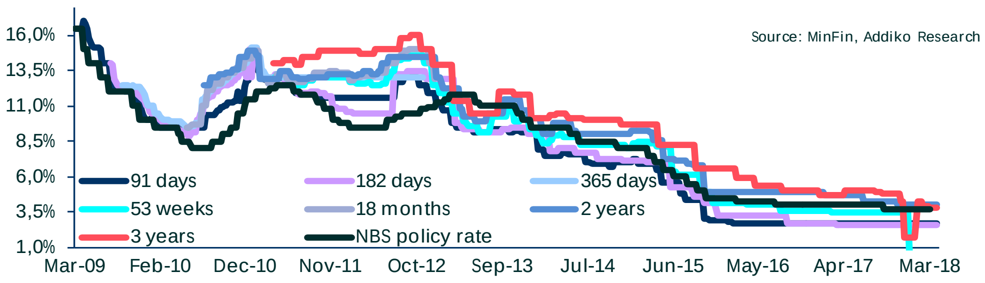
A bunch of domestic and external factors trumped the global market volatility and provided the NBS another opportunity for a 25bp policy rate cut: (i) low inflation in 1H18, (ii) stronger capital inflows and, hence, upward pressures on the RSD best depicted by EUR500m NBS' FX purchases, almost double the amount prior to last September's rate cut after a year on hold, (iii) confidence in domestic economic policy de-risking, and (iv) fairly dovish ECB rhetoric after dropping dovish bias on its asset purchasing program. While the NBS February Inflation Report saw a 0.4pp lower 2018 inflation forecast to sub-consensus 1.9%, CPI will end 2018 above that of the key trade partners, which alongside strong dinar hits price competitiveness. Apart form the NBS easing, we think the downward short-end rates adjustment has been supported by stronger MinFin's bargaining power in T-bill auctions given its hefty cash reserve and high interbank excess liquidity, which the NBS has continued to fine-tune through 1W REPO instrument to stabilize short dinar rates.

Notwithstanding predictable and patient global monetary normalization, EM spreads stay under pressure amid global trade disputes and monetary uncertainty as the markets have not yet fully priced another three Fed rate hikes in 2018 and CEE central banks (look to) tighten as well. Still, given the tighter monetary conditions amid persistent dinar strength, inflation downside surprises in 1H18, subdued 18M CPI outlook, and lower fiscal risks, we see further NBS easing via FX interventions, rate cut(s) and potentially reduction in the RSD part of the mandatory reserve. In a base case, we see another 25bp rate cut this week or in May to 3.0% followed by a pause until mid- to the second half of 2019 almost in line with the ECB policy, and stronger local inflation pressures. Fairly slow Fed tightening and ECB tapering won't affect Serbian assets strongly, in our view, thanks to record low Serbian risk premium as a result of the ongoing macro/fiscal and external balances improvement, new IMF reform program, lower state gross funding needs, stable domestic politics and improved rating prospects. The combination of improving sovereign risk profile, stronger dinar and low inflation allow the NBS easing, which together with hefty pick-up in Serbian long-term debt over similar CESEE issuers supports further Serbian yield compression. Our baseline could be compromised should the Fed/ECB frontload policy normalization, euro rallies further (not our base case given subdued inflation) and/or major volatility in the external environment impacts the dinar like a typical risk-off shock.

Appreciation pressures on dinar building…

Despite solid corporate FC demand as implied by soaring goods trade deficit, the EUR/RSD has approached 118, with the dinar rally smoothed only through frequent FX interventions. Sporadic pullbacks episodes around the NBS easing decisions aside, we expect the RSD strength to persist in 2018 on stronger macro/risk profile and political stability, stronger portfolio and privatization flows (airport soon, copper smelter RTB Bor later on), strong bank lending and inclusion in two major EM bond indices and more sustained non-residents' appetite for Serbian assets. A pick up in bank credit extensions adds to the dinar strength when it comes to both RSD and RSD-linked lending, the latter indicating much stronger corporate credit demand and prompting more frequent adjustments of banks' FX positions. Last but not least, stronger dinar has not only provided support in inflation targeting and the overall dinarization, but it also speeds up public debt reduction where the authorities apparently have interest. With occasional depreciation pressures during sporadic bouts of regional FX risk aversion or in the aftermath of import-intensive demand surprises, we see the EUR/RSD inside 116-119 with the risks skewed on the downside especially in the event of stronger-than-expected capital inflows.

Serbia: T-bill/notes yields



Budget stays in balance despite some spending easing

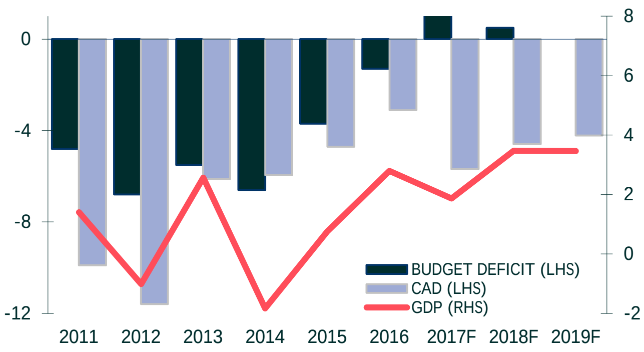
The FY17 budget surplus of 1.2% of GDP (against -1.7% deficit target) beat even the most optimistic expectations, which alongside 4% stronger dinar was decisive in public debt slump to 62.4% of GDP. That said, structural fiscal adjustment between 2015-2017 reached 6% of GDP, far stronger than the IMF-advocated 4% of GDP. The strong front-loaded fiscal overperformance owed to persistent tax revenue (notably CIT and VAT) overshooting, SOE dividend payments and stronger tax compliance, plus material public capex under-execution, subsidy cuts, falling interest bill and lower social transfers. While stronger tax-rich domestic demand supports another 8%+ stronger tax intake in 2018, and the interest bill will drop again, we still see the budget close to balance in 2018 on stronger public capex, wages and pension hikes and higher non-taxable income threshold, as well as childcare support. From a competitiveness point of view, it would have been better if labour taxes and para-fiscal fees were cut stronger instead of a renewed hike in public wage bill. The one silver-lining is that extraordinary fiscal results are not accompanied by meaningful reforms (especially in SOE and judiciary areas) and instead partly relaxed entitlement spending, which given the magnitude of (mainly SOE-related) contingent liabilities leaves Serbia vulnerable to cyclical shocks. The 2018 budget may again overperform relative to the MinFin's -0.8% of GDP deficit target given the unofficial policy of tax revenue underestimation, GDP growth surprises on steady EU outlook and lower interest rates. Given frontloaded consolidation, faster GDP growth, sustained primary surplus and strong dinar, we see further drop in public debt just below 55% of GDP in 2019, closer to ~50% 'BB' median.

… as stronger reform momentum is needed to grant stability

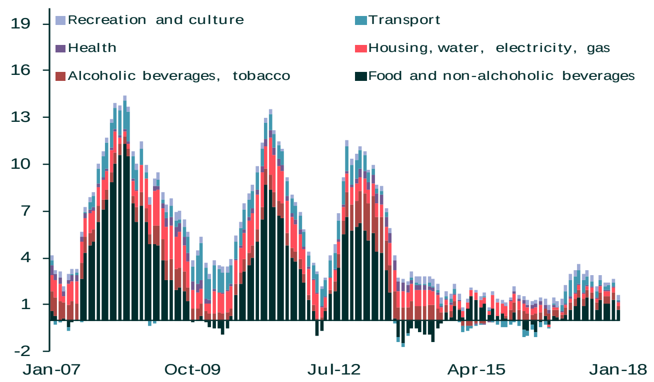
With further macro/fiscal improvement and positive investment backdrop, Serbia is eyeing euro-clearibility and much higher liquidity of the local bond market. That said, the MinFin issued as much as RSD183.1bn, of which RSD158.1 (3.4% of 2018 GDP) in 5&10Y dinar bonds at bid-to-cover at 1.5-2x. This almost covers the planned significant increase in the gross dinar T-bond issuance to 3.8% of GDP in 2018 (from just 0.7% of GDP in 2017) in a bid to raise the share of RSD in public debt to min. 25%, and support the overall dinarization agenda. After a 90bp drop in 2017, Serbian risk premium (5Y CDS spread) fell another 25bp in the year to mid-March in the aftermath of Fitch upgrade, only to retrace in recent weeks through the global market volatility. As before, we attribute almost interrupted risk rally to higher capital inflows into Serbian assets with the prospects of EM indices' inclusion, successful conclusion of the IMF deal, another more reformist one in sight, tangible fiscal healing and rating upgrade prospects ahead. Despite a large EUR1bn Eurobond in 2018 funding plan, we are sceptical and rather see the MinFin agile in (re)financing via 5&10Y dinar bonds on the assumed high non-resident investor participation with the eligibility criteria for index inclusion (including the USD1bn local market liquidity requirement) apparently met, and elevated real long-term rates in comparison with other CESEE sovereigns. Meanwhile the MinFin is set to repay FC debt off-market, e.g. from FX reserves. After further yield compression (up to 50bp on 10Y RSD from the current level) in the rest of 2018, we expect gradual dinar rates normalization in 2019 onwards in line with stronger bank lending and the NBS and other key central banks' tightening.

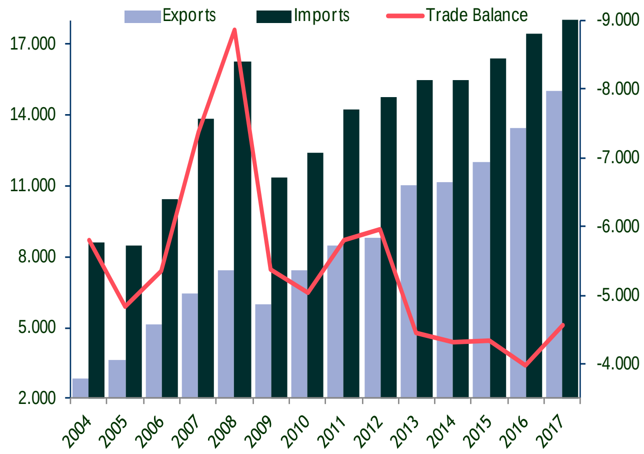
Serbia's data trends

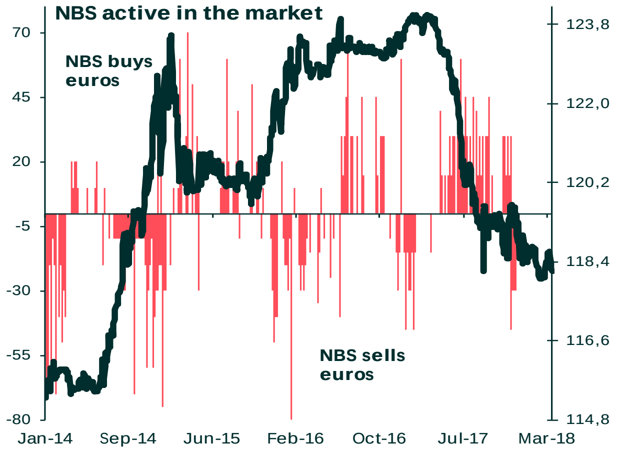
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



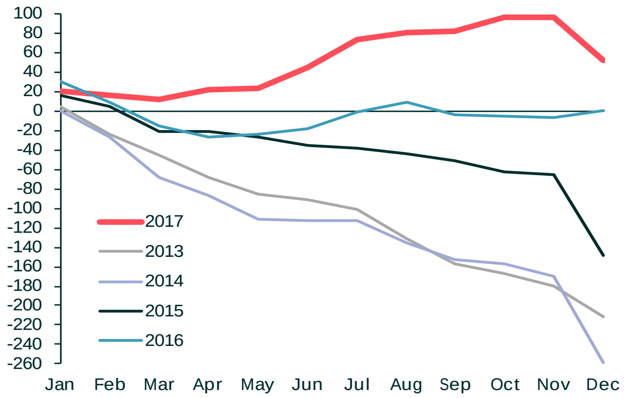
CPI contribution - key categories (pps)



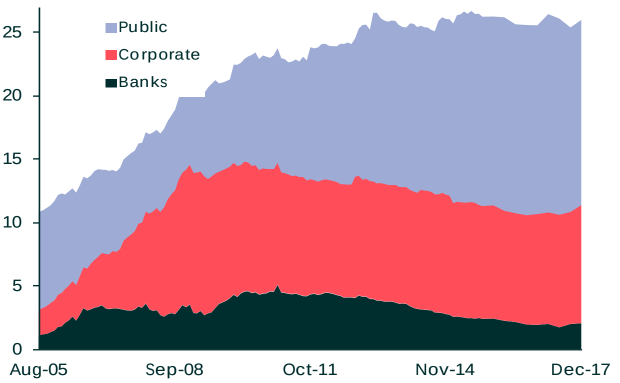




Consolidated government budget balance (RSDbn)



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	4.465	4.717	5.060
Nominal GDP (EURbn)	33,4	31,7	34,3	33,3	33,5	34,6	36,8	40,1	42,7
Nominal GDP (USDbn)	46,5	40,7	45,5	44,1	37,1	38,3	41,5	47,9	53,0
GDP per capita (EUR)	4.620	4.401	4.783	4.662	4.720	4.889	5.223	5.701	6.070
GDP per capita (USD)	6.423	5.650	6.353	6.177	5.234	5.415	5.897	6.811	7.442
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	1,8	2,9	3,2
Fixed investment (YoY, %)	4,6	13,2	-12,0	-3,6	5,6	5,1	6,2	8,7	7,0
Industrial production (YoY, %)	2,5	-2,2	5,4	-6,4	8,4	4,8	3,5	4,8	5,0
Unemployment rate (ILO, average %)	23,0	23,9	22,1	19,2	17,7	15,3	13,2	11,5	10,9
Prices									
CPI inflation (average % YoY)	11,0	7,8	7,8	2,1	1,4	1,1	3,1	2,1	3,6
CPI inflation (end-year % YoY)	7,0	12,2	2,2	1,7	1,5	1,6	3,0	2,7	3,8
PPI inflation (average % YoY)	14,2	5,6	3,6	0,7	0,2	-0,4	3,0	2,0	3,8
Net wage rates (% YoY, nominal, euros)	1,1	-1,8	-1,8	-4,3	-3,3	1,8	5,1	8,0	4,0
Fiscal balance (% of GDP)									
State budget balance	-4,8	-6,8	-5,5	-6,6	-3,7	-1,3	1,2	0,5	0,0
Public debt	45,4	56,2	59,6	70,4	74,7	71,9	61,6	57,8	54,1
Gross public funding needs	13,3	15,4	16,1	17,6	16,7	13,9	9,9	9,1	8,0
External balance									
Export of goods and services (EURbn)	n/a	11,469	13,937	14,451	15,631	17,385	19,330	21,325	23,151
Import of goods and services (EURbn)	n/a	16,992	17,782	18,096	18,899	19,597	22,365	24,514	26,312
Merchandise trade balance (EURbn)	n/a	-5,634	-4,159	-4,111	-3,993	-3,119	-3,986	-4,231	-4,344
Merchandise trade balance (% of GDP)	n/a	-17,8	-12,1	-12,3	-11,9	-9,0	-10,8	-10,5	-10,2
Remittances, net (EURbn)	n/a	1,989	2,217	1,931	2,155	1,953	2,151	2,259	2,372
Current account balance (EURbn)	-3,305	-3,671	-2,098	-1,985	-1,577	-1,075	-2,090	-1,843	-1,803
Current account balance (% of GDP)	-9,9	-11,6	-6,1	-6,0	-4,7	-3,1	-5,7	-4,6	-4,2
Net FDI (EURbn)	n/a	0,8	1,3	1,2	1,8	1,9	2,4	2,6	2,8
FDI (% of GDP)	n/a	2,4	3,8	3,7	5,4	5,5	6,6	6,5	6,4
FDI cover (%)	n/a	20,5	61,9	62,3	114,4	176,7	115,6	140,7	152,6
Gross international reserves (EURbn)	12,058	10,915	11,189	9,907	10,378	10,205	9,962	9,512	9,312
Import cover (months of imports)	n/a	7,7	7,6	6,6	6,6	6,2	5,3	4,7	4,2
Debt indicators									
Gross external debt (EURbn)	24,125	25,645	25,644	25,679	26,234	26,494	25,735	25,505	24,896
Government (EURbn)	10,773	12,185	13,120	14,145	15,295	15,680	13,894	13,744	13,944
Private (EURbn)	13,352	13,460	12,525	11,534	10,939	10,815	11,842	11,762	10,952
Gross external debt (% of GDP)	72,2	80,9	74,8	77,1	78,3	76,5	70,0	63,5	58,3
Gross external debt (% of exports)	n/a	223,6	184,0	177,7	167,8	152,4	133,1	119,6	107,5
Exchange rates and money									
USD/RSD (end-year)	80,87	86,18	83,13	99,46	111,64	117,93	99,30	95,90	93,65
USD/RSD (average)	73,34	88,12	85,17	88,54	108,88	111,17	107,55	98,38	95,48
EUR/RSD (end-year)	104,6	113,7	114,6	121,5	121,8	123,5	118,5	117,0	118,0
EUR/RSD (average)	102,0	113,1	113,1	117,3	120,7	123,1	121,4	117,5	118,4
Money supply M1 (% YoY)	16,9	-3,3	24,8	5,2	16,4	18,7	14,8	8,0	6,4
Broad money M3 (% YoY)	11,2	0,7	3,7	3,0	5,0	9,9	7,9	5,2	4,6
Domestic credit (% YoY, euros)	8,9	0,8	-5,2	-2,3	2,4	1,0	6,2	7,9	6,9
NBS policy rate (average %)	11,54	10,14	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	28.045	29.167	30.188
Assets (%, YoY)	5,5	0,0	-2,0	-1,1	2,1	4,8	6,8	4,0	3,5
Assets (% of GDP)	75,8	79,9	72,5	73,7	74,8	75,9	76,3	72,7	70,6
Gross loans (EURm)	17.013	17.148	16.255	15.879	16.253	16.412	17.431	18.817	20.115
Gross loans (%, YoY)	8,9	0,8	-5,2	-2,3	2,4	1,0	6,2	7,9	6,9
Gross loans (% of GDP)	50,9	54,1	47,4	47,7	48,5	47,4	47,4	46,9	47,1
Deposits (EURm)	13.099	13.310	13.634	13.967	14.728	16.159	17.404	18.381	19.218
Deposits (%, YoY)	10,1	1,6	2,4	2,4	5,4	9,7	7,7	5,6	4,6
Deposits (% of GDP)	39,2	42,0	39,8	41,9	44,0	46,7	47,3	45,8	45,0
Loan-to-deposit ratio (%)	129,9	128,8	119,2	113,7	110,4	101,6	100,2	102,4	104,7
Capital adequacy ratio (%)	19,1	19,9	20,9	20,0	20,9	21,8	22,6	22,7	22,9
Performance									
Net interest income (EURm)	1.131	1.025	1.044	1.063	1.075	1.006	1.038	1.079	1.117
Net interest income (%, YoY)	7,6	-9,4	1,9	1,8	1,1	-6,4	3,1	4,0	3,5
Total operating income (EURm)	1.590	1.484	1.435	1.489	1.520	1.393	1.554	1.608	1.636
Total operating income (%, YoY)	3,2	-6,7	-3,3	3,8	2,1	-8,4	11,6	3,5	1,7
Pre-provision profit (EURm)	617	571	504	529	574	467	623	664	678
Pre-provision profit (%, YoY)	9,6	-7,5	-11,6	4,8	8,6	-18,7	33,5	6,6	2,1
Provision charges (EURm)	313	339	510	490	494	294	40	50	58
Profitability and efficiency									
Net interest margin (%)	4,6	4,0	4,2	4,3	4,3	3,9	3,7	3,7	3,7
Pre-tax ROAA (%)	1,2	0,9	-0,1	0,1	0,3	0,7	2,1	2,1	2,1
Pre-tax ROAE (%)	5,9	4,3	-0,3	0,6	1,6	3,5	11,0	10,4	9,6
Cost-to-income ratio (%)	61,8	66,1	65,3	64,7	62,2	66,5	59,9	58,7	58,6
Operating expense (% of assets)	3,9	3,6	3,7	3,9	3,8	3,6	3,4	3,3	3,2
Credit quality and provisioning									
NPL ratio (%)	19,0	18,6	21,4	21,5	21,6	17,0	11,1	9,7	8,8
NPL coverage (%)	51,0	50,0	50,9	54,9	62,3	67,8	61,9	61,6	58,8
Provision charges (% of loans)	1,9	2,0	3,1	3,1	3,1	1,8	0,2	0,3	0,3
Provision charges (% of PPP)	50,7	59,4	101,1	92,8	86,0	62,9	6,4	7,5	8,6

Source: NBS, Addiko research

Strong credit growth despite NPL reduction

In 2017, credit growth accelerated to 6.2% yoy (from just 1.0% in 2016), driven by robust retail lending followed by corporate, while public sector continued de-leveraging amid improved debt management and cheaper IFI and bilateral loans. Retail loans increased 12.4% yoy mostly on the back of cash loans due to improved labour market and wage gains, as well as record low interest rates on both RSD and FX-indexed lending. Corporate lending grew 4.4% thanks to stronger demand for liquidity and working capital loans, despite strong NPL write-offs in that segment in particular (~EUR620m). Thanks to successful NPL sales (~EUR860m), NPL ratio fell to 11.0% from 17.0% in 2016. Adjusted for NPL effect, total credit growth was even faster, hitting almost 14%. Meanwhile, deposit growth decelerated to 7.7% yoy (vs. 9.7% in 2016) as both private and public deposit collection slowed down owing to high base effect and stronger consumer/investment appetite. Before the FY17 P&L report, we expect record pre-tax profit for 2017 (~EUR580m) thanks to strong non-interest income growth and lower provisioning.

Private sector keeps pushing stronger credit growth

In 2018, we expect credit growth around 8%, driven by private sector lending amid stronger consumption as well as investment outlook in the environment of persistently low interest rates and high interbank competition. Moreover, cleaning of banks' balance sheets has opened space for new lending, and we expect this practice to continue, lowering NPL ratio in 2018 to 9.7% on our estimates. Regarding deposit growth, we expect further deceleration towards 5.6% due to relatively high base and continuously low interest rates. We see pre-tax income slightly above 2017 level thanks to solid growth of NII, courtesy of increasing credit portfolio and lower funding costs, along with stable provisioning and opex.

IMF Funding Finally Unblocked

We keep our 2018 GDP growth forecast at 3.1% on the back stronger private consumption, external demand and faster public capex execution. Meanwhile, we expect inflation to gather pace in 2018 supported by private consumption and higher excise taxes on fuels, while C/A deficit is expected to re-widen.

GDP expands 3.0% in 2017

GDP growth came at 3.0% in 4Q17, implying the FY17 growth at 3.0% as well. In Q4, retail sales growth continued at a similar pace (4.7% yoy) on higher employment, wages and remittances, while industrial output slowed slightly (+2.7% yoy in Q4 and 3.2% for the FY17). While strong goods export growth continued in 4Q (+15.7% yoy) on the heels of stronger foreign demand, net trade contributed negatively given soaring import-intensive domestic demand. High frequency data suggest GDP growth accelerated in 1Q18. Faster employment alongside solid real net wage growth helped retail sales surge 9.9% yoy in 2M17 (vs. 5.1% in 2017), and industrial output accelerated to 5.9% yoy in 2M18. Moreover, exports sprinted 17.7% yoy in 2M18 (vs 15.7% in 4Q17), while imports increased 10.9% yoy (vs 10.2% in 4Q17), and the import cover surged 500bp yoy to a record 65.7% on a 3mma basis.

Public investments to support growth

In 2018, we see GDP growth of 3.1%, as B-H enjoys solid cyclical upswing and faster public capex execution. In February this year, B-H finally passed 2018 entity budget, committed to two incumbent telecoms' privatization and finally unblocked the second IMF tranche (EUR75m) being frozen over a year amid poor policy implementation. The IMF funding approval was crucial for other supranational material capex funding, after which the EBRD committed to invest at least EUR700m (4.4% of GDP) during 2018-2020 in the road infrastructure (Vc corridor). The main driver of economic growth is still private consumption growth around 2.5% on higher employment, wages as well as remittances. Net trade will still contribute negatively as stronger import demand aggravated by externally funded infrastructure capex will offset stronger exports driven by EU demand. The risks to growth are mainly political ahead of October elections, i.e. slower pace of reforms that could again affect external financing. Political tensions may rise ahead of the coming changes in the electoral required by the Constitutional court ruling in 2017. After elections, B-H may restart reforms after the authorities in February finally responded to the EU questionnaire, taking the country a step closer to the EU candidate status.

Credit rating affirmed

Rating agencies S&P and Moody's both confirmed B-H rating as highly speculative (at stable B and B3, respectively), reflecting economic and institutional weaknesses as well as high susceptibility to event risk. Political divisions, institutional weakness and poor policy implementation still limit the country's ability to improve its poor business environment and thus strengthen its growth potential. On the other hand, ratings are supported by steady economic growth, stable fiscal position and relatively low and affordable debt burden. Rating agencies would consider a rating upgrade should B-H accelerate reforms in more stable policy environment, which would help re-pricing of the growth and income potential. Reform priority should be given to upgrading physical infrastructure, red tape and administrative burden cuts, new labour market reforms, better SOE governance, stronger competition and in turn business climate. Compliance with the IMF-enshrined fiscal reforms to ensure debt sustainability would be also credit positive. After all, negative factors include any negative political impact on the reform process, EU accession and concessional funding, all of which will in our view prevent rating upgrades in the near term. We only see the EU candidacy associated with faster reforms as a potential game-changer to our baseline.

We expect small budget surplus

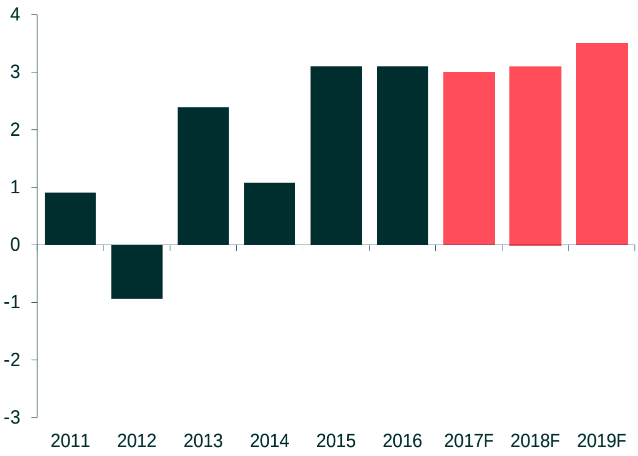
B-H likely saw a general government surplus around 1% of GDP in 2017 on our estimates thanks to a solid 7% indirect tax growth and contained spending amid public capex under-execution caused by a halt in external financing. In 2018, both entities (Federation BH and RS) plan to increase spending by 3-6% and project the national budget surplus around 1.4% of GDP according to B-H Directorate for Economic Planning. However, we see the national budget surplus narrowing to 0.3% largely due to higher public capex, and given the coming election, higher entitlement spending. Furthermore, this year budget won't be supported by the EUR116m (0.7%/GDP) inflow as Russia repaid its clearing debt from the former Soviet Union in 2017.

Inflation to gather pace in 2018

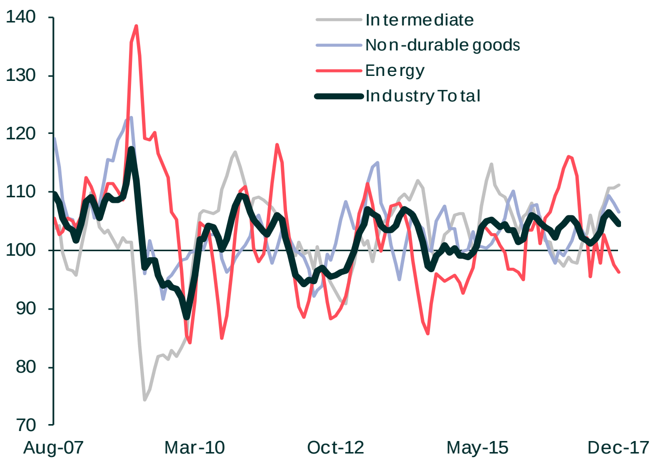
C/A deficit rose 4.3% to EUR773m in 2017 as 16.8% stronger goods exports and 9.0% higher service surplus couldn't offset 11.9% higher imports driven by stronger import-intensive domestic demand. As a percentage of GDP, C/A deficit narrowed slightly to 4.8% of GDP. In 2018, we see C/A widening to 5.4% of GDP on stronger import demand underpinned by higher import intensive infrastructure investments. As for inflation, we expect the average 2018 CPI at 1.9% (from 1.3% in 2017) supported by further acceleration in private consumption as well as higher excise taxes on fuels.

Bosnia and Herzegovina's data trends

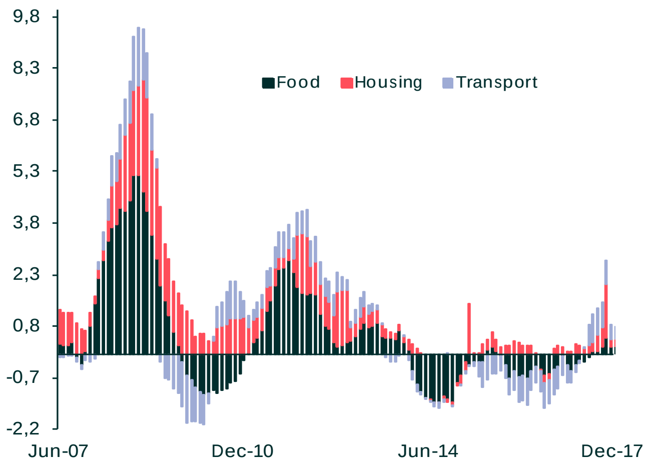
Real GDP growth (% YoY)



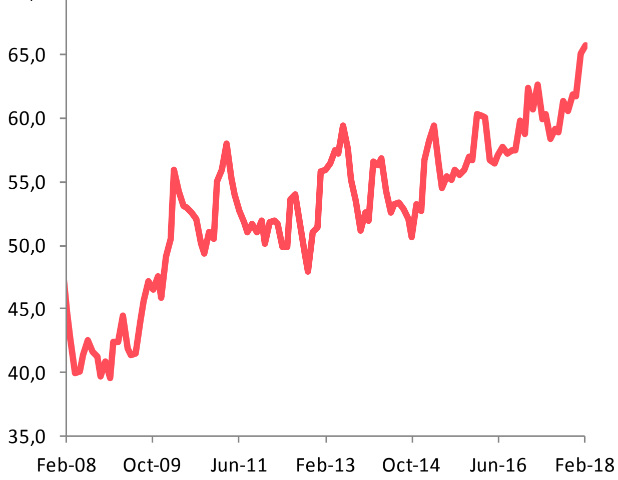
Industrial production (%, yoy, s-a, 3mma)



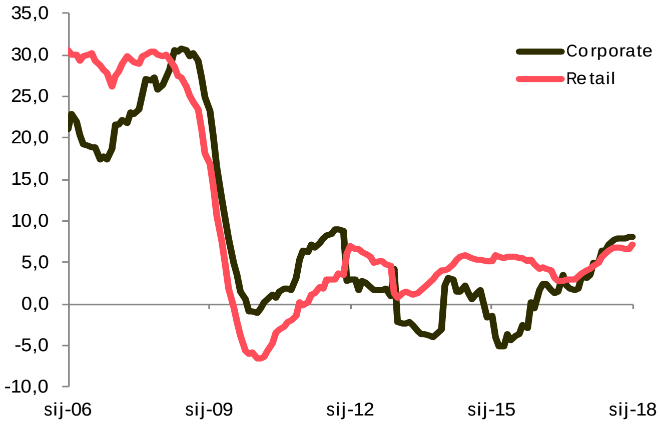
Key CPI contributions (pp)



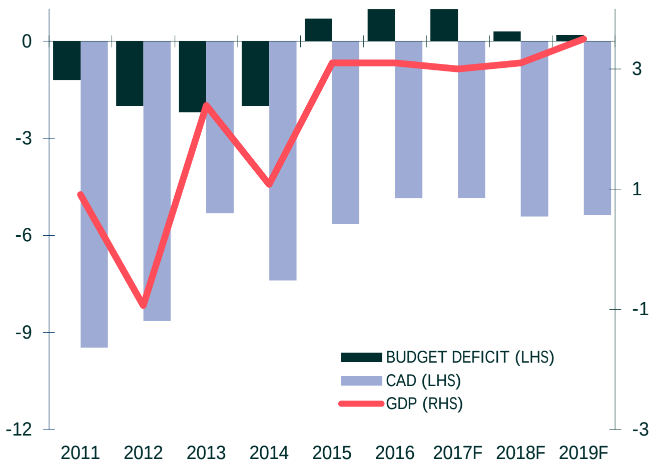
Merchandise import cover (%, 3mma)



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	32,8	34,7
Nominal GDP (EURbn)	13,4	13,4	13,7	14,0	14,6	15,3	16,0	16,8	17,7
Nominal GDP (USDbn)	18,7	17,2	18,2	18,6	16,2	16,9	18,0	20,0	22,0
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	4.765,5	5.040,8
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	5.693,4	6.250,6
Real GDP (constant prices YoY, %)	0,9	-0,9	2,4	1,1	3,1	3,1	3,0	3,1	3,5
Private consumption (YoY, %)	-0,2	-0,7	1,9	2,8	2,8	3,2	2,0	2,5	2,3
Fixed investment (YoY, %)	14,1	4,0	-3,4	7,0	-5,4	4,1	3,0	5,5	8,0
Industrial production (YoY, %)	5,9	-5,2	6,7	0,1	2,6	4,5	3,2	4,5	5,0
Unemployment rate (ILO, average, %)	27,6	28,0	27,4	27,5	27,7	25,4	20,6	18,7	16,5
Prices									
CPI inflation (average % YoY)	3,7	2,1	-0,1	-0,9	-1,0	-1,1	1,3	1,9	2,2
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	1,9	2,5	2,9
Fiscal balance (% of GDP)									
State budget balance	-1,2	-2,0	-2,2	-2,0	0,7	1,2	1,0	0,3	0,2
Public debt	43,1	43,4	44,5	45,0	45,5	43,7	42,6	41,9	41,0
External balance									
Export of goods and services (EURbn)	4,297	4,337	4,620	4,754	5,056	5,432	6,228	6,652	6,985
Import of goods and services (EURbn)	-7,484	-7,481	-7,419	-7,927	-7,801	-7,985	-8,922	-9,534	-9,820
Merchandise trade balance (EURbn)	-4,131	-3,977	-3,630	-4,026	-3,677	-3,600	-3,835	-4,057	-4,035
Merchandise trade balance (% of GDP)	-30,8	-29,7	-26,5	-28,8	-25,2	-23,5	-24,0	-24,2	-22,8
Remittances (EURbn)	1,027	1,070	1,111	1,181	1,216	1,247	1,335	1,382	1,423
Current account balance (EURbn)	-1,270	-1,159	-0,728	-1,033	-0,826	-0,742	-0,773	-0,908	-0,953
Current account balance (% of GDP)	-9,5	-8,6	-5,3	-7,4	-5,7	-4,9	-4,8	-5,4	-5,4
Net FDI (EURbn)	0,3	0,3	0,2	0,4	0,2	0,2	0,3	0,5	0,5
FDI (% of GDP)	2,6	1,9	1,3	2,9	1,7	1,6	2,1	2,9	3,0
FDI cover (%)	27,1	22,3	24,0	38,8	30,1	32,4	43,9	54,2	55,2
Gross international reserves (EURbn)	3,285	3,328	3,614	4,001	4,400	4,873	5,170	5,044	4,907
Import cover (months of imports)	5,3	5,3	5,8	6,1	6,8	7,3	7,0	6,3	6,0
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	52,1	49,2
Gross external debt (% of exports)	152,6	161,1	154,4	152,1	154,4	153,1	140,4	131,3	124,9
Exchange rates and money growth									
USD/BAM (end-year)	1,51	1,48	1,42	1,61	1,79	1,87	1,64	1,60	1,55
USD/BAM (average)	1,40	1,52	1,47	1,47	1,76	1,77	1,73	1,64	1,58
EUR/BAM (end-year)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
EUR/BAM (average)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
Money supply M1 (% YoY)	4,8	-0,7	9,0	9,2	11,9	13,7	13,7	9,8	9,2
Broad money M2 (% YoY)	5,8	3,4	7,9	7,3	8,0	8,3	9,5	7,8	7,6
Domestic credit (% YoY)	5,3	4,1	0,5	2,8	2,4	2,0	7,1	5,5	5,4
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,10

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	13.344	14.440	15.022	15.724
Assets (%, YoY)	3,4	1,9	3,3	4,3	3,7	4,6	8,2	4,0	4,7
Assets (% of GDP)	83,5	85,1	86,1	87,9	87,3	87,3	90,5	89,6	88,7
Gross loans (EURm)	7.828	8.151	8.194	8.423	8.624	8.795	9.419	9.939	10.475
Gross loans (%, YoY)	5,3	4,1	0,5	2,8	2,4	2,0	7,1	5,5	5,4
Gross loans (% of GDP)	58,4	60,8	59,8	60,2	59,0	57,5	59,0	59,3	59,1
Deposits (EURm)	6.643	6.814	7.285	7.861	8.452	9.077	10.057	10.763	11.482
Deposits (%, YoY)	3,7	2,6	6,9	7,9	7,5	7,4	10,8	7,0	6,7
Deposits (% of GDP)	49,5	50,8	53,2	56,2	57,8	59,4	63,0	64,2	64,8
Loan-to-deposit ratio (%)	117,8	119,6	112,5	107,1	102,0	96,9	93,7	92,3	91,2
Capital adequacy ratio (%)	17,1	17,0	17,8	16,3	14,9	15,8	15,7	15,8	16,3
Performance									
Net interest income (EURm)	396	389	385	383	398	411	438	461	501
Net interest income (%, YoY)	8,2	-1,8	-1,0	-0,5	3,9	3,3	6,5	5,4	8,7
Total operating income (EURm)	620	610	618	623	642	680	770	800	855
Total operating income (%, YoY)	1,8	-1,5	1,2	0,8	3,1	6,0	13,1	3,9	6,9
Pre-provision profit (EURm)	209	207	184	213	206	222	306	325	363
Pre-provision profit (%, YoY)	-5,1	-0,8	-11,1	15,8	-3,6	8,1	37,7	6,3	11,7
Provision charges (EURm)	125	130	192	117	171	91	94	95	92
Profitability and efficiency									
Net interest margin (%)	3,6	3,4	3,3	3,2	3,2	3,1	3,2	3,1	3,3
Pre-tax ROAA (%)	0,8	0,7	-0,1	0,8	0,3	1,0	1,5	1,6	1,8
Pre-tax ROAE (%)	5,9	4,8	-0,5	5,6	1,9	7,0	10,7	10,7	11,4
Cost-to-income ratio (%)	66,3	66,0	70,2	65,7	67,9	67,3	60,2	59,3	57,5
Operating expense (% of assets)	3,7	3,6	3,7	3,4	3,5	3,5	3,3	3,2	3,2
Credit quality and provisioning									
NPL ratio (%)	11,8	13,5	15,1	14,2	13,7	11,8	10,0	9,0	8,6
NPL coverage (%)	66,3	65,9	66,7	69,7	71,2	74,4	76,7	77,2	78,6
Provision charges (% of loans)	1,6	1,6	2,3	1,4	2,0	1,0	1,0	1,0	0,9
Provision charges (% of PPP)	-60,0	-62,8	-104,1	-55,1	-83,1	-41,1	-30,6	-29,2	-25,3

Source: CBBH, banking agencies, Addiko research

Private sector as key growth driver

Total loan growth accelerated to 7.1% yoy in 2017 (vs. 2.0% yoy in 2016) driven by stronger lending to the private sector in the context of cyclical recovery and record low interest rates, rising employment and wages as well as record tourist season. Retail loans increased 6.7% yoy supported by strong demand for long-term non-purpose cash loans. Loans to corporate increased by 8.0% yoy also carried by demand for long-term financing, although a significant part of volume increase (~20%) should be attributed to the integration of one leasing company into the banking sector, otherwise corporate loans growth would be around 6.4% yoy. Public loans recovered modestly at 0.4% yoy, after a slump in 2016 (-17.2 yoy). Loan book quality manifested further improvement and NPL ratio continued its downward path reaching 10.0% at end-2017, from 11.8% the year before. Meanwhile, deposit collection accelerated to 10.8% in 2017 (vs. 7.4% yoy in 2016), driven by 17.6% higher corporate and 5.7% higher retail deposits amid cyclical recovery, higher wages and remittances. Public deposits soared 29.5% yoy, mainly driven by payment of the Russian clearing debt to the BH authorities. Regarding profits, in the light of missing FY17 data, we keep our assumption unchanged and expect 2017 pre-tax profit at around EUR200m.

Credit growth and deposit collection decelerating in 2018

Looking into 2018, we see credit growth of 5.5% due to high base effect and expected decline in public loans, given unblocked external financing. Credit activity will be supported by further decline in interest rates, higher employment and wages, as well as investment recovery. Likewise, we expect deceleration of deposit growth towards 7.0% yoy due to a high base, intensifying private capex and higher consumption propensity, particularly given low passive interest rates. We also expect further reduction of NPL ratio to 9.0%, supported by NPL sales, write-offs, recovery and better debt collection, while stronger disbursements and steady provisioning should ensure 2018 profits slightly above last year’s level.

Growth Driven by Tourism and Public Capex

We keep our view of a 3.5% GDP growth in 2018 intact as the planned fiscal consolidation will be the main drag on private consumption. Growth will be driven again with tourism, public capex (Bar-Boljare highway) and FDIs in energy and tourism. Highway construction and first EUR70m instalment for EPCG buy-back will keep the budget deficit around 5% of GDP, while inflation is expected to pick up on higher excise taxes, VAT and stronger demand.

GDP growth accelerates on investments and tourism

GDP growth stayed strong in Q4 (4.0% yoy) for an average 4.3% in 2017, driven by another record tourist season and investments. Namely, foreign tourist arrivals and tourist nights soared 12.9% and 8.9% (in 2017), respectively, which alongside 2.5% higher net wages (in 2017) and employment gains saw retail trade accelerate in 2H17 (+5.5% yoy from 4.9% in 1H17). Investments were driven by intensified road construction and plethora of projects in tourism and energy. Meanwhile, industrial output (-4.2%) disappointed due to a slump in electricity and gas production (-24.6%). Net trade contributed negatively as trade deficit increased by 11.3% in 2017 given stronger import-intensive domestic demand and the record tourist season. High frequency data suggest strong growth has continued in early 2018 as retail sales grew 5.2% yoy in 2M18, and industrial production soared 41.0% yoy. This is partly counterbalanced by 10.1% yoy higher trade deficit in 2M18, lowering already poor 3mma import cover to just 17.9% (-140pp yoy).

3.5% GDP growth call for 2018 remains intact

While Q1 GDP growth is set to come close to the Q4's outturn, we keep 2018 GDP growth forecast at 3.5% intact as the planned fiscal consolidation will be the main drag on private consumption. The main drivers of growth are again tourism and infrastructure works (Bar-Boljare highway), FDIs in tourism and energy (wind power), EBRD-funded investment in Port of Adria and the BMG Industries' investment in the new tobacco plant. Private spending will nevertheless be driven by employment growth and strong tourism, but will still succumb to senior staff wage and childcare support cuts. While the new tobacco factory will support industrial production, net trade will contribute negatively given strong imports of construction and other investment-related equipment. The main upside risk to our forecast is even stronger tourist season, while downside risks stem from delays in infrastructure investments and stronger-than-expected negative impacts of fiscal consolidation.

Elevated capex and EPCG buy-back keep deficit at 5%

The FY17 consolidated budget deficit widened to 5.4% of GDP on soaring 10.2% higher expenditure, driven by public capex. Meanwhile the record tourist season, 9.6% stronger VAT intake and better tax compliance lead to 6.0% yoy higher budget revenues. The government has recently amended 2018 deficit target to 3.2% of GDP (prev. 2.6%) given the first EUR70m repurchase instalment for the electricity board EPCG from Italy's A2A initiated de-consolidation last summer over disagreements on EPCG capex plan. Total cost for the buy-back of EUR250m will be spread over seven years. On financing, this week the authorities have started the road show and are eyeing a new EUR500m 7Y fixed rate bond with YTM around 3% in a bid to refinance the coming redemptions cheaper. While fiscal consolidation measures in the 2018 budget - 2pp VAT hike (21%), higher excise duty on tobacco, alcohol, sugar drinks, employment ban and public wage cuts have a positive effect on public finances, we still expect infrastructure capex and the first EUR70m instalment for EPCG buy-back to result in higher than planned budget deficit at around 5% of GDP.

2018 average CPI inflation seen at 3.0%

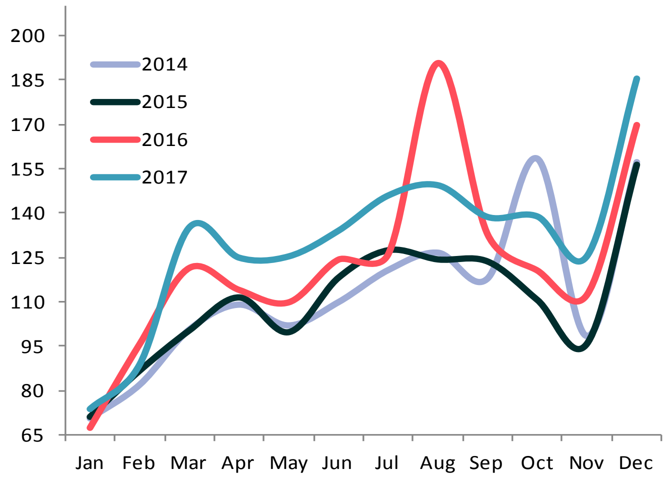
Higher alcohol and tobacco excises, plus higher transport and food prices pushed CPI inflation to 2.4% on average in 2017. As expected, inflation accelerated to 2.7% yoy in February courtesy of higher VAT. Looking ahead, higher VAT and excise duty hikes will add 0.8-1.0pp to the average 2018 inflation, while subdued imported inflation will act as an offset. We expect 2018 inflation to average around 3%, while in 2019 average CPI inflation will decelerate to 2.6%.

Current account gap on elevated levels

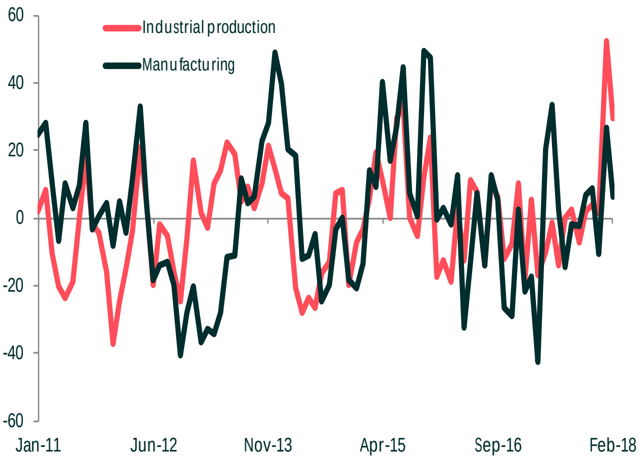
Current account deficit increased 11.8% in 2017 and hit 18.9% of GDP (from 18.1% in 2016) as 8.8% higher service surplus couldn't offset 11.7% higher infrastructure-related imports. Meanwhile, net FDI increased by 27.6% to just under EUR0.5bn (11.2% of GDP), covering 59.3% of C/A gap. In 2018, we see C/A gap at a similar level as another record tourist season, alongside with higher goods exports and primary income balance offset stronger investment driven import demand.

Montenegrin data trends

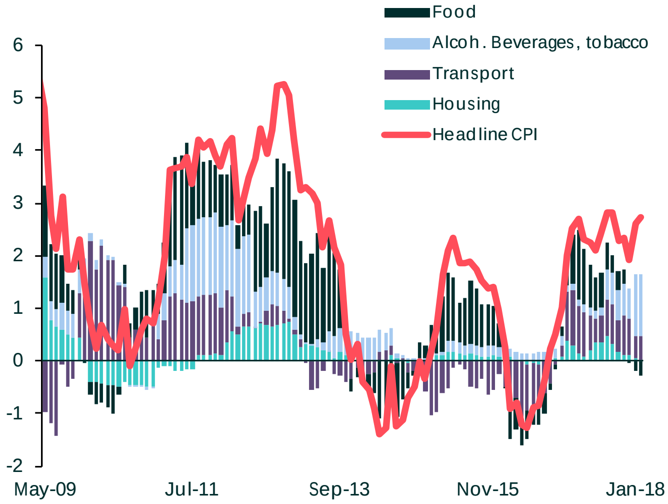
Budget revenue movements (EURm)



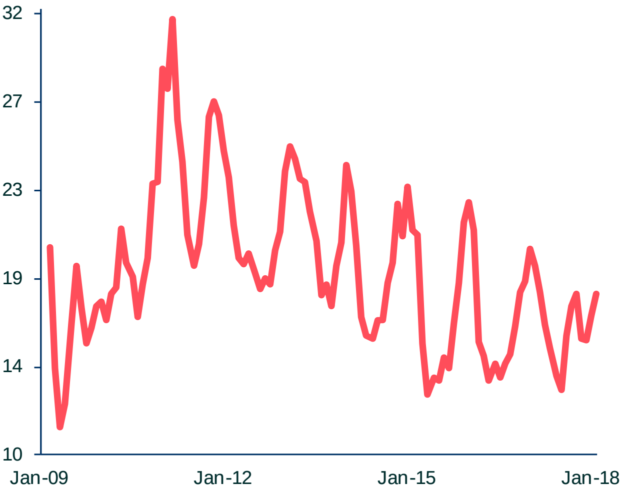
Industrial production (%, yoy)



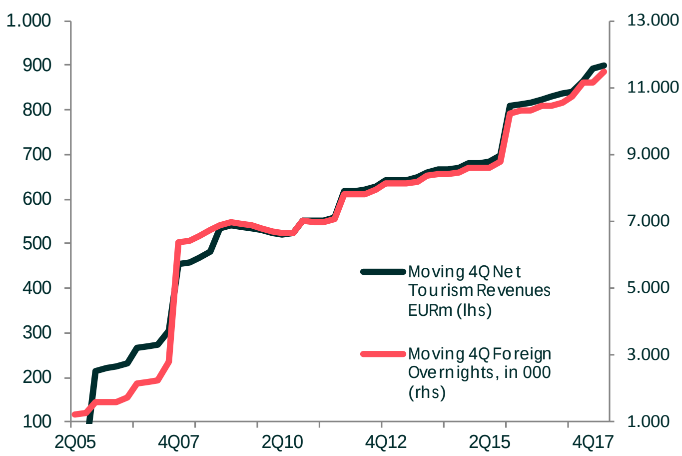
CPI by key contributions (pps)



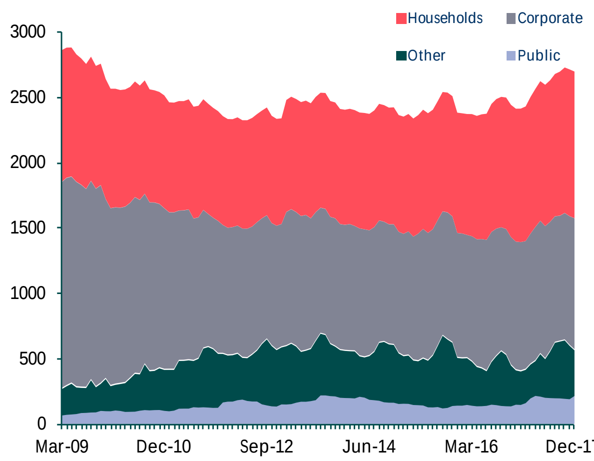
Merchandise import cover (%, 3mma)



Tourism



Gross loans by sector (EURm)



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	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	5,4	5,9
GDP per capita (EUR)	5.261	5.114	5.415	5.564	5.875	6.355	6.784	7.235	7.649
GDP per capita (USD)	7.327	6.577	7.191	7.391	6.516	7.037	7.660	8.643	9.484
Real GDP (constant prices YoY, %)	3,2	-2,7	3,5	1,8	3,4	2,9	4,3	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	-4,3	4,5	3,2
Unemployment rate (ILO, average %)	19,9	19,9	19,5	18,0	17,6	17,7	16,1	15,8	15,5
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	0,5	2,4	2,4	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	-5,4	-5,0	-3,5
Public debt	45,6	53,4	57,5	59,9	66,7	67,5	69,9	72,9	74,2
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	1,739	1,890	2,025
Import of goods and services (EURbn)	-2,082	-2,109	-2,066	-2,074	-2,214	-2,488	-2,762	-2,981	-3,163
Merchandise trade balance (EURbn)	-1,303	-1,384	-1,329	-1,376	-1,464	-1,657	-1,860	-2,012	-2,130
Merchandise trade balance (% of GDP)	-39,9	-43,5	-39,5	-39,8	-40,0	-41,9	-44,0	-44,7	-44,7
Tourism receipts (EURbn)	0,619	0,643	0,666	0,682	0,813	0,836	0,901	0,969	1,025
Current account balance (EURbn)	-0,573	-0,588	-0,487	-0,526	-0,483	-0,715	-0,799	-0,846	-0,872
Current account balance (% of GDP)	-17,6	-18,5	-14,5	-15,2	-13,2	-18,1	-18,9	-18,8	-18,3
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	11,2	11,6	11,8
FDI cover (%)	67,9	78,6	66,6	67,3	128,3	52,0	59,3	61,6	64,6
Gross international reserves (EURbn)	0,273	0,318	0,395	0,514	0,641	0,780	0,877	1,172	1,324
Import cover (months of imports)	1,6	1,8	2,3	3,0	3,5	3,8	3,8	4,7	5,0
Debt indicators									
Gross external debt (EURbn)	4,734	4,959	5,093	5,353	5,559	6,121	6,612	7,232	7,693
Government (EURbn)	1,460	1,295	1,352	1,646	2,061	2,187	2,358	2,526	2,651
Private (EURbn)	3,275	3,665	3,742	3,707	3,498	3,934	4,254	4,705	5,041
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	380,3	382,7	379,9
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,19	1,22	1,26
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,13	1,19	1,24
Money supply M1 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Broad money M3 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (% YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	11,8	7,1	5,2
ECB reference rate (end-year %)	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,20
EURIBOR 3M interest rate (average, %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,10

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	4.182	4.500	4.761
Assets (%, YoY)	-4,5	-0,1	5,4	6,0	10,7	9,2	10,3	7,6	5,8
Assets (% of GDP)	86,1	88,3	88,0	90,7	95,0	95,9	99,0	99,8	99,8
Gross loans (EURm)	2.359	2.342	2.414	2.367	2.386	2.416	2.701	2.893	3.044
Gross loans (%, YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	11,8	7,1	5,2
Gross loans (% of GDP)	72,3	73,6	71,8	68,5	65,3	61,1	63,9	64,2	63,8
Deposits (EURm)	1.817	1.981	2.098	2.308	2.625	2.871	3.267	3.514	3.748
Deposits (%, YoY)	1,5	9,0	5,9	10,0	13,7	9,4	13,8	7,6	6,7
Deposits (% of GDP)	55,7	62,3	62,4	66,7	71,8	72,6	77,3	77,9	78,6
Loan-to-deposit ratio (%)	129,8	118,2	115,1	102,6	90,9	84,1	82,7	82,3	81,2
Capital adequacy ratio (%)	16,5	14,7	14,4	16,2	15,5	16,1	17,6	18,4	19,0
Performance									
Net interest income (EURm)	106	106	104	111	117	122	125	135	139
Net interest income (%, YoY)	-4,8	-0,1	-1,6	6,6	5,3	4,2	2,4	7,8	3,2
Total operating income (EURm)	221	178	156	158	171	175	189	202	208
Total operating income (%, YoY)	42,6	-19,5	-12,0	1,2	8,3	1,9	8,2	6,8	3,2
Pre-provision profit (EURm)	114	65	48	46	52	53	59	66	66
Pre-provision profit (%, YoY)	114,7	-43,2	-26,7	-2,6	11,5	2,6	11,3	11,1	0,6
Provision charges (EURm)	124	121	44	21	53	44	22	35	45
Profitability and efficiency									
Net interest margin (%)	3,7	3,8	3,6	3,6	3,5	3,4	3,1	3,1	3,0
Pre-tax ROAA (%)	-0,3	-2,0	0,1	0,8	-0,1	0,3	0,9	0,7	0,5
Pre-tax ROAE (%)	-3,2	-18,7	1,0	6,0	-0,4	2,0	7,4	5,9	4,1
Cost-to-income ratio (%)	48,2	63,5	69,6	70,7	69,8	69,6	68,7	67,5	68,3
Operating expense (% of assets)	3,7	4,0	3,8	3,7	3,6	3,3	3,3	3,1	3,1
Credit quality and provisioning									
NPL ratio (%)	15,5	17,6	18,4	16,8	12,6	10,3	7,3	6,4	6,0
NPL coverage (%)	33,0	40,0	39,1	39,5	39,5	41,3	42,9	43,5	46,3
Provision charges (% of loans)	5,1	5,1	1,9	0,9	2,2	1,8	0,9	1,3	1,5
Provision charges (% of PPP)	108,5	185,7	92,5	45,6	103,2	82,2	37,2	53,3	67,5

Source: CBCG, Addiko research

Loan growth surprising on the upside

Overall loan growth in 2017 soared to 11.8% yoy (vs. 1.3% in 2016), just over our 11.2% expectations, with all sectors contributing positively. The main drivers of growth were retail loans which increased 10.3% yoy amid higher employment and wages and volatile 'other' loans (mostly financial institutions) with a 33.0% growth rate. Public sector loans increased by 43.0% yoy driven by highway construction, while corporate lending rose 2.7% yoy. Credit portfolio quality improved with NPL ratio falling to 7.3% at end-2017, as banks continued with selling of their non-performing portfolios or transferring them to the factoring companies. At the same time deposit growth accelerated to 13.8% (vs. 9.4% in 2016), with the strongest positive contribution coming from 11.1% increase in household deposits, given higher employment, wages and tourism earnings. Corporate deposits soared 21.2% thanks to a record tourist season, while public and 'other' sector contributed positively as well, with 8.6% and 21.7% growth respectively. Regarding profitability, pre-tax profit rose to record EUR37m on 21.7% higher non-interest income and 49.7% lower impairment costs.

Slower credit and deposit growth expected in 2018

In 2018, we expect credit activity decelerating to around 7.1% 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. With cleaner bank balance sheets, we expect corporate credit to accelerate amid generally stronger private capex, notably in tourism and energy. NPL ratio should decline towards 6.4% level as banks will continue resolving their non-performing portfolios. We see deposit collection also slowing down to around 7.6%, mostly due to high base effect and fiscal consolidation, which will have a negative impact on retail deposits. Although credit activity will reinforce NII growth, we expect somewhat lower level of pre-tax profit as higher opex and provisioning costs will offset the rising operating income.

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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