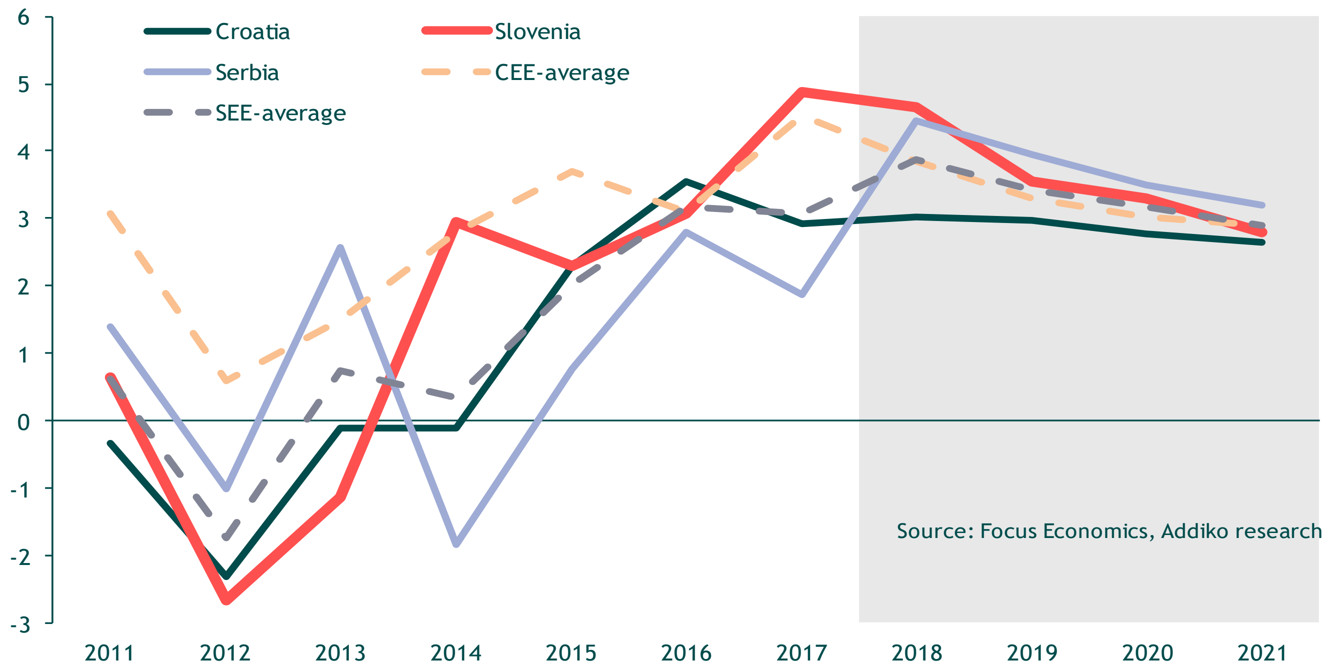
SEE Quarterly

Addiko Bank

28 September 2018

# ACCELERATION OVER BUT NO REVERSAL YET

## SEE GDP growth (%)






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

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

Consensus Economics Forecast Accuracy Award Winner Slovenia 2017

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2016

Consensus Economics Forecast Accuracy Award Winner 2014 Croatia

# EXECUTIVE SUMMARY

**Bottom LINE:** In We upgraded 2019 GDP growth forecast in Serbia by 0.5pp to 4.5% on of stronger-than-expected 2018 outcome, stronger investments and agriculture output. Elsewhere, we kept 2019 growth forecasts unchanged as favourable domestics demand development has largely compensated for concerns on the external demand front. In Croatia, we see 3% growth intact on above-trend EU demand, tourism boost, stronger disposable income, hiring and private consumption and stronger investment. While the growth in Slovenia has plateaued, it will stay above potential (3.6%) as solid export growth ahead as competitiveness gains, increased diversification and constant moves up the value chains offset signals of slowing EU upswing. That said, the SEE region (on average) is set to grow just above 3% both in 2018 and 2019. Inflation will likely remain similar or increase slightly in 2019 in all countries in the environment of increased retailers' competition, subdued import prices and stable local currencies. We see ongoing cyclical budget surpluses in most of the markets as well as narrower budget deficit in Montenegro as highway construction projects slow down.

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

*vs USD

**KEY POINTS:**

1. In Slovenia, we keep 4.7% GDP growth call in 2018 with downside risks from external trade, while in 2019 we keep 3.6% GDP growth forecast confident in solid export growth ahead as competitiveness gains, increased diversification and constant moves up the value chains offset signals of slowing EU upswing. In Croatia, we reiterate 2018 growth forecast at 3.0% for both 2018 and 2019 as we see the underlying 3% growth intact on above-trend EU demand, tourism boost, stronger disposable income, hiring and private consumption and stronger investment. In Serbia, we lift 2018 GDP forecast by 0.5pp to 4.5% due to strong 1H18, stronger investments and agriculture output stronger investments and agriculture output followed by also 0.5pp upgrade for 2019 to 4.0%, with investment one of the key drivers on the wings of manufacturing FDI, public capex, high firms' profits, cheap funding and corporate tax cuts in 2019. In Bosnia-Herzegovina, we keep 2017 and 2018 growth forecast at 3.1% and 3.5%, respectively on the back of delayed public capex. In Montenegro, we keep 2018 growth forecast at 4.0% before a slowdown to 3.0% in 2019 on fading highway construction activities.

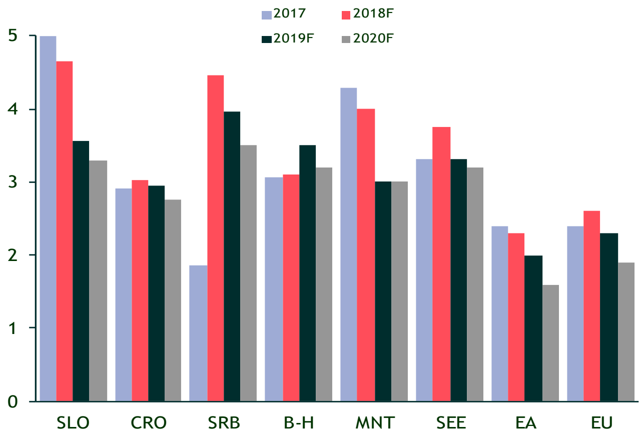
2. With Slovenia's budget surplus close to 1% of GDP in both 2018 and 2019 followed by ongoing decline in public debt, the new coalition will keep 2019 on auto-pilot before eventual new spending decisions in 2020. In Croatia, budget is on track to end 2017 with 0.5%/GDP surplus, and we see more of the same in 2019 on cyclically stronger tax revenues, further decline in interest spending (-4% after -12% in 2018), contained pension and wage outlays. In Serbia, we expect the budget surplus to drop to 0.5% of GDP followed by a return to balance in 2019, in both years due to public capex acceleration and in 2019 yet-to-be-defined wage tax cuts.

3. Slovenian inflation stabilized around 2% and will average 1.8% in both 2018 and 2019 as private consumption and tighter labour markets will keep upward price pressures alive, being partly offset by hard discounters and on-line sales. In Croatia, after an average 1.6% in 2017, we expect CPI inflation to remain around the same level in 2019 on stronger retailers' rivalry and VAT cuts, despite accelerating wages. In Serbia, we see the average 2018 CPI at 2.1% as the core inflation remains below the 3%+/-1.5pp NBS' target interval. Given the expected normalization in fresh food prices after better harvest in 2H18, decreasing pressure from fuel prices and stable dinar we cut the average 2019 inflation forecast to 2.6%.

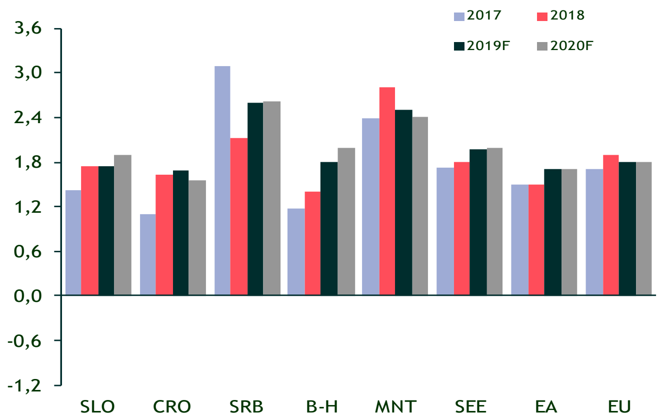
4. We expect gradual ECB policy normalisation combined of ceasing asset purchases at year-end, pushing out the first rate hike to 4Q19 and support to duration risk via QE reinvestment policy. We see Slovenian yields in sync with the development in core yields (no more than little spread widening) on thanks to macro/fiscal over-performance, proactive asset/liability management and strong cash cushion. While mandatory reserve cuts fit well in Croatia's accelerated ERM II bid, the CNB will in our view peg liquidity provision to assessment of demand for SME credit. We stay positive on Croatian credit on sustainable public debt slump, lower funding needs, stronger external metrics, reform appetite under ERM II 2020 entry aspirations, stronger growth potential (and reduced political/financial sector risks) upon Agrokor restructure and investment grade prospects. In Serbia, we expect the NBS to stay on hold through 2019 given the uncertain external backdrop, low domestic core inflation and stronger ECB's forward guidance. There is still some downside potential in long-term dinar yields on the back of GDP growth potential upgrades, strong fiscal results and lower funding needs, newest IMF policy anchor, stronger rating outlook and looming EM indices' inclusion.

# SEE data trends

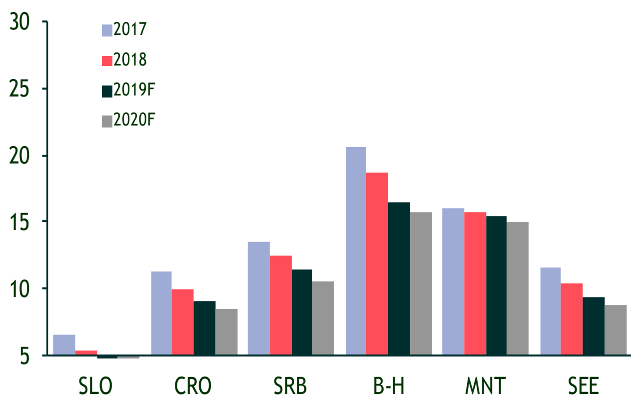
### Real GDP growth (%)



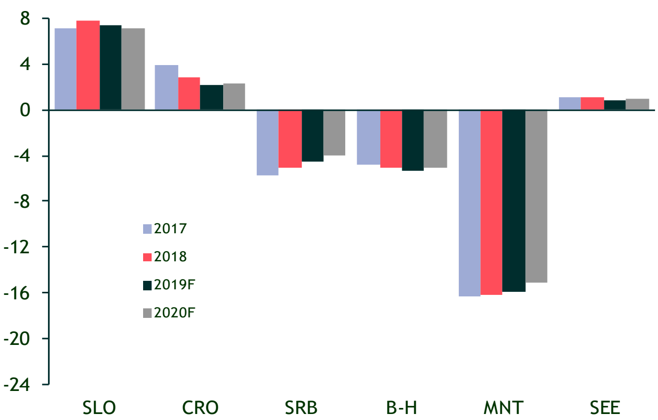

### CPI inflation (average, %, YoY)



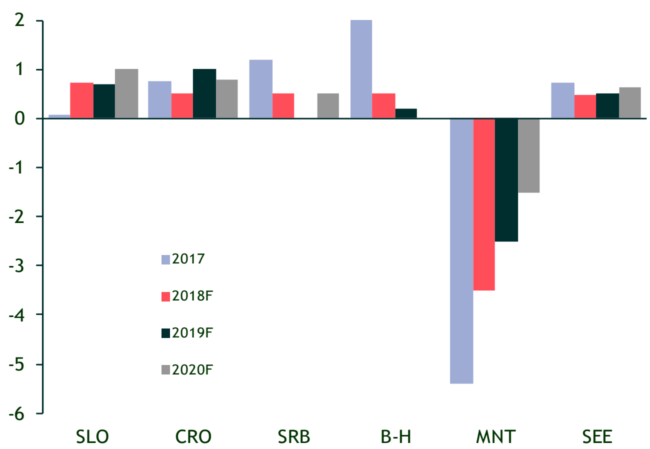

### Unemployment rate (ILO, average, %)



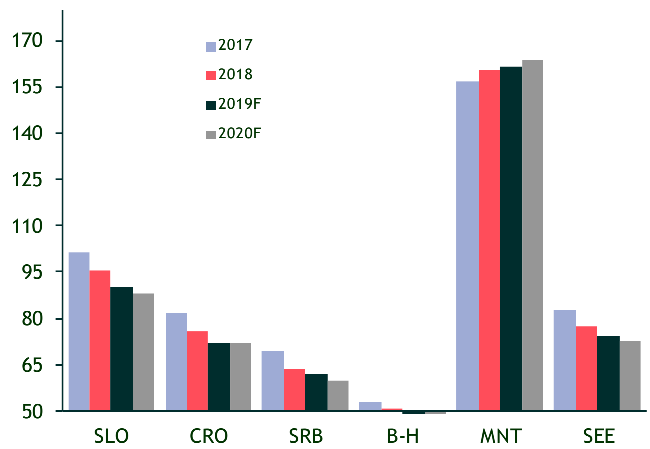

### Current account balance (% of GDP)




### Government balance (% of GDP)



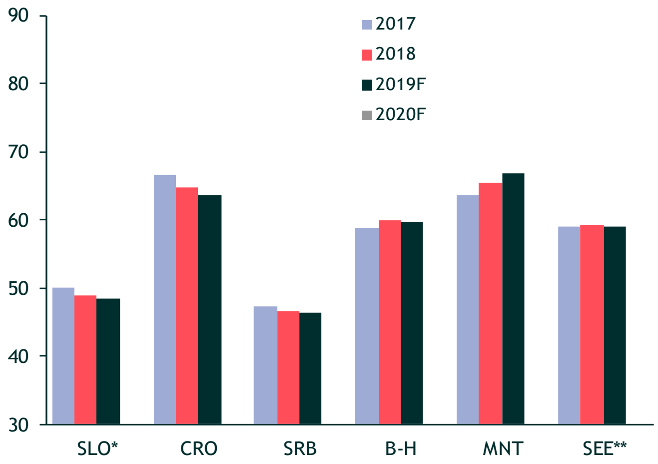

### Gross foreign debt (% of GDP)



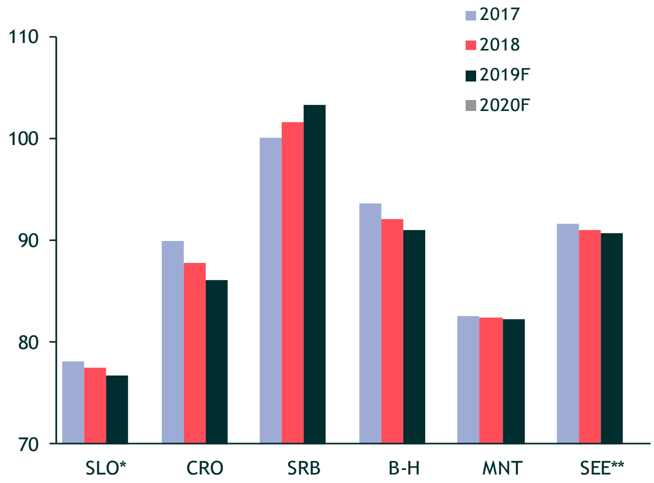

Source: National sources, Addiko research

# SEE banking sector trends

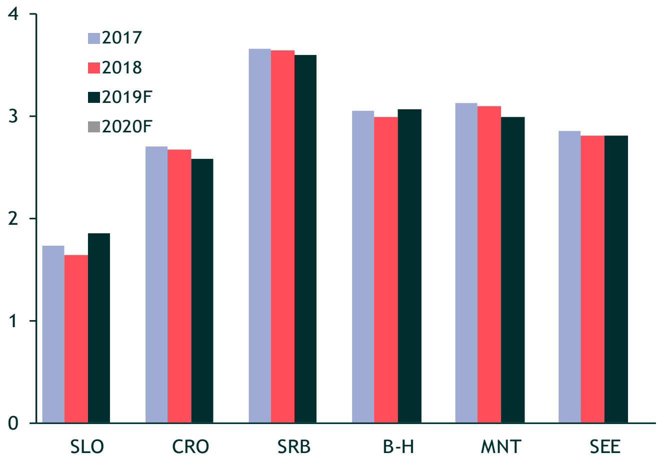
### Gross loans (% of GDP)



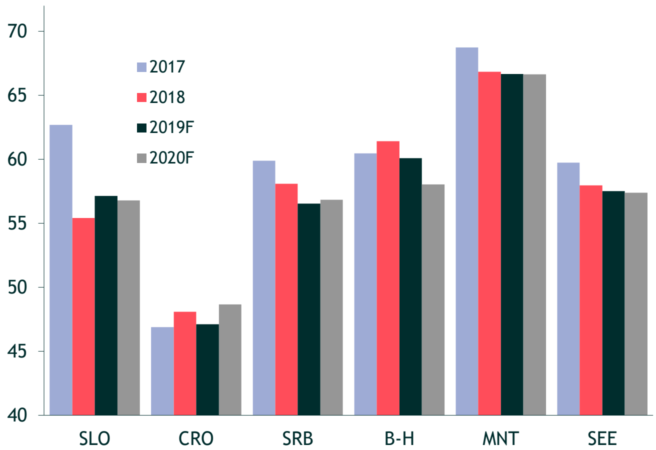

### Loan-to-deposit ratio (%)



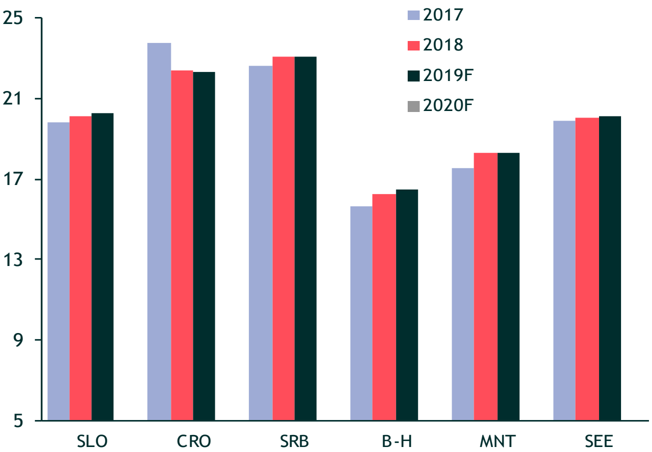

### Net interest margin (%)



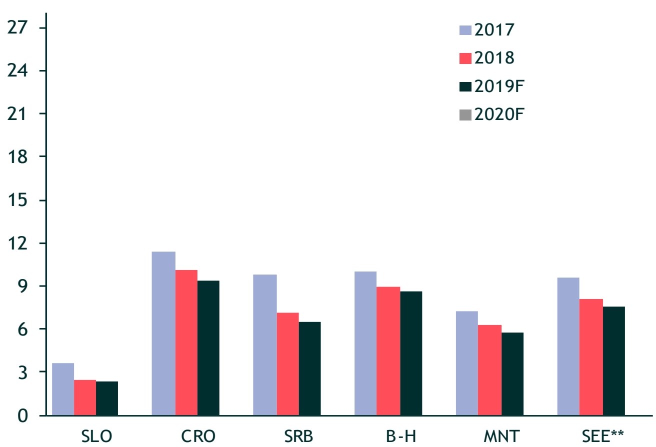

### Cost-to-income ratio (%)




### Capital adequacy ratio (%)




### NPL ratio (%)




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

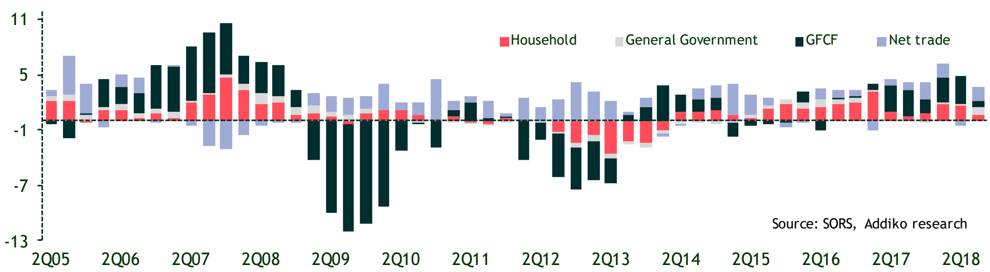
# Moving Forward at a Slower Pace

**GDP growth retains strong momentum as resilient local demand and ultra-loose monetary condition counter weaker external demand momentum and associated downside risks. Compared to earlier expectations, the brand-new political coalition could exhibit less fiscal profligacy and may not interfere into NLB privatization, but may not survive a full mandate due to heterogeneous interests, in our view. With sound financing position and no sudden changes in the ECB policy ahead, Slovenian base case is driven by macro/fiscal over performance, asset/liability management and rating upgrade prospects (S&P).**

***Momentum still matters...***

Despite disappointing local demand, Q2 growth (0.8% qoq, 4.3% yoy seasonally adjusted) met expectations as net trade added a hefty 1.6pp to total growth. Once again, exports (+9.3% yoy) stole the show as Germany also surprised on the upside in Q2 despite often-heard global trade skirmishes. Private consumption (+1.1% yoy) succumbed to weaker sentiment and milder wage growth, but still at odds with strong (~10% yoy) re-leveraging dynamics, soaring care sales and booming real-estate markets. Investments also disappointed (+2.9% yoy after mid-teens growth in previous two quarters) as PM Cerar's resignation left technical cabinet in place and big-ticket (EU-funded) infrastructure capex and some private projects came to a halt. As business sentiment supports GDP growth at 0.7% qoq/4% yoy pace in H2, we reiterate above-consensus 4.7% GDP growth call for 2018. The balance of risks is a bit on the downside mostly bound to weaker foreign demand i.e. more serious global trade disputes and escalating Italian situation.

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




***Growth has plateaued, but remains above-trend***

We keep 3.6% GDP growth forecast for 2019, confident in solid export growth ahead as competitiveness gains, increased diversification and constant moves up the value chains offset signals of slowing EU upswing. The last three months did not see material changes in broadly robust view on the euro zone's growth for 2019 (just below 2%), which together with noticeable improvement in domestic fundamentals and markedly reduced leverage may extend the current cycle at least into 2020, taking away some uncertainty for Slovenian exports and investments. Competitiveness has improved in terms of medium/high-tech goods share in total exports, contained unit labour cost despite tighter labour market, and the overall export market shares. While sentiment has weakened, we still see private consumption growth at 3% yoy on the heels of stronger wage and near-term employment outlook and re-leveraging. Hefty retained profits, fiscal expansion, stronger EU funding and cheap finance all drive investment, including export capacity expansion. Downside risks largely include slower euro zone growth, US-China trade spat (limiting European export potential) and Italy's economic downturn. While soaring tariffs my disrupt Sino-US supply chains and finally affect ~12% of world trade, Italy is more important than China as the share of domestic value added in final Italian demand (15% of exports) dwarfs that of Chinese. Positive surprises on global growth, fiscal expansion and state banks' privatization and stronger rebound in (public) capex pose the main upside risks.

***Inflation picks up? More moderate than it seems.***

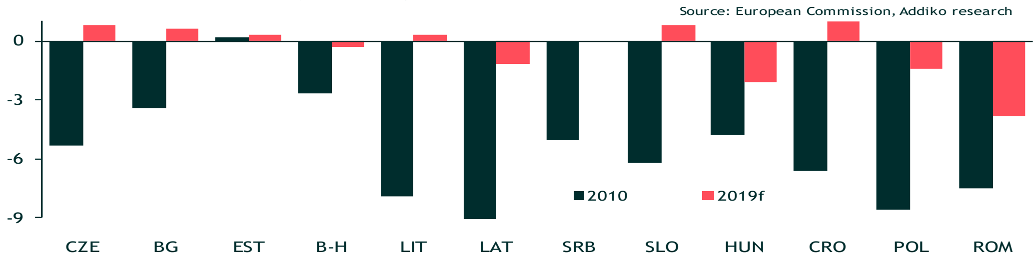
Most of the recent price pressures can be attributed to higher energy and tourism prices, which keeps headline inflation around 2% in the rest of the year and lead to the average 2018 CPI of 1.8%. Prolonged core inflation stickiness at low levels is consistent with developments in the euro zone where the non-wage component has recently overstated the overall labour cost growth, while the growth of the wage component has decelerated. The latter is consistent with somewhat slower-than-expected gradual return of area-wide underlying domestic inflation towards the ECB targets. While increased competition from hard discounters and online sales dampen retailers' margins, private consumption and tighter labour markets will keep upward pressure on prices alive. Going forward, we expect inflation to stabilize and fluctuate within 1.8%+/-0.2pp and average again 1.8% for 2019, in line with the euro zone average. With inflation target still below reach, the ECB looks set to be on hold for the foreseeable future, with a first (20bp-alike) rate hike in 4Q19 at the earliest. Once the ECB starts to hike, we expect an annual pace of hikes of only around 40bp-50bp.

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

We Another C/A surplus expansion in 2018 owes to stronger goods export growth, soaring tourism FC receipts and higher primary income surplus. The next year will see CA surplus moderation as import-intensive demand stays strong amid similar drivers and leads to lower goods trade surplus. As long as net external debt continues to decline and domestic banks' liquidity is ample, we expect a further improvement in the net international investment position towards -25% of GDP by end-2019, where Slovenia scores substantially better compared to A-rated median and highlights much lower external vulnerabilities compared to pre-2008 crisis period.

With sizeable C/A surplus, hefty 9%/GDP fiscal reserve and the MinFin actively eyeing sovereign debt restructuring options, funding position stays strong with average debt duration comfortably extended. We expect proactive debt management approach to continue, seeking further more favourable (re)financing opportunities against still benign ECB backdrop. FDI flows should pick-up with financial sector in the spotlight given the renewed privatization attempts for NLB bank now that ring-fencing from potential litigation costs of a Croatian court-ordered reimbursement of FC deposits from old Yugoslav-era removes one of the two main legal obstacles in investors' eyes. Clarity on NLB's ownership and strategic path will also help further NLB restructuring, enhance competition and in our view incentivise banking sector consolidation. Narrowing the group of 'strategic' SOEs that are not available for sale is of utmost importance to boost FDI and grow presence in the global value chains, both comparatively weak by euro zone standards.

**Slovenia: fiscal deficits (% of GDP)**




*Fiscal consolidation continues...*

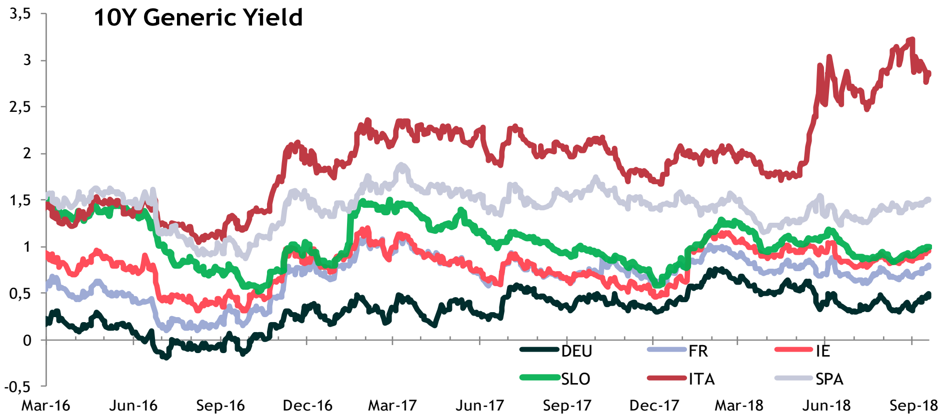
A EUR294.6m budget surplus in the year to July (vs. EUR107.6m shortfall a year ago) is driven by cyclically higher tax revenue (+6.2% yoy, from income, profit to VAT) vs. 1.5% higher spending. Despite public wage, pension and social transfer hikes, and healthcare overruns, subdued spending reflects interest cost slump in 2018 and somewhat unexpected public capex under-execution (unusual during election cycles). Adding to that a positive BAMC effect, we see 0.8%/GDP budget surplus in 2018, followed by a similar outcome in 2019 as the budget stays on auto-pilot, underpinned by tax-rich demand, further interest bill cuts, BAMC result and higher SOE dividends, while new spending decisions are pending and may only get into the 2020 budget. Despite costly spending wish list of five-party coalition, we understand the MinFin will comply with fiscal rules, being reasonable in the light of 1.5% structural budget gap and mitigation measures eagerly expected by the EC. By the looks so far the announced income cuts, electricity excise, higher healthcare contributions, lower corporate tax allowance for R&D and progressive real estate taxes may be revenue-neutral. The main uncertainty involves social transfers given the last year's 'temporary' EUR50m in social safety net and the coalition's dependence on a populist Leftist party. The EC-required structural adjustment of 0.65% of GDP in 2019 (similar to the official forecast of 0.7pp deterioration) as ever hinges on healthcare and pension reforms, and real estate taxation, without which the zero structural deficit target for 2020 is in danger.

*...as public debt and interest costs stay on a downward trend*

After the last year's drop below 74% of GDP on strong deficit reduction, we expect public debt to fall further in 2019-2020 close to 60% of GDP as budget surpluses persist, GDP growth continues above-trend and the MinFin runs down slightly hefty cash reserve (9% of GDP). This effectively brings the adjusted net public debt close to 52% by end-2020, with BAMC activity and state bank sell-offs (EUR1.85bn for 75% in NLB at 1.2x PBV) cutting down public debt even lower. At the same time, pre-funding operations for 2019 and interest cost savings management will likely combine further USD bond buybacks, lengthening of the euro yield curve and ALM transactions. With the final aim to lower the average nominal effective interest rate to 2.5% in 2020 from 3.1% in 2018 and 4.4% in the peak year 2014. We remind our readers that pro-active debt management has not just appeased risks to potential interest rate shock, but also brought about a significant reduction in the sovereign-banks nexus. In the medium term (beyond 2020), when GDP growth converges toward 2.5% on average, public debt reduction essentially depend on stronger reform content in further fiscal consolidation hopefully enacted in the next year or so. Further banking sector consolidation, development of alternative sources of funding for SMEs and SOEs' restructuring are equally important in mitigating the risks in public finance in the medium term.

***Stable bonds development***

In the past few months, Slovenian benchmark 10Y yield exhibited stable development around 0.90%, insensitive to the renewed risk aversion amid global trade tensions, EM volatility and escalating Italian risk. Strong macro/fiscal performance, further sovereign interest bill cuts as well as S&P's rating outlook upgrade have all offset concerns about governability, allowing Slovenian bonds to follow semi-core issuers in their stable spread performance vs. Bund yields. While the influential Fed's board member Brainard made it clear the Fed could do more than the market generally expected, Fed communications should support flatter curve over time and the risks to long-term Bund/Slovenian yields are balanced given the prolonged Italian political volatility and substantial QE reinvestment ahead. Even accounting for already high risk premium in BTPs, any negative development on ratings and Italy's creditworthiness would generate negative market response, with negative repercussions on bank stocks and corporate spreads.

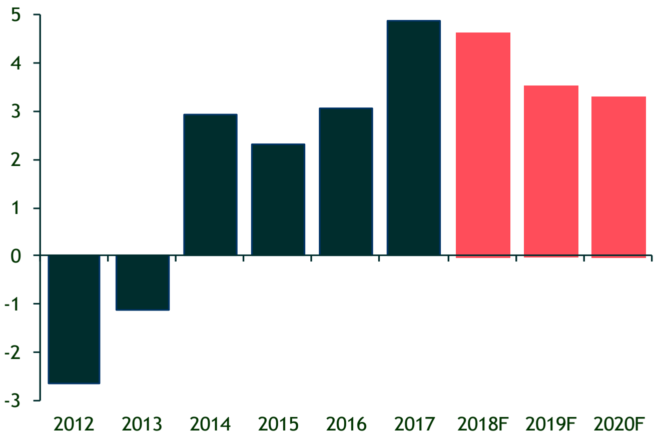



***The end of QE does not hurt Slovenian bonds...***

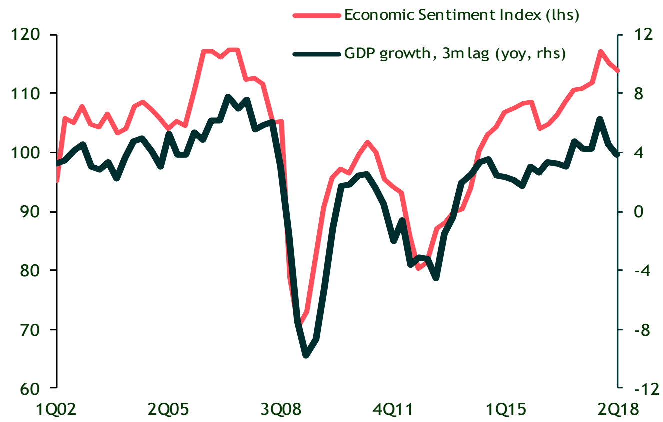
We expect the ECB to embark on the gradual path of monetary policy normalisation combined of ceasing asset purchases at year-end, pushing out the first rate hike to 4Q19 and support duration risk via reinvestment of maturing bonds on its balance sheet. While the ECB's speeches have endorsed the modest tightening priced in after a late 2019 lift off, the ECB policy has to manage downside risks emanating from trade wars, Brexit and Italy. Should the growth slow below trend and inflation undershoot again, the ECB would be compelled to ease monetary policy likely by diluting rate hike expectations and/or re-starting asset purchases. With Slovenia's extremely good financing position and the subsequent issuance at a slower pace, and no sudden changes in the ECB policy ahead, the Slovenian base case is driven by macro/fiscal over performance, proactive asset/liability management and hence future opportunistic cheaper prefunding (for 2019). That said, in the face of heated euro zone moments through Q4, Slovenian semi-core-perceived bonds will likely continue stable performance inside 45-60bp spread range above Bund. While the narrower and more benign expectation around 2019 budget compared to earlier announcements and commitment to NLB IPO are good news, we have to wait until populist noise within heterogeneous coalition in power drops out before assessing the risks to ongoing fiscal adjustment and structural reforms in the medium-term. As ever, positive risks for bond performance include further sovereign asset/liability management, successful NLB sale, above-trend GDP growth and ensuing rating upgrades that would all ensure faster public debt reduction closer to sub-50% single-A median.

# Slovenia's data trends

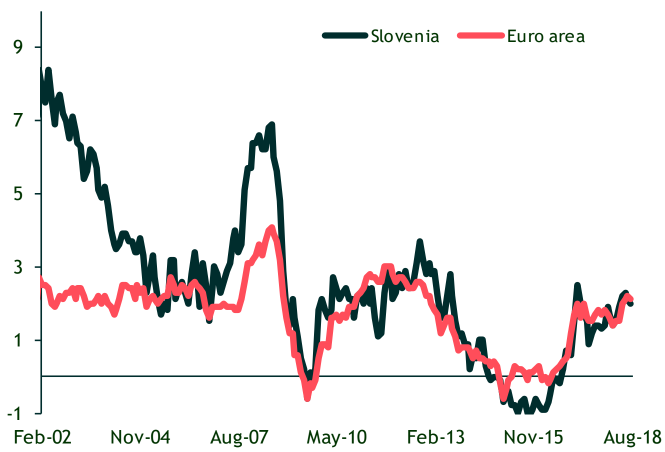
### Real GDP growth (% YoY)



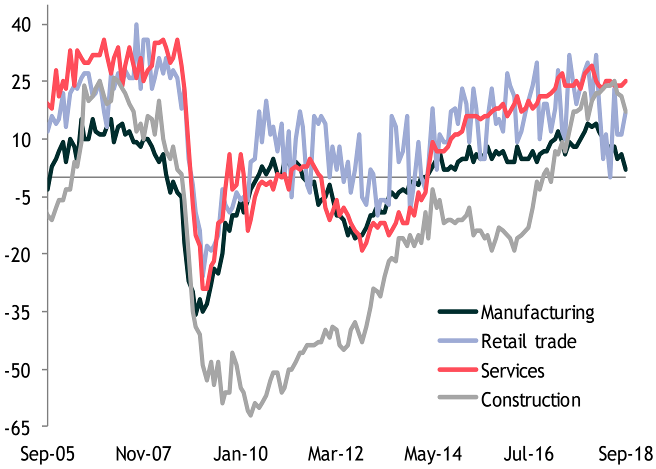

### Economic confidence vs. GDP growth



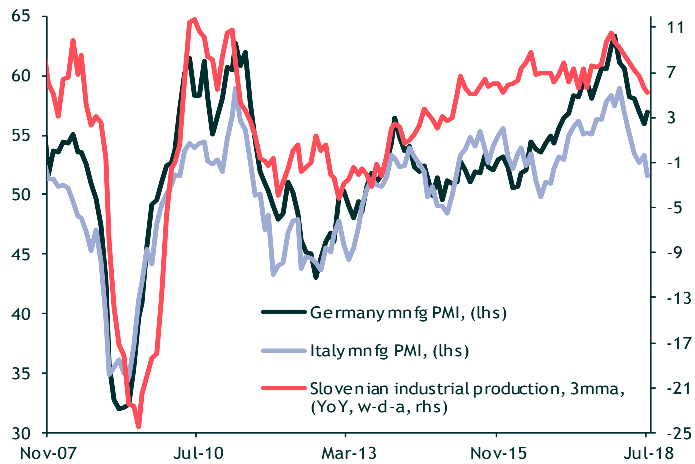

### CPI inflation dynamics (% YoY)



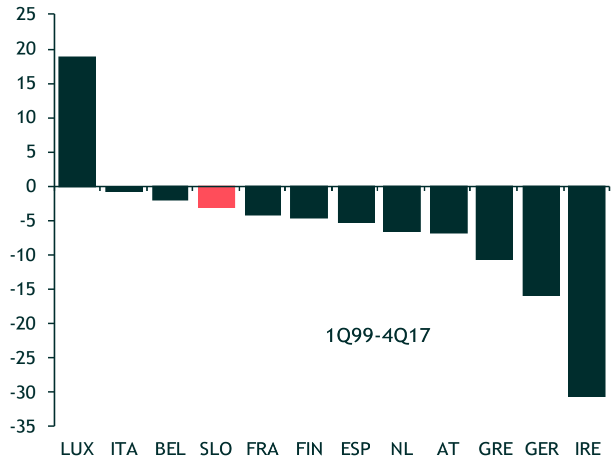

### SLO: Business sentiment




### 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

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | | |
| Nominal GDP (EURbn, current prices) | 36,1 | 36,2 | 37,6 | 38,9 | 40,4 | 43,0 | 45,8 | 48,2 | 51,0 |
| Nominal GDP (USDbn) | 46,4 | 48,1 | 50,0 | 43,1 | 44,7 | 48,6 | 54,0 | 57,2 | 61,7 |
| GDP per capita (EUR) | 17.538,2 | 17.591,8 | 18.244,4 | 18.839,4 | 19.551,1 | 20.814,1 | 22.152,0 | 23.336,1 | 24.537,7 |
| GDP per capita (USD) | 22.554,1 | 23.363,7 | 24.237,7 | 20.894,9 | 21.650,7 | 23.501,2 | 26.139,3 | 27.653,3 | 29.813,3 |
| Real GDP (constant prices YoY, %) | -2,7 | -1,1 | 3,0 | 2,3 | 3,1 | 4,9 | 4,7 | 3,6 | 3,3 |
| Private consumption (YoY, %) | -2,4 | -4,2 | 1,9 | 2,3 | 4,0 | 1,9 | 3,5 | 2,9 | 2,7 |
| Fixed investment (YoY, %) | -8,8 | 3,2 | 1,0 | -1,6 | -3,7 | 10,7 | 8,7 | 7,5 | 5,7 |
| Industrial production (YoY, %) | -0,8 | -0,9 | 1,7 | 5,1 | 7,8 | 8,3 | 6,5 | 6,0 | 5,5 |
| Unemployment rate (ILO, average %) | 8,9 | 10,1 | 9,7 | 9,0 | 8,0 | 6,6 | 5,5 | 5,0 | 4,8 |
| **Prices** | | | | | | | | | |
| CPI inflation (average % YoY) | 2,6 | 1,8 | 0,2 | -0,5 | -0,1 | 1,4 | 1,8 | 1,8 | 1,9 |
| CPI inflation (end-year % YoY) | 2,7 | 0,7 | 0,1 | -0,5 | 0,5 | 1,7 | 1,8 | 1,6 | 2,0 |
| PPI inflation (average % YoY) | 0,9 | 0,3 | -0,6 | -0,2 | -1,4 | 2,2 | 2,1 | 2,4 | 2,6 |
| Net wage rates (% YoY, nominal) | 0,4 | 0,6 | 0,8 | 0,7 | 1,8 | 2,7 | 3,4 | 3,3 | 2,4 |
| **Fiscal balance (% of GDP)** | | | | | | | | | |
| State budget balance (ESA-95) | -4,0 | -14,7 | -5,5 | -2,9 | -1,9 | 0,1 | 0,8 | 0,8 | 1,0 |
| Public debt | 53,8 | 70,4 | 80,3 | 82,6 | 78,7 | 74,1 | 68,8 | 64,8 | 61,0 |
| Gross public funding needs | 8,2 | 19,3 | 14,5 | 6,4 | 9,7 | 6,4 | 5,0 | 5,3 | 2,8 |
| **External balance** | | | | | | | | | |
| Export of goods and services (EURbn) | 26,363 | 27,010 | 28,520 | 29,975 | 31,478 | 35,737 | 38,703 | 41,590 | 43,649 |
| Import of goods and services (EURbn) | 24,934 | 24,569 | 25,641 | 26,569 | 27,690 | 31,457 | 34,244 | 37,224 | 39,196 |
| Merchandise trade balance (EURbn) | -0,081 | 0,708 | 1,181 | 1,476 | 1,537 | 1,561 | 1,699 | 1,607 | 1,703 |
| Merchandise trade balance (% of GDP) | -0,2 | 2,0 | 3,1 | 3,8 | 3,8 | 3,6 | 3,7 | 3,3 | 3,4 |
| Tourism receipts (EURbn) | 2,008 | 2,043 | 2,060 | 2,098 | 2,190 | 2,434 | 2,580 | 2,703 | 2,800 |
| Current account balance (EURbn) | 0,775 | 1,594 | 2,179 | 1,760 | 2,224 | 3,077 | 3,570 | 3,569 | 3,552 |
| Current account balance (% of GDP) | 2,1 | 4,4 | 5,8 | 4,5 | 5,5 | 7,2 | 7,8 | 7,4 | 7,0 |
| Net FDI (EURbn) | 0,5 | 0,0 | 0,6 | 1,3 | 0,9 | 0,4 | 1,2 | 1,3 | 1,5 |
| FDI (% of GDP) | 1,3 | 0,1 | 1,6 | 3,3 | 2,1 | 1,0 | 2,6 | 2,6 | 3,0 |
| FDI cover (%) | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| Gross international reserves (EURbn) | 0,722 | 0,669 | 0,837 | 0,760 | 0,700 | 0,800 | 0,800 | 0,800 | 0,800 |
| Import cover (months of imports) | 0,3 | 0,3 | 0,4 | 0,3 | 0,3 | 0,3 | 0,3 | 0,3 | 0,2 |
| **Debt indicators** | | | | | | | | | |
| Gross external debt (EURbn) | 42,872 | 41,658 | 46,314 | 46,627 | 44,810 | 43,813 | 44,273 | 44,973 | 46,223 |
| Government (EURbn) | 11,092 | 15,459 | 22,416 | 24,824 | 22,953 | 21,769 | 22,219 | 22,419 | 23,669 |
| Private (EURbn) | 25,709 | 23,457 | 21,815 | 19,587 | 18,400 | 18,224 | 18,554 | 19,054 | 19,254 |
| Gross external debt (% of GDP) | 118,8 | 115,0 | 123,2 | 120,0 | 111,0 | 101,9 | 96,7 | 93,2 | 91,1 |
| Gross external debt (% of exports) | 162,6 | 154,2 | 162,4 | 155,6 | 142,4 | 122,6 | 114,4 | 108,1 | 105,9 |
| **Exchange rates and money growth** | | | | | | | | | |
| EUR/USD (end-year) | 1,32 | 1,38 | 1,21 | 1,09 | 1,05 | 1,19 | 1,15 | 1,23 | 1,26 |
| EUR/USD (average) | 1,29 | 1,33 | 1,33 | 1,11 | 1,11 | 1,13 | 1,18 | 1,19 | 1,22 |
| Money supply M1 (% YoY)* | 4,4 | 0,1 | 18,5 | 24,9 | 17,1 | 16,0 | 10,4 | 9,7 | 0,0 |
| Broad money M3 (% YoY)* | -1,4 | -1,3 | 6,1 | 4,6 | 7,1 | 7,8 | 6,8 | 5,2 | 0,0 |
| Domestic credit (% YoY) | -5,8 | -21,4 | -11,5 | -5,9 | 1,3 | 4,8 | 4,2 | 4,1 | 0,0 |
| ECB reference rate (end-year %) | 0,75 | 0,25 | 0,05 | 0,05 | 0,00 | 0,00 | 0,00 | 0,00 | 0,50 |
| EURIBOR 3M interest rate (average %) | 0,58 | 0,22 | 0,21 | -0,02 | -0,18 | -0,33 | -0,32 | -0,30 | 0,10 |
| SLO 5Y yield (average %) | 4,55 | 4,35 | 2,14 | 1,64 | 0,70 | 0,33 | 0,45 | 0,84 | 1,20 |
| SLO 10Y yield (average %) | 6,01 | 5,87 | 3,28 | 1,67 | 0,82 | 1,12 | 1,00 | 1,40 | 1,65 |

* 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

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Balance sheet** | | | | | | | | | |
| Assets (EURm) | 46.125 | 40.344 | 38.714 | 37.383 | 37.050 | 37.946 | 39.004 | 39.695 | 40.668 |
| Assets (%, YoY) | -5,4 | -12,5 | -4,0 | -3,4 | -0,9 | 2,4 | 2,8 | 1,8 | 2,5 |
| Assets (% of GDP) | 127,9 | 111,3 | 102,9 | 96,3 | 91,7 | 87,7 | 84,7 | 81,8 | 79,7 |
| Net loans (EURm) | 30.964 | 24.338 | 21.540 | 20.275 | 20.534 | 21.523 | 22.431 | 23.353 | 24.294 |
| Net loans (%, YoY) | -5,8 | -21,4 | -11,5 | -5,9 | 1,3 | 4,8 | 4,2 | 4,1 | 4,0 |
| Net loans (% of GDP) | 85,8 | 67,2 | 57,3 | 52,2 | 50,8 | 49,7 | 48,7 | 48,1 | 47,6 |
| Deposits (EURm) | 23.856 | 22.550 | 24.426 | 25.140 | 26.133 | 27.528 | 28.956 | 30.420 | 32.043 |
| Deposits (%, YoY) | -1,3 | -5,5 | 8,3 | 2,9 | 3,9 | 5,3 | 5,2 | 5,1 | 5,3 |
| Deposits (% of GDP) | 66,1 | 62,2 | 64,9 | 64,7 | 64,7 | 63,6 | 62,9 | 62,7 | 62,8 |
| Loan-to-deposit ratio (%) | 129,8 | 107,9 | 88,2 | 80,6 | 78,6 | 78,2 | 77,5 | 76,8 | 75,8 |
| Capital adequacy ratio (%) | 11,9 | 14,0 | 19,2 | 20,8 | 20,8 | 19,8 | 20,1 | 20,3 | 20,5 |
| **Performance** | | | | | | | | | |
| Net interest income (EURm) | 886 | 708 | 832 | 746 | 670 | 652 | 652 | 693 | 707 |
| Net interest income (%, YoY) | -12,9 | -20,1 | 17,5 | -10,4 | -10,2 | -2,7 | 0,0 | 6,2 | 2,1 |
| Total operating income (EURm) | 1.566 | 1.091 | 1.231 | 1.158 | 1.127 | 1.075 | 1.183 | 1.165 | 1.189 |
| Total operating income (%, YoY) | 8,2 | -30,3 | 12,8 | -6,0 | -2,6 | -4,6 | 10,1 | -1,6 | 2,1 |
| Pre-provision profit (EURm) | 823 | 370 | 544 | 472 | 460 | 401 | 528 | 499 | 514 |
| Pre-provision profit (%, YoY) | 22,8 | -55,0 | 47,0 | -13,3 | -2,5 | -12,8 | 31,5 | -5,3 | 2,9 |
| Provision charges (EURm) | 1.599 | 3.809 | 650 | 313 | 96 | -43 | -100 | 24 | 45 |
| **Profitability and efficiency** | | | | | | | | | |
| Net interest margin (%) | 1,9 | 1,6 | 2,1 | 2,0 | 1,8 | 1,7 | 1,7 | 1,9 | 1,9 |
| Pre-tax ROAA (%) | -1,6 | -8,0 | -0,3 | 0,4 | 1,0 | 1,2 | 1,6 | 1,2 | 1,2 |
| Pre-tax ROAE (%) | -20,3 | -92,9 | -2,7 | 3,7 | 8,1 | 9,5 | 12,8 | 9,2 | 8,8 |
| Cost-to-income ratio (%) | 47,4 | 66,1 | 55,8 | 59,3 | 59,2 | 62,7 | 55,4 | 57,1 | 56,8 |
| Operating expense (% of assets) | 1,6 | 1,7 | 1,7 | 1,8 | 1,8 | 1,8 | 1,7 | 1,7 | 1,7 |
| **Credit quality and provisioning** | | | | | | | | | |
| NPL ratio (%) | 14,4 | 13,4 | 11,9 | 9,9 | 5,5 | 3,7 | 2,5 | 2,4 | 2,2 |
| NPL coverage (%) | 42,7 | 56,8 | 60,8 | 65,0 | 65,2 | 66,8 | 64,9 | 65,3 | 65,5 |
| Provision charges (% of loans) | 3,4 | 8,8 | 1,6 | 0,8 | 0,3 | -0,1 | -0,3 | 0,1 | 0,1 |
| Provision charges (% of PPP) | 194,3 | 1.029,2 | 119,5 | 66,4 | 20,9 | -10,6 | -19,0 | 4,7 | 8,8 |

Source: BSI, Addiko research

***Private sector credit accelerating***

Lending activity increased moderately in the year to July, with 1.6% ytd net loans growth carried by higher private sector lending, while public sector continued down the de-leveraging path. Retail loans increased 3.7% ytd supported by strong economic fundamentals, improved labour market conditions and persistently low interest rates. Corporate loans also picked-up, although at somewhat slower pace of 2.9% ytd. Meanwhile, deposit growth accelerated to 2.9% ytd in July, driven by 4.7% ytd higher households' deposits, reflecting traditionally strong savings propensity of Slovenian savers, even against the odds of low interest rates on savings. Corporate deposits followed with 1.3% ytd growth owing to higher 1H18 earnings, while government deposits continued decelerating at 5.8% ytd. Regarding profits, NII increased by 3.4% yoy as interest income finally showed some signs of recovery with modest 0.7% yoy growth, supported by 13.8% yoy lower funding costs. Additionally supported by higher non-interest income and lower operating costs, the banking sector thus manifested strong earnings till July, with EUR377m pre-tax profit (21.7% yoy).

***Economic prospects support credit activity going forth***

Despite private sector lending activity developing according to our expectations, we lowered our 2018 credit growth forecast by 1.2pp to 4.2% owing to much stronger de-leveraging dynamics from the public side, while for 2019 we expect similar pace of 4.1%. We expect strong retail loans growth to continue on favourable employment conditions and disposable income growth, in the context of easier and cheaper financing access, with still relatively low indebtedness. Solid investment outlook and export activity bode well for corporate loan demand, while strong bank competition might appeal even to clients inclined towards internal funding sources. With NPL ratio already reaching low 2.8% in July, we expect limited decline potential, mainly on the account of SME NPL resolution efforts, while the new lending cycle could increase pressures on credit quality in the medium term. We see deposit collection moderating towards 5.1% in 2019, owing to high base effects and stronger capex needs, in the environment of persistently low interest rates. On profitability, 2018 will see strong profit increase amid provisions release, with trend reversal in 2019, when new provisioning costs will bring about lower profit level, despite strong NII and contained opex growth.

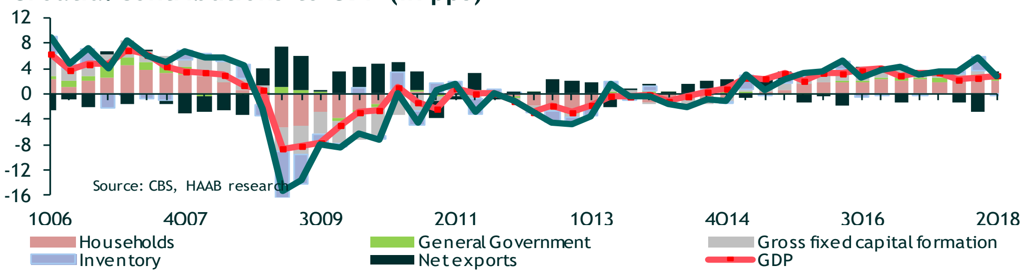
# Entering Investors' Radar Screen

**Growth stays robust at 3% this year and next as stronger domestic demand, another record tourist season, fiscal impulse and accelerated EU funding offset weaker external demand momentum. The budget is on track to end 2018 with 0.5%/GDP surplus, and we see more of the same in 2019 on cyclically stronger tax revenues, further decline in interest spending, contained pension and wage outlays. We stay positive on Croatian credit on sustainable public debt slump, lower funding needs, stronger external metrics, reform appetite under ERM II 2020 entry aspirations, stronger growth potential (and reduced political/financial sector risks) upon Agrokor restructure and investment grade prospects.**

***A temporary slowdown, not a turning point...***

GDP growth has hit 3% pace again after a soft patch last winter, driven by robust private consumption, stellar tourist season, solid external demand and easy monetary policy. With strong consumer momentum, tourism records and robust sentiment offsetting investment underperformance in H1 and the weakness from abroad, we retain above-consensus 2018 GDP forecast at 3.0%. Private consumption does not only rest on tourism spill-overs and World Cup fever, but citizens benefit from higher real wages (+4% yoy on top of 2.5%-alike employment growth), re-leveraging, tax cuts and remittances. Strong overall demand outlook, accelerating bank lending amid easier SMEs' access to credit, pick-up in EU funding, record SMEs' profits (+13.0% yoy in 2017), resurgent new-building works and low interest rates all fuel investments. While exports keep pace in H2 on stronger manufacturing activity and tourism services, robust local demand and commodity price normalization will see net trade contribute negatively.

**Croatia: contributions to GDP (in pps)**




***Stronger potential growth needed to shield from shocks***

With a lag Croatia' is adopting EC standards in business climate and services liberalization but the effects of those will not last long in the absence of public sector right-sizing, privatization and entitlement reforms as the political cycle matures. Hence, the cabinet is using the same magic - HRK2.7bn/0.7%/GDP tax cuts - combined by gradual red tape cuts, ultra-easy monetary policy, interest bill cuts, education reform and targeted demographic spend. While Agrokor risks abate after widely-supported debt settlement, we see 3% growth intact on above-trend EU demand, tourism boost, stronger disposable income, hiring and private consumption, plus capex on the wings of EU funding, construction, policy-induced optimism and retained profits. To ensure 3% growth medium-term, we need a more demonstrable proof that competitiveness of private firms can be sustained via liberalization, labour flexibility and innovation policy, and associated with higher probability to export. The risks to our baseline are balanced, even if downside risks from softer EU demand, financial market volatility, labour shortages and high net emigration, corporate de-leveraging and political risks amid Agrokor restructuring gained prominence. Even if the leading HDZ party gained popularity at the expense of rivals, the rise of populism in case of distressed sectors rescues, expropriation of banks, etc. makes it difficult for slim political majority to run bolder reforms in the short run. Upside risks involve tourism overshooting, EU funding, rating upgrades and more fiscal easing ahead of 2020 elections.

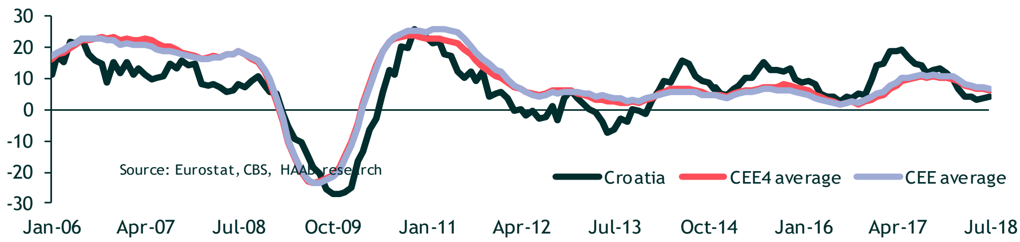
***Headline inflation likely peaked, but core set to keep firming***

While the recent strong increases in energy and tourism prices pushed CPI inflation above 2% and the average 2018 CPI forecast to 1.6%, we expect it to fall below back below 2% in the rest of 2018 on weaker imported food inflation and substantial base effects. There are signs of subsiding core inflation momentum (excluding energy and food) amid structural changes in retail trade, including growing influence of hard-discounters, competition for Agrokor's retail space and the growing online retailers' price signals to brick-and-mortar stores. However, we expect the Q4 CPI softness will be temporary as we expect administrative energy-related price hikes in 2019 and higher wheat and meat prices as an aftermath of recent heat waves in Europe. Moreover, upside risks from accelerating wage pressure, foreign tourists' demand and the recent output gap closure, but are mitigated by decreasing pressure from fuel prices, VAT cuts on some food items and citizens' de-leveraging out of stronger disposable income. All said, after an average 1.6% in 2018 (one of the lowest in the EU), we see

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

The euro zone GDP growth domestic-demand-driven stabilization and noticeable improvement in Croatian exporters' business fundamentals bode well for export market share gains and the total export growth this year and next one. Competitiveness gains based largely on hefty tax cuts have hit limits, requiring bolder red tape cuts and productivity gains in non-price area (including corporate governance). Stronger consumer and investment demand, higher commodity prices and corporate credit recovery underpin imports as well, leading to higher goods trade gap and lower C/A surplus next year. Still, stably higher services surplus on the wings of tourism activity and stronger EU funding and remittances will on our estimates keep C/A surplus above 2% of GDP. Foreign debt slump owing to hefty firms' profits used to pay down debts and Agrokor-related write-offs, high banks' net foreign assets and portfolio as well as FDI inflows all support a significant improvement in the net international investment position towards -50% of GDP in 2019 from -71% in 2016.

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




***Finding the right pace of monetary accomodation***

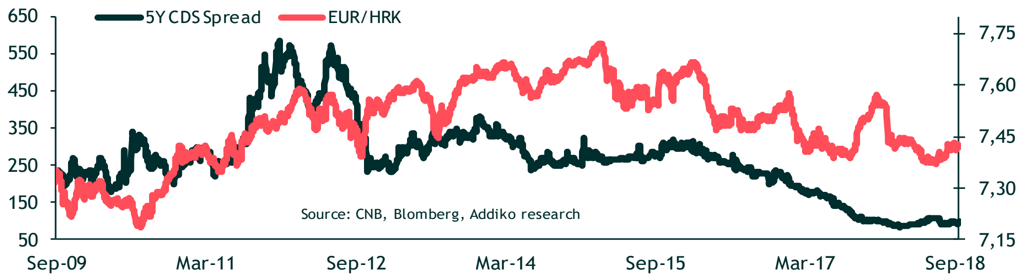
As long as the ECB continued to suggest monetary policy will remain 'accommodative', we expect the CNB to staying in its easing mode by targeting the excessive kuna liquidity at 8%+ of GDP at least in 2019 on top of FC liquidity surplus above 5% of GDP. The expected end of the net bond purchases by end-2018 does not certainly mean imminent tightening since the ECB will reinvest QE holdings. Abundant monetary support accompanied by marked reduction in domestic leverage and banks' de-risking in mature phase and solid macro anchor short-term rates at record lows and support private-sector re-leveraging. While mandatory reserve cuts fit well in Croatia's accelerated ERM II bid, the CNB will in our view peg any significant liquidity provision to assessment of SME demand since large corporate anyhow borrow externally and retail loans are overfunded with record cheap deposits. While households' exposure to variable interest rate and FX risks and the overall systemic vulnerability (including solvency, liquidity and snowball effect risks) are noticeably reduced, floating retail loans still dominate, bolstering the case for ample long-term kuna funding options like long-term FX swaps, longer/cheaper REPO facility or interest rate swaps. Thankfully, there won't be ECB rate hikes by at least 4Q19, and the CNB has ample liquidity arsenal (e.g. stronger REPO capacity) to support its bank lending objective even after the ECB starts normalizing ultra-easy policy. Risk-wise, improving private-sector external positions, fiscal healing and stable kuna allow the CNB's easy stance. As before, banks need unambiguous criteria for automatic NPL resolution, tax incentives, capital raising platforms and faster insolvency mechanisms that help arrest cost of risk and facilitate monetary transmission.

***EUR/HRK in narrow range***

The EUR/HRK stubborn stability around 7.40 this summer reflects the lack of last years' foreign tourist nights overshooting and some uncertainty surrounding the belated approval of the new CNB board. As expected the kuna did not react to EM jitters as fundamentals factors (sovereign risk profile, BoP) bode well for mild appreciation in the future. Given the kuna stability, much higher interbank excess liquidity (on annual basis), short-end rates stayed record low. Despite a major EM sell-off in Q3, CEE assets are largely isolated thanks to the region's safe haven status on lower external/fiscal vulnerability and flexible monetary space, all of which leaves CEE better positioned for a significant change of financial conditions. Croatian bonds outperformed (trading below higher-rated Romania) on the heels of Fitch rating outlook upgrade to positive (last step ahead of investment grade status) on rosier public and external debt outlook and ERM II bid prospects, which helps reduce sensitivity to EM jitters and local political infighting.

Despite steady C/A and firmer external position outlook, we see FX rate normalization in the upper half of the 7.40-7.50 band in Q4 on weakening impact of FC tourist inflow and stronger consumer and investment-driven imports. As seen last years, tourism-related FX supply overhang may though last, which could be well accompanied by stronger EU funding as opposed to last year's undershooting. That would certainly force the CNB to intervene due to its competitiveness consideration as exports of goods and services (48.9% of GDP in 2017) for the first time exceed corporate FC and FX linked debt (44.6% of GDP), and improving goods trade cover help justify the CNB's FX considerations. Finally, stable/slightly stronger kuna at year-end bodes well for improvement in closely-watched end-year public debt metrics as the country prepares to start ERM II entry talks.

**Croatia: 5Y CDS spreads and EUR/HRK**




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

With the CNB's ultra-easy liquidity in place, still gradual bank lending recovery and steady kuna, we see short-end rates record low. Despite surging kuna disbursements, new volumes overall are insufficient to have a material impact on MM rates. In a more challenging EM environment in terms of growth/trade and financial conditions, falling EM inflows and the overall lack of conviction, investors may now take profit on Croatia's recent bond outperformance. The next months will be anyhow challenging for CEE assets due to Italian sovereign risk, as Croatian risk exhibits high (long-term) albeit diminishing correlation. Given, however, Italy's willingness to eventually deliver a conservative 2019 budget law, subsequent drop in Italian risk and calming of trade tension between the US and EU, we think the major risk events can be avoided. In the medium term, we stay positive on Croatian credit on sustainable public debt slump, stably lower funding needs, stronger external metrics, resilient reform agenda under the ERM II 2020 entry aspirations, stronger growth potential (and reduced political/financial sector risks) upon Agrokor operating restructure and viable investment grade prospects. For this to happen we also need benign global financing conditions (dovish Fed, no ECB real rate hikes in the next years) and CEE spreads decoupled from EMBI. The major disruptors to our baseline are Italian rating downgrades, soaring US real yields and term premium and liquidity events like the VIX spike.

***Fiscal overperformance continues...***

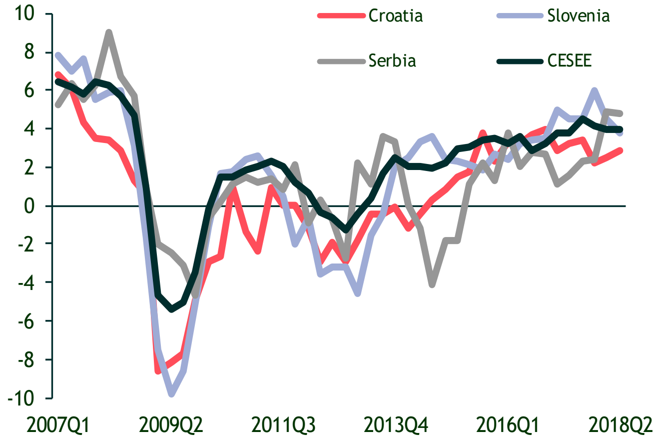
Fiscal side improved further in 1H18, with consolidated budget surplus at HRK1.6bn (0.4% of GDP vs. 0.0% in 1H17) as higher extra-budgetary and local government surpluses and solid tax revenues counter accelerating outlays. Even after personal income taxes fully passed to local bodies, revenues are driven by VAT (+5% yoy), social contributions (+7.5% yoy) and EU transfers (+13% yoy). While hefty interest bill cuts made way for public wages (+6% yoy) and social transfers (+4% yoy) hikes, EU-co-funded investments finally take off and healthcare arrears accumulate in the absence of reform, public finances need to address the elephant in the room - large traditional industries in financial troubles. With restructuring costs for the latter around EUR300m in three years, there is plenty of room for an upside surprise in tax-rich demand on the wings of record tourist season as well as consumer sentiment, all leaving us with 0.5%-alike surplus in 2018. We see similar budget outcome in 2019 on cyclically stronger tax revenues, further decline in interest spending (-4% after -12% in 2018), contained pension and wage cost (below nominal GDP growth) and ongoing tax revenue underestimation, despite higher demographic spending and considerable tax cuts. With stable primary balance around 2% of GDP and 4.5%-alike nominal GDP growth, we see further public debt cuts to 70% of GDP at the end of 2019, stronger than required under the Maastricht 1/20th rule. Such a fiscal over performance alongside strongly improved external metrics lead to credit rating upgrades (to investment grade), thus permanently lowering the burden of debt via reduced risk premium.

***...but stronger focus on competitiveness needed***

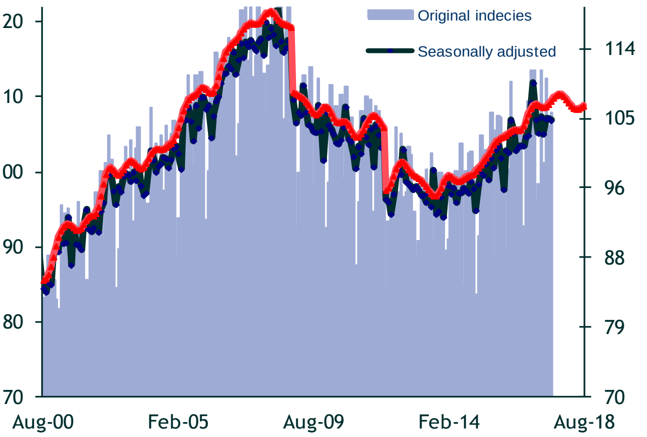
After HRK6.5bn tax cuts in 2017-2019, future tax changes can't have a huge impact on firms' competitiveness if there is no some burden shift from output factors (wage, profits) to asset/ sales taxes, and further broadening of the tax base underpinning Croatia's entitlement spending beyond the private sector. Property taxation does not only improve growth-friendliness of the tax system overall but ensures the much-needed tax revenue stability if the external demand and growth outlooks change, while material tax changes ahead also have to be aligned with non-discretionary spending cuts with a negative impact on demand in the short run. Naturally, Croatia is eyeing gradual entitlement reforms in healthcare and state administration, as well as its pension system (e.g. penalization of early retirement). Economically, transfer of purchasing power from public-sector workers (who will end up paying more taxes) towards salaried private-sector jobs (who will pay less in social contributions), thereby making private-sector jobs relatively more attractive. The reform process can be better designed if: (i) action is prompter (immediately after elections) and more definitive (pushing reforms through 'ordinances' and robust institutions which bypass parliamentary procedures), (ii) a more holistic approach is adopted (reforms should not focus only on cost cuts but on efficiency gains, systematic evaluation of reforms and capex rigorously on economic value), and (iii) political headwinds are contained via expectations management. The final goal of above mentioned is to help raise Croatia's growth potential and build a sizeable primary surplus (of at least 4% of GDP) in the next years, arrest sovereign risk premium and anchor public debt dynamics after the cycle naturally slows.

# Croatia's data trends

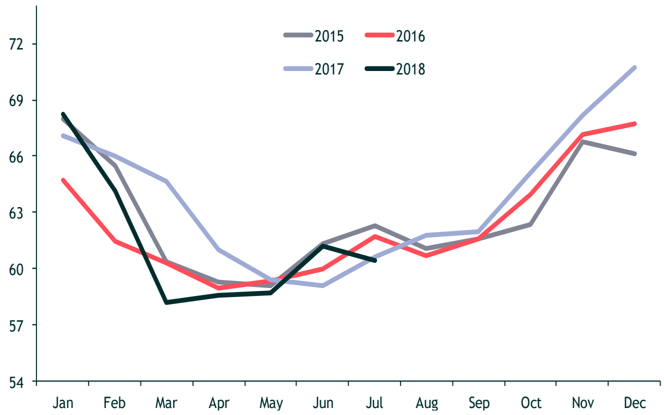
### CRO growth in line with CESEE



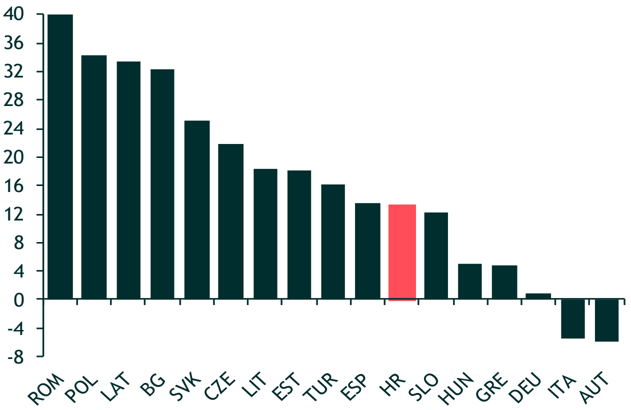

### Industrial production, 2015=100



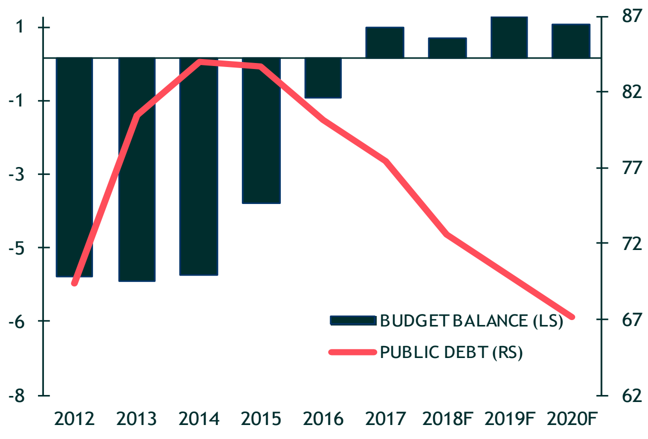

### CRO: Merchandise trade import cover on 3mma basis



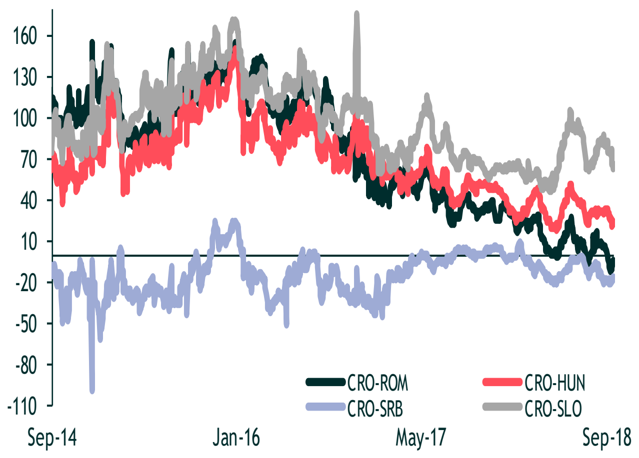

### Change in export shares vs EU countries, 2017-2008, (%)




### Budget balance and public debt (%/GDP)




### Spread on CRO USDs vs peers (bp)




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

## SELECTED ECONOMIC FORECASTS

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | | |
| Nominal GDP (HRKbn, current prices) | 330,8 | 331,8 | 331,6 | 339,6 | 351,3 | 365,6 | 383,7 | 402,7 | 421,7 |
| Nominal GDP (EURbn) | 44,0 | 43,8 | 43,5 | 44,6 | 46,7 | 49,0 | 51,7 | 54,5 | 57,3 |
| Nominal GDP (USDbn) | 56,5 | 58,1 | 57,7 | 49,5 | 51,6 | 55,2 | 61,0 | 64,6 | 69,6 |
| GDP per capita (EUR) | 10.311 | 10.293 | 10.254 | 10.616 | 11.180 | 11.882 | 12.634 | 13.388 | 14.147 |
| GDP per capita (USD) | 13.233 | 13.663 | 13.617 | 11.772 | 12.372 | 13.385 | 14.909 | 15.865 | 17.188 |
| Real GDP (constant prices YoY, %) | -2,3 | -0,1 | -0,1 | 2,3 | 3,5 | 2,9 | 3,0 | 3,0 | 2,8 |
| Private consumption (YoY, %) | -3,0 | -1,9 | -1,6 | 1,0 | 3,4 | 3,6 | 3,6 | 3,0 | 2,8 |
| Fixed investment (YoY, %) | -3,3 | 1,4 | -2,8 | 3,8 | 6,5 | 3,8 | 5,0 | 6,5 | 6,0 |
| Industrial production (YoY, %) | -5,5 | -1,7 | 1,4 | 2,5 | 5,1 | 1,9 | 2,6 | 3,0 | 3,0 |
| Unemployment rate (ILO, average %) | 15,9 | 17,3 | 17,3 | 16,3 | 13,1 | 11,2 | 10,0 | 9,0 | 8,5 |
| **Prices** | | | | | | | | | |
| CPI inflation (average % YoY) | 3,4 | 2,2 | -0,2 | -0,5 | -1,1 | 1,1 | 1,6 | 1,6 | 1,6 |
| CPI inflation (end-year % YoY) | 4,7 | 0,3 | -0,5 | -0,6 | 0,2 | 1,2 | 1,6 | 1,2 | 1,9 |
| PPI inflation (average % YoY) | 7,0 | 0,5 | -2,7 | -3,9 | -4,1 | 2,0 | 2,0 | 2,1 | 2,3 |
| Net wage rates (% YoY, nom., €) | -0,4 | -0,1 | -0,4 | 1,5 | 2,9 | 5,0 | 5,5 | 4,1 | 2,8 |
| **Fiscal balance (% of GDP)** | | | | | | | | | |
| State budget balance | -5,2 | -5,3 | -5,1 | -3,4 | -0,9 | 0,8 | 0,5 | 1,0 | 0,8 |
| Public debt | 69,4 | 80,5 | 84,0 | 83,7 | 80,2 | 77,5 | 72,6 | 69,8 | 67,2 |
| Gross public funding needs | 17,8 | 24,8 | 18,2 | 19,9 | 16,3 | 20,1 | 14,8 | 15,0 | 14,5 |
| **External balance** | | | | | | | | | |
| Export of goods and services (EURbn) | 18,319 | 18,768 | 19,677 | 21,473 | 22,778 | 25,148 | 27,030 | 28,520 | 29,661 |
| Import of goods and services (EURbn) | 18,125 | 18,599 | 18,852 | 20,442 | 21,456 | 24,073 | 26,103 | 27,997 | 29,189 |
| Merchandise trade balance (EURbn) | -6,296 | -6,587 | -6,512 | -6,974 | -7,385 | -8,254 | -9,087 | -10,065 | -10,709 |
| Merchandise trade balance (% of GDP) | -14,3 | -15,0 | -15,0 | -15,6 | -15,8 | -16,8 | -17,6 | -18,5 | -18,7 |
| Tourism receipts (EURbn) | 6,859 | 7,203 | 7,402 | 7,962 | 8,635 | 9,493 | 10,262 | 10,830 | 11,231 |
| Current account balance (EURbn) | -0,050 | 0,414 | 0,858 | 2,018 | 1,204 | 1,902 | 1,510 | 1,224 | 1,346 |
| Current account balance (% of GDP) | -0,1 | 0,9 | 2,0 | 4,5 | 2,6 | 3,9 | 2,9 | 2,2 | 2,3 |
| Net FDI (EURbn) | 1,2 | 0,8 | 0,7 | 0,2 | 1,9 | 1,2 | 1,8 | 1,9 | 2,0 |
| FDI (% of GDP) | 2,8 | 1,9 | 1,6 | 0,5 | 4,1 | 2,5 | 3,4 | 3,5 | 3,4 |
| FDI cover (%) | 2.469,6 | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| Gross international reserves (EURbn) | 11,236 | 12,908 | 12,688 | 13,707 | 13,514 | 15,706 | 17,156 | 18,689 | 19,248 |
| Import cover (months of imports) | 7,4 | 8,3 | 8,1 | 8,0 | 7,6 | 7,8 | 7,9 | 8,0 | 7,9 |
| **Debt indicators** | | | | | | | | | |
| Gross external debt (EURbn) | 45,297 | 45,803 | 46,416 | 45,384 | 41,668 | 40,069 | 38,986 | 39,305 | 41,287 |
| Government (EURbn) | 12,705 | 14,647 | 15,841 | 18,049 | 16,230 | 16,312 | 16,154 | 15,926 | 17,000 |
| Private (EURbn) | 32,592 | 31,157 | 30,575 | 27,335 | 25,438 | 23,756 | 22,831 | 23,378 | 24,287 |
| Gross external debt (% of GDP) | 102,9 | 104,6 | 106,8 | 101,7 | 89,3 | 81,8 | 75,4 | 72,1 | 72,1 |
| Gross external debt (% of exports) | 247,3 | 244,1 | 235,9 | 211,4 | 182,9 | 159,3 | 144,2 | 137,8 | 139,2 |
| **Exchange rates and money growth** | | | | | | | | | |
| USD/HRK (end-year) | 5,47 | 5,55 | 6,30 | 6,99 | 7,17 | 6,27 | 6,49 | 6,04 | 5,87 |
| USD/HRK (average) | 5,85 | 5,71 | 5,75 | 6,86 | 6,80 | 6,62 | 6,29 | 6,24 | 6,06 |
| EUR/HRK (end-year) | 7,55 | 7,64 | 7,66 | 7,64 | 7,56 | 7,51 | 7,46 | 7,43 | 7,40 |
| EUR/HRK (average) | 7,52 | 7,57 | 7,63 | 7,61 | 7,53 | 7,46 | 7,42 | 7,39 | 7,36 |
| Money supply M1 (% YoY) | 0,9 | 11,5 | 9,6 | 11,3 | 18,2 | 19,1 | 13,4 | 13,3 | 12,7 |
| Broad money M4 (% YoY) | 3,6 | 4,0 | 3,2 | 5,1 | 4,7 | 2,1 | 3,9 | 3,6 | 3,9 |
| Domestic credit (% YoY, euros) | -2,6 | -0,4 | -2,6 | -1,7 | -5,1 | -4,2 | 2,5 | 3,3 | 4,1 |
| ZIBOR 3M interest rate (average %) | 3,55 | 1,54 | 0,99 | 1,27 | 0,90 | 0,65 | 0,38 | 0,30 | 0,40 |
| HRK 1Y yield (average %) | 3,93 | 2,54 | 1,86 | 1,50 | 0,96 | 0,43 | 0,08 | 0,05 | 0,40 |
| HRK 10Y yield (average %) | 6,26 | 4,30 | 4,00 | 4,09 | 3,60 | 2,75 | 2,17 | 2,29 | 2,59 |

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

## SELECTED BANKING SECTOR DATA

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Balance sheet** | | | | | | | | | |
| Assets (EURm) | 54.395 | 54.338 | 54.719 | 54.536 | 54.689 | 54.416 | 55.372 | 56.764 | 58.921 |
| Assets (%, YoY) | -1,7 | -0,1 | 0,7 | -0,3 | 0,3 | -0,5 | 1,8 | 2,5 | 3,8 |
| Assets (% of GDP) | 123,6 | 124,0 | 125,9 | 122,2 | 117,2 | 111,0 | 107,1 | 104,2 | 102,8 |
| Gross loans (EURm) | 37.678 | 37.543 | 36.561 | 35.941 | 34.125 | 32.706 | 33.536 | 34.638 | 36.073 |
| Gross loans (%, YoY) | -2,6 | -0,4 | -2,6 | -1,7 | -5,1 | -4,2 | 2,5 | 3,3 | 4,1 |
| Gross loans (% of GDP) | 85,6 | 85,7 | 84,1 | 80,5 | 73,1 | 66,7 | 64,9 | 63,6 | 63,0 |
| Deposits (EURm) | 30.087 | 30.959 | 31.874 | 33.660 | 35.237 | 36.355 | 38.186 | 40.211 | 42.145 |
| Deposits (%, YoY) | 2,7 | 2,9 | 3,0 | 5,6 | 4,7 | 3,2 | 5,0 | 5,3 | 4,8 |
| Deposits (% of GDP) | 68,4 | 70,7 | 73,3 | 75,4 | 75,5 | 74,2 | 73,9 | 73,8 | 73,6 |
| Loan-to-deposit ratio (%) | 125,2 | 121,3 | 114,7 | 106,8 | 96,8 | 90,0 | 87,8 | 86,1 | 85,6 |
| Capital adequacy ratio (%) | 20,9 | 21,0 | 21,8 | 20,9 | 23,0 | 23,8 | 22,4 | 22,4 | 21,3 |
| **Performance** | | | | | | | | | |
| Net interest income (EURm) | 1.449 | 1.360 | 1.366 | 1.401 | 1.457 | 1.477 | 1.440 | 1.521 | 1.502 |
| Net interest income (%, YoY) | -5,9 | -6,2 | 0,5 | 2,5 | 4,0 | 1,4 | -2,5 | 5,7 | -1,2 |
| Total operating income (EURm) | 2.015 | 1.923 | 1.922 | 1.904 | 2.150 | 2.134 | 2.109 | 2.211 | 2.214 |
| Total operating income (%, YoY) | -10,4 | -4,5 | 0,0 | -1,0 | 12,9 | -0,7 | -1,2 | 4,8 | 0,1 |
| Pre-provision profit (EURm) | 972 | 920 | 934 | 915 | 1.178 | 1.134 | 1.095 | 1.169 | 1.137 |
| Pre-provision profit (%, YoY) | -13,7 | -5,4 | 1,6 | -2,0 | 28,7 | -3,8 | -3,4 | 6,8 | -2,8 |
| Provision charges (EURm) | 501 | 780 | 645 | 1.529 | 380 | 574 | 298 | 273 | 354 |
| **Profitability and efficiency** | | | | | | | | | |
| Net interest margin (%) | 2,6 | 2,5 | 2,5 | 2,6 | 2,7 | 2,7 | 2,7 | 2,6 | 2,6 |
| Pre-tax ROAA (%) | 0,9 | 0,3 | 0,5 | -1,1 | 1,5 | 1,0 | 1,5 | 1,6 | 1,4 |
| Pre-tax ROAE (%) | 6,2 | 1,9 | 3,9 | -8,7 | 11,4 | 7,3 | 10,0 | 11,0 | 9,6 |
| Cost-to-income ratio (%) | 51,7 | 52,2 | 51,4 | 51,9 | 45,2 | 46,9 | 48,1 | 47,1 | 48,7 |
| Operating expense (% of assets) | 1,9 | 1,8 | 1,8 | 1,8 | 1,8 | 1,8 | 1,8 | 1,9 | 1,9 |
| **Credit quality and provisioning** | | | | | | | | | |
| NPL ratio (%) | 13,9 | 15,7 | 17,1 | 16,7 | 13,8 | 11,4 | 10,1 | 9,4 | 8,9 |
| NPL coverage (%) | 42,6 | 46,2 | 51,3 | 56,9 | 63,7 | 61,5 | 62,7 | 63,6 | 64,9 |
| Provision charges (% of loans) | 1,3 | 2,1 | 1,7 | 4,2 | 1,1 | 1,7 | 0,9 | 0,8 | 1,0 |
| Provision charges (% of PPP) | 51,5 | 84,8 | 69,0 | 167,0 | 32,2 | 50,6 | 27,2 | 23,3 | 31,1 |

Source: CNB, Addiko research

***1H18 profit benefiting from lower provisioning costs***

Following extensive de-leveraging series, credit activity resumed its 2018 recovery with 2.8% ytd growth in July. The strongest positive contribution came from 4.1% ytd higher retail lending, owing to increased demand for cash non-purpose loans in line with positive labour market developments and strong consumer sentiment, additionally supported by record low interest rates and fierce bank competition. Corporate sector followed with 2.7% ytd growth, carried on higher firms' earnings and business optimism, together with more relaxed credit standards (for SME in particular). Meanwhile, deposit growth accelerated to 4.1% ytd in July, again driven by retail segment contribution (3.2% ytd), with corporate deposits also showing signs of recovery (1.6% ytd). Regarding profits, NII decreased 4.1% yoy in 1H18 after 10.9% yoy lower interest income, despite much lower funding costs (-28.7% yoy). Total operating income thus increased 4.7% yoy on the back of higher non-interest income (trading result), while pre-tax profit recorded 171% yoy stronger growth due to substantially lower provisioning costs.

***Stronger credit recovery expected going forward***

With lending activity so far developing according to our expectations, we reiterate our 2.5% forecast for 2018, while next year we see loan growth accelerating at 3.3% pace. Our expectations are build on solid economic outlook and further investment growth, alongside stronger labour market and private consumption prospects, while loose monetary conditions and high competition among banks will keep interest rates at low level. We expect further cleaning of bank portfolios to bring NPL ratio down to 10.1% in 2018 (vs. 11.2% in 1H18) and below 10% mark next year, thus freeing more space for new lending activity. Despite low interest rates on savings, we see deposit growth at 5.0% till year end and then accelerating slightly in 2019 amid ongoing economic recovery, better labour market outlook and strong wage growth, again supported by high tourism inflows. Regarding profitability, while lower impairment costs will boost 2018 profits, next year we expect further profit increase supported by new lending cycle, though strong bank competition will keep margins under pressure.

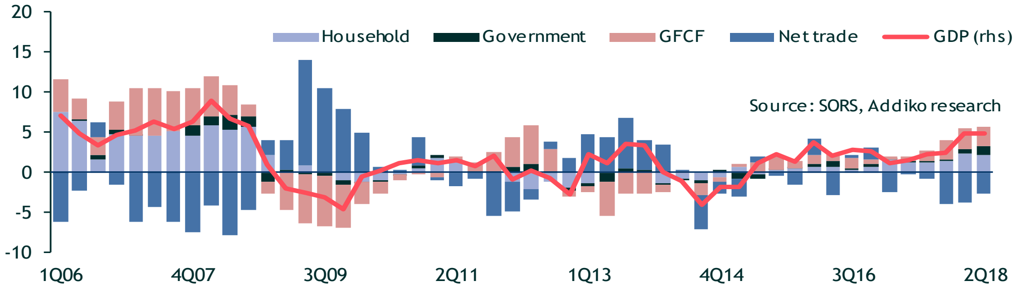
# Still Going Stronger

**We again lift 2018 GDP growth forecast on stronger-than-expected 1H18, better investment outlook and agricultural season, defying external concerns. Ongoing budget surplus and lower cost of funding will help public debt to fall below 60% of GDP. The newest IMF program and EU accession talks bode well for reforms. We expect the NBS to stay on hold through 2019 given the uncertain external backdrop, low domestic core inflation and stronger ECB's forward guidance. There is still some downside potential in long-term dinar yields on the back of GDP growth potential upgrades, strong fiscal results and lower funding needs, newest IMF policy anchor, stronger rating outlook and looming EM indices' inclusion.**

***Even stronger 1H18 growth profile after revisions***

Another broad-based growth surprise in Q2 (+4.8% yoy) was driven by soaring investment (+13% yoy) including hefty inventory build-up, strong private/public consumption as well as goods exports, plus firmer-than-expected agriculture and energy output from a low base. Fixed investments jumped on soaring FDI (9% yoy in 1H18), long-delayed public capex (+44% yoy), hefty corporate profits as well as re-leveraging. Meanwhile, household consumption is driven by private job creation (3% yoy in 1H18), 6%-alike yoy wage, soaring foreign workers' remittances (+25% yoy), pension and social safety net hikes and re-leveraging. With strong demand continuing to suck in imports, strong export growth could not reduce negative net trade contribution much. While external demand uncertainty has increased, we still expect robust investments (including public capex), steady consumer momentum, new capacity-driven exports growth and stronger sentiment gauges to support 4%-alike GDP growth in Q3.

**Serbia: contributions to GDP (pps, %)**




***Raising GDP forecasts again on surging investment***

On the back of stronger-than-expected 1H18 outcome, stronger investments and agriculture output, we lift 2018 GDP forecast by 0.5pp to 4.5%. Notwithstanding foreign demand concerns, we still see 4%-alike growth in the next quarters, with investment one of the key drivers on the wings of manufacturing FDI, state-sponsored EUR2.5bn railway/road construction, high firms' profits, cheap funding and corporate tax cuts in 2019. Closely following, private consumption will see the strongest growth in ten years backed by private job growth, soaring remittances, cheaper debt service, re-leveraging and tourist inflows. Among other factors, the strong carryover leads us to 0.5pp GDP growth upgrade to 4.0% for 2019 on robust domestic demand and stronger export growth, the former driven by investment and private spending against the backdrop of fiscal easing, stronger disposable income (incl. wage/pension hikes), FDI support and soaring construction. Despite high import-intensity of robust domestic demand, stronger export growth on hefty export capacity expansion will reduce negative net trade contribution, just as stronger supply side is driving potential growth higher. With the risks to our baseline balanced, potential 2pp/GDP fiscal space in 2019 (via entitlements/capex/tax cuts), even stronger FDIs and agriculture output and policy-induced optimism amid IMF-supported reforms and EU accession talks. Downside risks stem from softer EU demand, negative sentiment toward EM assets and domestic public capex under-execution.

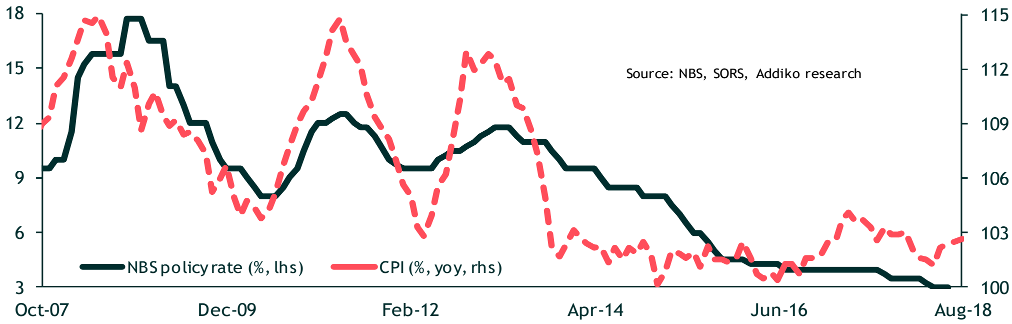
***Inflation stabilization ahead***

Inflation While inflation surprised on the upside on higher energy and fresh fruit prices, and we marked up the average 2018 CPI forecast to 2.1% CPI, the real story is stubbornly low core inflation below the 3%+/-1.5pp NBS' target interval. The latter needs to pick up on resurgent domestic demand and tighter labour markets, but the much-anticipated acceleration has so far failed to happen. Given the expected normalization in fresh food prices after better harvest in 2H18 (especially corn crop), decreasing pressure from fuel prices and stable dinar, our projected path of inflation has been pushed lower and we cut the average 2019 inflation forecast to 2.6% (prev. 3.0%). There is hope for higher core inflation since the long labour market recovery, higher entitlement spending and the growing labour shortages intensify wage pressures. Stronger retailers' competition after Lidl's entry in the market and subdued import prices amid uncertain business outlook pose the main risks on the downside.

***External position continues to improve***

With the euro zone re-accelerating after the summer break, Serbian export market share gains, rapidly growing export capacity and soaring agriculture as well as ICT exports, we see exports growth in two-digits in 2H18-2019. Even then, stronger capex-related and consumer goods imports suggest slightly higher goods trade deficits in both 2018 and 2019, which alongside record remittances on persistent employment/wage trends across the EU, and lower investment income deficit lower C/A gap to 4.5% of GDP by end-2019. Meanwhile, hefty industrial capacity build-up, big-ticket privatizations (Airport Nikola Tesla, copper smelter RTB Bor, etc.), foreign retailers' expansion and other real estate projects and higher non-resident banks' profit are driving FDI to 7% of GDP. FDI over-financing, MinFin's external de-leveraging (exceeding private external re-leveraging) support improvement in net international investment position. Higher FDI in tradable sectors will help lift export activity (to CEE-alike 75-80% of GDP in five years, in our view) and lower C/A deficit toward 1-2% of GDP in the medium term.

**Serbia: CPI inflation and NBS policy rate**



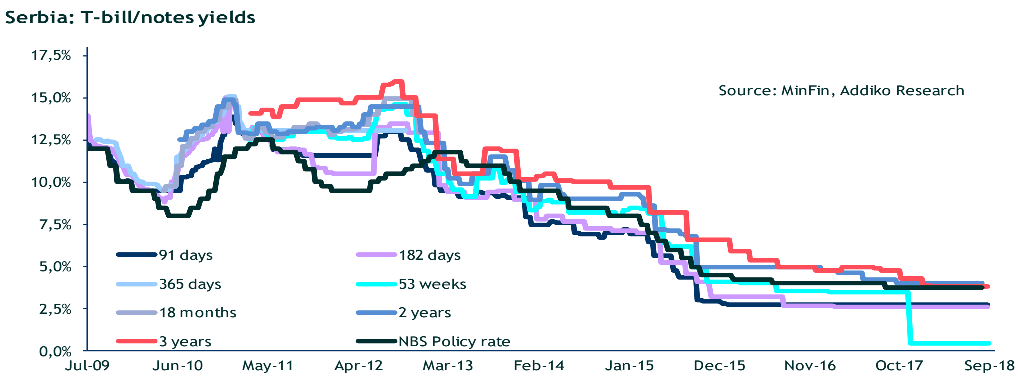

***NBS' smooth sailing***

The removal of the short-term risk of inflation target undershooting, shaky global (trade/ financial markets) backdrop and weaker appetite for EM assets prompted the NBS to stop cutting rates. Apart from RSD appreciation potential, everything else, both locally and internationally, suggests long pause, in our view. The NBS sees CPI below the target mid-point (3.0% yoy) by 4Q19 and has recently cut 2019 inflation forecast mainly due to the waning food/energy price pressures. While expectations are well anchored within the target band in the next two years, the NBS in our view still looks inclined to stay on hold for a long time as the latest data confirm its view of low core inflation below sub-1% despite robust GDP growth. The ECB's forward guidance (pushing out expectations of the first rate hike timing- and pace-wise is just adding to the NBS' dovish stance. While never said publicly, given perceived auto-pilot Fed tightening, we expect the ECB policy will be a more important driver for the NBS to start hiking only in 1H20. Hence, we expect the ECB’s first move will send a 'significant signal'. Risk-wise, lower public/private sector external imbalances, stable inflation/FX outlook and low fiscal risk allow the NBS easy stance. Our baseline is idle if the Fed/ECB hike faster/sooner in response to stronger inflation, and the EM-DM interest rate differentials need to adjust from near historical lows to curb capital outflows. On the contrary, new asset purchases (in case of a major shock) and even later ECB hikes (due to deteriorating growth/inflation outlook) may allow NBS cut(s).

***Dinar stabilization on the cards***

Despite stronger corporate FC demand on soaring goods trade deficit, state USD buying to retire USD debt in December, portfolio outflow and non-resident financial agents' dividend payments, the EUR/RSD has been stable above 118. Simultaneous appreciation pressures owed mainly to hefty FDIs, soaring remittances and stronger FX-linked corporate lending, offsetting the goods import cover deterioration and sporadic portfolio outflows in the absence of new T-bond RSD issuance. While idiosyncratic stories (Argentina, Turkey), strong USD, tighter funding conditions and EM bond fund outflows have pulled EM spreads wider, Serbia has stayed immune as investors differentiated in favour of improving macro/fiscal story while C/A is overfunded and the short-term external debt to FX reserves ratio does not stand out as being high in an EM context. Moreover, long-term dinar yields have continued on their way down given much lower local debt supply, new reform-minded IMF program and prospects for EM indices' inclusion.

Looking ahead, possible further state USD buying, seasonal goods trade pattern and lower capital inflows amid non-existent local debt supply and shaky EM sentiment will in our view limit the EUR/RSD downside. While, moreover, C/A deficit is widening, we still expect hefty FDI over financing, stronger exports and improving goods import cover, soaring remittances and stronger corporate demand for FX-linked/FC credit to stabilize the dinar going forth. The biggest unknown is the timing of the Airport concession EUR500m payment, potentially triggering stronger appreciation pressure. With the dinar showing little sensitivity to regional FX risk episodes, we see the EUR/RSD inside the 117-119 range in Q4 before brief 119+ peaks early next year in a seasonal fashion due to stronger domestic demand-driven and energy imports. Our constructive RSD outlook in the medium term is driven by GDP growth acceleration, ongoing fiscal de-risking, strong FDI and export growth in support of C/A rebalancing, and appetite for Serbian assets after rating upgrades and dinar-debt inclusion in EM bond indices.




*Serbian rates have further downside potential on macro overperformance and fiscal de-risking*

Given the NBS' accommodativeness and low inflation, we see short-end rates close to record lows, despite stronger banks' RSD lending. Following a light issuance activity in Q3 and the growing budget surplus (i.e. no need for new net issuance), we understand the MinFin wants to engage in buy-back operations in Q4 and issue long-term 5Y/10Y RSD bonds opportunistically, since the strong cash reserve will suffice for USD bond redemption. In the year to September, Serbia sold RSD101bn and RSD98bn in 5Y and 10Y bonds, respectively, or cumulatively 4.2% of GDP (vs. just 0.7% in 2017) as part of the MinFin's aspirations to boost the RSD share in public debt to min. 25% (we see it around 30% after USD bond redemption). Given the ongoing strong fiscal performance this year, lower debt amortization in 2019 and lower domestic debt supply ahead, improving sovereign rating-relevant metrics and still some pick-up over CESEE peers, long-term dinar yields have a little further downside potential. Meanwhile, should the EM turmoil continue without decisive policy action on weaker global growth/trade prospects, Serbian USD rates would suffer in sympathy with some of the high-yielders. While the potential for significant EM assets draw-downs remains high, and stronger USD can also reduce carry on Serbian bonds, once EM spill-over and volatility end, we see stronger interest for Serbian assets on the back of GDP growth potential upgrades, strong fiscal results, newest IMF policy anchor, stronger rating outlook and the prospects of EM indices' inclusion with the eligibility criteria (including the USD1bn local market liquidity requirement) met in the near future.

*Fiscal overperformance continues...*

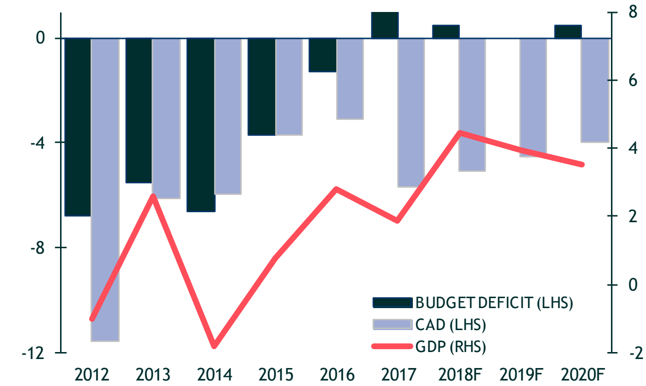
The consolidated budget balance hit a RSD50.6bn surplus (1.1% of GDP) in the year to July, with primary surplus at RSD124.3bn (2.6% of GDP). Such performance mainly owes to strong tax revenue growth (+4.8% yoy) increasingly broad-based and driven by tax-rich domestic demand, stronger labour market as well as better tax compliance. At the same time, expenditures rose 7.3% yoy on soaring infrastructure capex and pension hikes, partly offset by interest bill and guarantees cuts. While robust domestic demand will ensure somewhat stronger tax growth pace in H2 and interest rate spending declines further, we expect the budget surplus to drop to 0.5% of GDP followed by a return to balance in 2019, in both years due to public capex acceleration and in 2019 yet-to-be-defined wage tax cuts. While entitlement spending hikes is a material risk after years of austerity and given accelerating GDP growth, we understand the government wants to keep public wage and pension growth around nominal GDP growth. From a competitiveness point of view, it would have been wiser if the approximated ~2pp/GDP fiscal space is spent on tax cuts and efficiency-boosting capex projects, and entitlement spending growth milder. Last but not least the MinFin will cash in EUR500m (1% of GDP) from airport concession but we do not know yet whether this will be booked in 2018 or in 2019. All said, public debt decline is set to continue toward 50% of GDP by end-2019 thanks to the current GDP growth hump, sustained primary surplus (~3% of GDP) and stronger dinar. With the state debt on its way below the 'BB' median in the medium term, we expect rating agencies to react positively early enough ahead of more synchronized global/domestic monetary normalization.

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

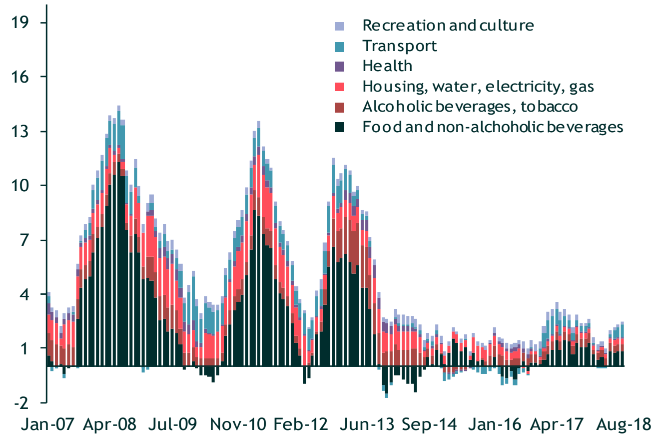
The key signposts to watch beyond sound fiscal metrics is whether the cabinet follows up with significant reforms (notably when it comes to public sector reforms and in particular SOE restructuring, despite some notable privatization deals) and contain entitlement spending that would prove unaffordable in case of cyclical slowdown. The main fiscal risks involve contingent liabilities by non-restructured SOEs (EPS, Srbijagas) that could be promptly mitigated only through privatization. The focus of the newest IMF program is hopefully be on the ongoing improvement in the spending mix via fair public wage setting models, better-targeted entitlement spending and higher more-productive capex. This is also part of the ongoing Serbia-IMF discussions haw to most effectively deploy the aforementioned 2pp/GDP fiscal space on way to a medium-term balanced budget after frontloaded fiscal consolidation in the past years. The much-vaunted utility (electricity, gas) price hikes to support financing of badly-needed energy infrastructure upgrade shall initially lead to higher energy inflation in our view, but energy capacity expansion is a must for continuous hefty FDI attractions. While the risks to GDP growth and fiscal balance are skewed to the upside, Serbia needs smart industrialization strategy to move up the value chain alongside red tape non-wage labour cost cuts and higher non-taxable income thresholds for salaried private-sector jobs. These competitiveness-enhancing measures could foster FDI, private investment growth and, ultimately, raise potential growth.

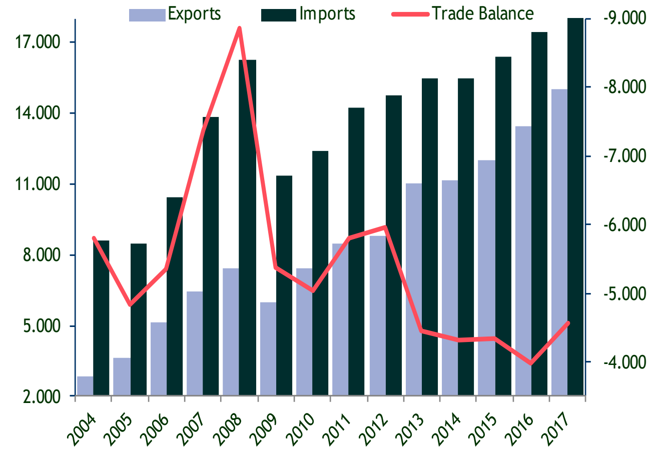
# Serbia's data trends

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

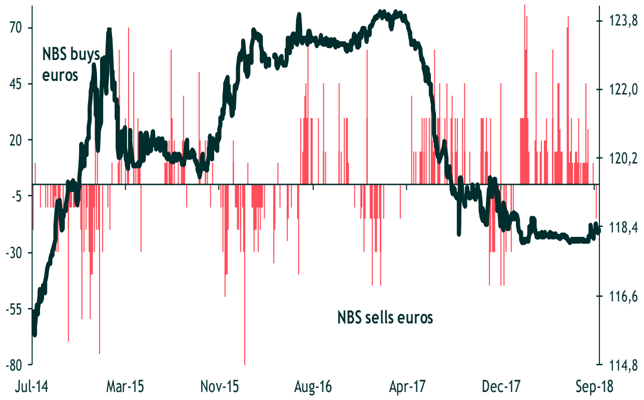



CPI contribution - key categories (pps)

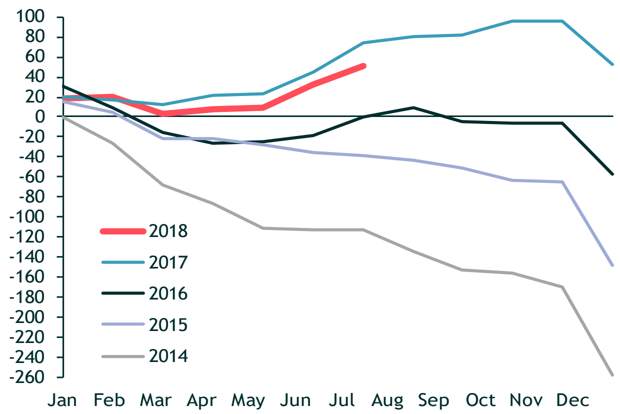


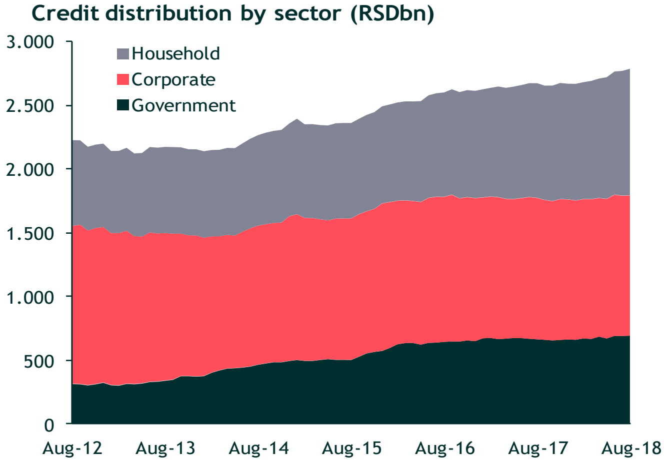

NBS active in the market




Consolidated government budget balance (RSDbn)




Credit distribution by sector (RSDbn)




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

## SELECTED ECONOMIC FORECASTS

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | | |
| Nominal GDP (RSDbn,current prices) | 3.584 | 3.876 | 3.908 | 4.043 | 4.262 | 4.465 | 4.765 | 5.094 | 5.419 |
| Nominal GDP (EURbn) | 31,7 | 34,3 | 33,3 | 33,5 | 34,6 | 36,8 | 40,4 | 43,3 | 46,2 |
| Nominal GDP (USDbn) | 40,7 | 45,5 | 44,1 | 37,1 | 38,3 | 41,5 | 47,7 | 51,3 | 56,2 |
| GDP per capita (EUR) | 4.401 | 4.783 | 4.662 | 4.720 | 4.889 | 5.226 | 5.736 | 6.153 | 6.568 |
| GDP per capita (USD) | 5.650 | 6.353 | 6.177 | 5.234 | 5.415 | 5.901 | 6.768 | 7.208 | 7.890 |
| Real GDP (constant prices YoY, %) | -1,0 | 2,6 | -1,8 | 0,8 | 2,8 | 1,9 | 4,5 | 4,0 | 3,5 |
| Private consumption (YoY, %) | -2,1 | -0,4 | -1,3 | 0,4 | 0,8 | 1,8 | 3,3 | 3,4 | 3,4 |
| Fixed investment (YoY, %) | 13,2 | -12,0 | -3,6 | 5,6 | 5,1 | 6,2 | 12,8 | 9,6 | 7,1 |
| Industrial production (YoY, %) | -2,2 | 5,4 | -6,4 | 8,4 | 4,7 | 3,5 | 5,3 | 5,5 | 5,3 |
| Unemployment rate (ILO, average %) | 23,9 | 22,1 | 19,2 | 17,7 | 15,3 | 13,5 | 12,5 | 11,5 | 10,6 |
| **Prices** | | | | | | | | | |
| CPI inflation (average % YoY) | 7,8 | 7,8 | 2,1 | 1,4 | 1,1 | 3,1 | 2,1 | 2,6 | 2,6 |
| CPI inflation (end-year % YoY) | 12,2 | 2,2 | 1,7 | 1,5 | 1,6 | 3,0 | 2,4 | 2,8 | 2,4 |
| PPI inflation (average % YoY) | 5,6 | 3,6 | 0,7 | 0,2 | -0,4 | 3,0 | 2,4 | 3,8 | 3,5 |
| Net wage rates (% YoY, nominal, euros) | -1,8 | -1,8 | -4,3 | -3,3 | 1,8 | 3,5 | 7,9 | 4,5 | 3,4 |
| **Fiscal balance (% of GDP)** | | | | | | | | | |
| State budget balance | -6,8 | -5,5 | -6,6 | -3,7 | -1,3 | 1,2 | 0,5 | 0,0 | 0,5 |
| Public debt | 56,2 | 59,6 | 70,4 | 74,7 | 71,9 | 61,3 | 57,2 | 53,5 | 50,1 |
| Gross public funding needs | 15,4 | 16,1 | 17,6 | 16,7 | 13,9 | 8,7 | 7,4 | 7,4 | 6,5 |
| **External balance** | | | | | | | | | |
| Export of goods and services (EURbn) | 11,469 | 13,937 | 14,451 | 15,728 | 17,385 | 19,330 | 21,421 | 23,459 | 24,914 |
| Import of goods and services (EURbn) | 16,992 | 17,782 | 18,096 | 18,643 | 19,597 | 22,365 | 25,068 | 27,345 | 28,986 |
| Merchandise trade balance (EURbn) | -5,634 | -4,159 | -4,111 | -3,645 | -3,119 | -3,986 | -4,535 | -4,885 | -5,157 |
| Merchandise trade balance (% of GDP) | -17,8 | -12,1 | -12,3 | -10,9 | -9,0 | -10,8 | -11,2 | -11,3 | -11,2 |
| Remittances, net (EURbn) | 1,989 | 2,217 | 1,931 | 2,155 | 1,953 | 2,151 | 2,624 | 2,834 | 2,976 |
| Current account balance (EURbn) | -3,671 | -2,098 | -1,985 | -1,234 | -1,075 | -2,090 | -2,043 | -1,954 | -1,826 |
| Current account balance (% of GDP) | -11,6 | -6,1 | -6,0 | -3,7 | -3,1 | -5,7 | -5,1 | -4,5 | -3,9 |
| Net FDI (EURbn) | 0,8 | 1,3 | 1,2 | 1,8 | 1,9 | 2,4 | 2,7 | 2,9 | 3,1 |
| FDI (% of GDP) | 2,4 | 3,8 | 3,7 | 5,4 | 5,5 | 6,6 | 6,7 | 6,7 | 6,7 |
| FDI cover (%) | 20,5 | 61,9 | 62,3 | 146,2 | 176,7 | 115,6 | 131,7 | 148,9 | 170,8 |
| Gross international reserves (EURbn) | 10,915 | 11,189 | 9,907 | 10,378 | 10,205 | 9,962 | 11,105 | 11,998 | 12,947 |
| Import cover (months of imports) | 7,7 | 7,6 | 6,6 | 6,7 | 6,2 | 5,3 | 5,3 | 5,3 | 5,4 |
| **Debt indicators** | | | | | | | | | |
| Gross external debt (EURbn) | 25,645 | 25,644 | 25,679 | 26,234 | 26,494 | 25,630 | 25,730 | 26,803 | 27,645 |
| Government (EURbn) | 12,185 | 13,120 | 14,145 | 15,295 | 15,680 | 13,911 | 12,971 | 12,821 | 13,121 |
| Private (EURbn) | 13,460 | 12,525 | 11,534 | 10,939 | 10,815 | 11,719 | 12,759 | 13,982 | 14,524 |
| Gross external debt (% of GDP) | 80,9 | 74,8 | 77,1 | 78,3 | 76,5 | 69,7 | 63,7 | 61,9 | 59,8 |
| Gross external debt (% of exports) | 223,6 | 184,0 | 177,7 | 166,8 | 152,4 | 132,6 | 120,1 | 114,3 | 111,0 |
| **Exchange rates and money** | | | | | | | | | |
| USD/RSD (end-year) | 86,18 | 83,13 | 99,46 | 111,64 | 117,93 | 99,30 | 102,78 | 95,49 | 92,86 |
| USD/RSD (average) | 88,12 | 85,17 | 88,54 | 108,88 | 111,17 | 107,47 | 100,00 | 99,24 | 96,46 |
| EUR/RSD (end-year) | 113,7 | 114,6 | 121,5 | 121,8 | 123,5 | 118,5 | 118,2 | 117,5 | 117,0 |
| EUR/RSD (average) | 113,1 | 113,1 | 117,3 | 120,7 | 123,1 | 121,3 | 118,0 | 117,6 | 117,2 |
| Money supply M1 (% YoY) | -3,3 | 24,8 | 5,2 | 16,4 | 18,7 | 14,8 | 9,0 | 7,2 | 6,3 |
| Broad money M3 (% YoY) | 0,7 | 3,7 | 3,0 | 5,0 | 9,9 | 7,9 | 5,9 | 5,2 | 4,7 |
| Domestic credit (% YoY, euros) | 0,8 | -5,2 | -2,3 | 2,4 | 1,0 | 6,2 | 7,9 | 6,9 | 6,3 |
| NBS policy rate (average %) | 10,10 | 10,90 | 8,75 | 5,63 | 4,13 | 3,81 | 3,06 | 3,00 | 3,20 |
| NBS policy rate (end-year %) | 11,25 | 9,50 | 8,00 | 4,50 | 4,00 | 3,50 | 3,00 | 3,00 | 3,50 |
| 6M BELIBOR interest rate (average %) | 12,00 | 10,40 | 8,53 | 6,43 | 3,65 | 3,60 | 3,03 | 3,00 | 3,25 |

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

## SELECTED BANKING SECTOR DATA

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Balance sheet** | | | | | | | | | |
| Assets (EURm) | 25.326 | 24.825 | 24.546 | 25.060 | 26.257 | 28.045 | 29.167 | 30.188 | 31.244 |
| Assets (%, YoY) | 0,0 | -2,0 | -1,1 | 2,1 | 4,8 | 6,8 | 4,0 | 3,5 | 3,5 |
| Assets (% of GDP) | 79,9 | 72,5 | 73,7 | 74,8 | 75,9 | 76,2 | 72,2 | 69,7 | 67,6 |
| Gross loans (EURm) | 17.148 | 16.255 | 15.879 | 16.253 | 16.412 | 17.431 | 18.817 | 20.115 | 21.379 |
| Gross loans (%, YoY) | 0,8 | -5,2 | -2,3 | 2,4 | 1,0 | 6,2 | 7,9 | 6,9 | 6,3 |
| Gross loans (% of GDP) | 54,1 | 47,4 | 47,7 | 48,5 | 47,4 | 47,4 | 46,6 | 46,4 | 46,2 |
| Deposits (EURm) | 13.310 | 13.634 | 13.967 | 14.728 | 16.159 | 17.404 | 18.500 | 19.453 | 20.374 |
| Deposits (%, YoY) | 1,6 | 2,4 | 2,4 | 5,4 | 9,7 | 7,7 | 6,3 | 5,2 | 4,7 |
| Deposits (% of GDP) | 42,0 | 39,8 | 41,9 | 44,0 | 46,7 | 47,3 | 45,8 | 44,9 | 44,1 |
| Loan-to-deposit ratio (%) | 128,8 | 119,2 | 113,7 | 110,4 | 101,6 | 100,2 | 101,7 | 103,4 | 104,9 |
| Capital adequacy ratio (%) | 19,9 | 20,9 | 20,0 | 20,9 | 21,8 | 22,6 | 23,1 | 23,1 | 23,0 |
| **Performance** | | | | | | | | | |
| Net interest income (EURm) | 1.025 | 1.044 | 1.063 | 1.075 | 973 | 996 | 1.065 | 1.087 | 1.109 |
| Net interest income (%, YoY) | -9,4 | 1,9 | 1,8 | 1,1 | -9,5 | 2,4 | 6,9 | 2,1 | 2,1 |
| Total operating income (EURm) | 1.484 | 1.435 | 1.489 | 1.520 | 1.387 | 1.563 | 1.574 | 1.665 | 1.723 |
| Total operating income (%, YoY) | -6,7 | -3,3 | 3,8 | 2,1 | -8,8 | 12,7 | 0,7 | 5,8 | 3,5 |
| Pre-provision profit (EURm) | 571 | 504 | 529 | 574 | 501 | 627 | 660 | 724 | 744 |
| Pre-provision profit (%, YoY) | -7,5 | -11,6 | 4,8 | 8,6 | -12,8 | 25,2 | 5,2 | 9,7 | 2,8 |
| Provision charges (EURm) | 339 | 510 | 490 | 494 | 333 | 61 | 30 | 52 | 60 |
| **Profitability and efficiency** | | | | | | | | | |
| Net interest margin (%) | 4,0 | 4,2 | 4,3 | 4,3 | 3,8 | 3,7 | 3,7 | 3,6 | 3,6 |
| Pre-tax ROAA (%) | 0,9 | -0,1 | 0,1 | 0,3 | 0,7 | 2,1 | 2,2 | 2,3 | 2,2 |
| Pre-tax ROAE (%) | 4,3 | -0,3 | 0,6 | 1,6 | 3,3 | 10,7 | 10,7 | 10,4 | 9,7 |
| Cost-to-income ratio (%) | 66,1 | 65,3 | 64,7 | 62,2 | 63,9 | 59,9 | 58,1 | 56,5 | 56,8 |
| Operating expense (% of assets) | 3,6 | 3,7 | 3,9 | 3,8 | 3,5 | 3,4 | 3,2 | 3,2 | 3,2 |
| **Credit quality and provisioning** | | | | | | | | | |
| NPL ratio (%) | 18,6 | 21,4 | 21,5 | 21,6 | 17,0 | 9,8 | 7,1 | 6,5 | 5,8 |
| NPL coverage (%) | 50,0 | 50,9 | 54,9 | 62,3 | 67,8 | 58,1 | 61,5 | 62,1 | 64,6 |
| Provision charges (% of loans) | 2,0 | 3,1 | 3,1 | 3,1 | 2,0 | 0,4 | 0,3 | 0,3 | 0,3 |
| Provision charges (% of PPP) | 59,4 | 101,1 | 92,8 | 86,0 | 66,6 | 9,8 | 4,5 | 7,2 | 8,1 |

Source: NBS, Addiko research

***Retail credit leading the way***

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

***Credit activity set to accelerate***

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

# Confronting Political Reality

**We keep GDP growth forecast for 2018 and 2019 at 3.1% and 3.5% yoy (respectively) on the back of stronger private consumption, external demand and externally-funded public capex. We expect C/A deficit to re-widen to 5.1% of GDP in 2018 due to higher trade deficit, while inflation is set to increase 1.4% in 2018 before accelerating to 2.0% in 2019.**

*GDP growth set to accelerate*

After a modest 2.0% yoy GDP growth in Q1, high frequency data suggest economic activity will accelerate in Q2 and beyond, driven by strong exports and buoyant private consumption. Namely, retail sales jumped 8.6% yoy on average in April-July amid strong employment growth (+6.5% yoy), 11.2% yoy higher foreign tourist nights, higher wages and household re-leveraging. Furthermore, strong goods exports growth (+11.6% yoy) on the back of stronger EU demand and removal of several export bans offset 8.0% higher imports in April-July, lifting the 3mma import cover by 200bp to 61.1%. Transportation and storage, as well as tourism, also had a strong performance in 1H18 (+6.9% yoy and +15.3% yoy, respectively).

*We keep GDP forecasts intact*

We are comfortable with 3.1% yoy FY18 GDP forecast, driven by stronger private consumption on employment and wage growth, record tourist season, remittances and re-leveraging. Moreover, investments will be driven by public capex amid stronger infrastructure works in support of GDP growth acceleration in 2019 toward 3.5%. While the IMF postponed its EUR38m tranche in July, we expect better budget liquidity and EUR700m EBRD commitment for infrastructure upgrades in 2018-2020 and stronger exports outlook to support capex. Projects in energy; EUR925m Tuzla TPP, EUR200m HPPs Foca and Paunci and FDIs in wind energy back up our expectations. Extra boost to the energy sector will come from IPA funds from the EU as B-H authorities adopted a Framework energy strategy until 2035 after ten years on negotiation between the entities. Strong export growth has staying power thanks to higher energy sector capacity and food exports liberalization with Turkey, EU and Russia. We though expect negative net export contribution in 2018 as rising private consumption along with import-intensive infrastructure capex will push imports higher and offset export gains. Upside risks stem from stronger capex and higher remittances. Downside risks include weaker investments and slower and reforms in response to political stalemate after October elections and recently halted IMF programs, plus weaker Turkish demand (B-H exports in Turkey- 1.4% of GDP).

*Credit rating affirmed*

S&P confirmed B-H rating as highly speculative (B/B) with stable outlook, reflecting economic and institutional weakness, high current account deficits, prolonged formation of a functioning national parliament after elections and hence slower reforms. Meanwhile, ratings are supported by steady economic growth, stable fiscal position and low and affordable debt burden. S&P would consider a rating upgrade should politics stabilize, authorities improve reform agility and if external financing flows stabilize, resulting in stronger growth, investment momentum and higher income levels. Negative factors include a prolonged political deadlock, public unrest, reversal of the recent reforms, failure to secure external financing and reduced growth momentum. In our view, negative political impact on the reform process will prevent any rating upgrades in the near term, while reform priority after the elections should be given to red tape and administrative burden cuts, new labour market reforms and better SOE governance in order to improve the business climate and secure the EU candidacy status.

*We expect the budget surplus at 0.5% of GDP in 2017*

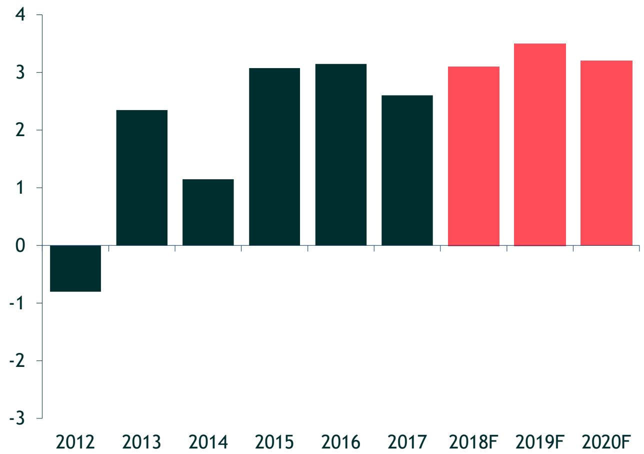
According to belated 2017 fiscal accounts, consolidated budget surplus increased to 2.6% of GDP (vs. 1.2% of GDP in 2016), against broadly expected 1.4% surplus. Better than expected fiscal balance owes to non-existent IMF funding that prompted B-H to cut public capex and Russia's repayment of EUR116m (0.7%/GDP) clearing debt. This year, solid fiscal trends continued with revenues up 7.7% yoy in the year to May on higher VAT (+7.1% yoy), PIT (+11.4% yoy) as well as CIT (14.4% yoy). Despite positive revenue trends, we see the national budget surplus narrowing to 0.5% of GDP, followed by 0.2% in 2019 largely due to higher public capex, higher entitlement spending and the RS' EUR168m bond issue ahead of elections. This year budget won't be supported by EUR116m inflow from Russia. Negative risk to B-H fiscal accounts stems from the new law on war veterans' benefits and public wage hikes in RS now that budget liquidity and the authorities do not need IMF support until at least mid-2019.

*Average CPI at 1.4% in 2018*

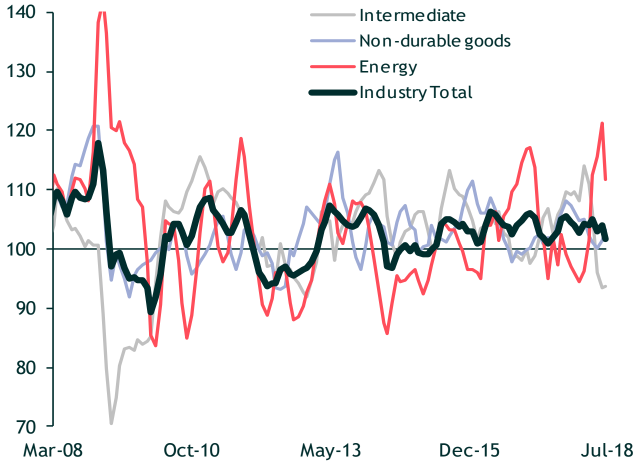
Notwithstanding we see wider C/A deficit at 5.5% of GDP in 2018 (vs. 4.8% in 2017) on stronger import demand underpinned, external risks appear contained by higher FDI cover, higher FX reserves and still available IFI financing. Inflationary pressures increased this year, as headline CPI hit multi-year high of 1.9% in June (1.8% in July) on higher food, energy and tobacco prices. With inflation in line with our expectations, we keep 1.4% average inflation growth forecast for 2018, while in 2019 we see inflation at 1.8% on stronger domestic demand.

# Bosnia and Herzegovina's data trends

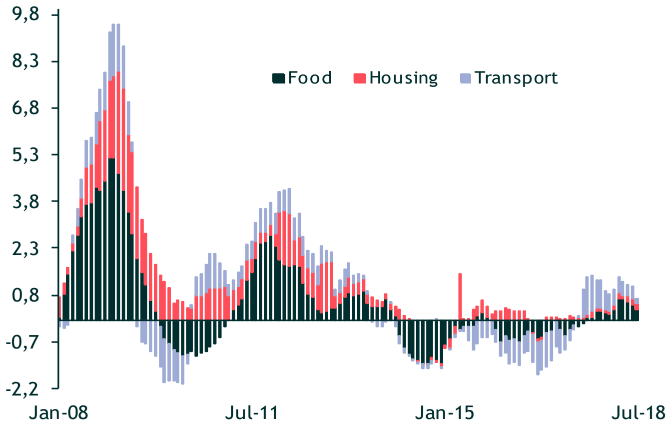
### Real GDP growth (% YoY)



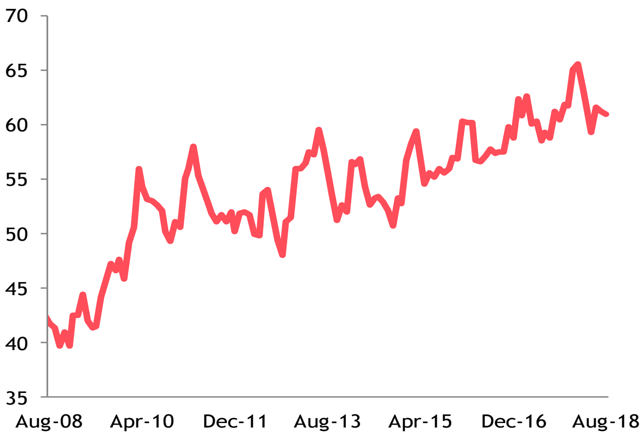

### Industrial production (%, yoy, s-a, 3mma)



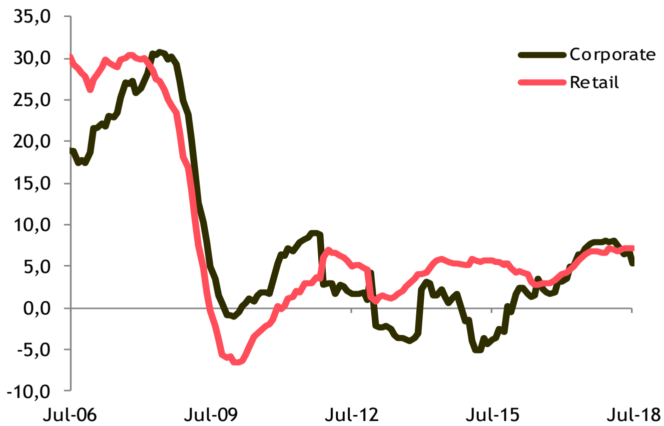

### Key CPI contributions (pp)



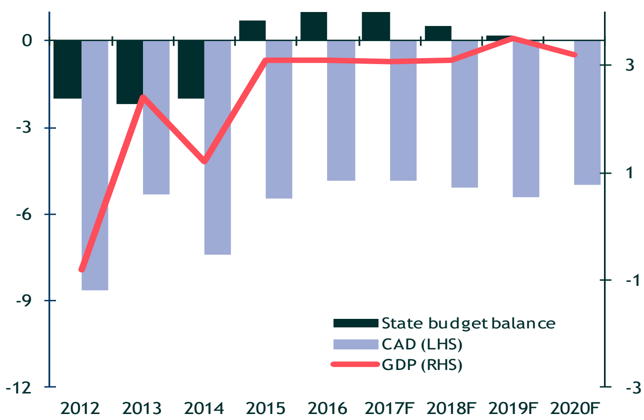

### Merchandise import cover (%, 3mma)




### 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

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | | |
| Nominal GDP (BAMbn, current prices) | 26,2 | 26,8 | 27,4 | 28,6 | 29,9 | 31,3 | 32,8 | 34,5 | 36,3 |
| Nominal GDP (EURbn) | 13,4 | 13,7 | 14,0 | 14,6 | 15,3 | 16,0 | 16,7 | 17,6 | 18,6 |
| Nominal GDP (USDbn) | 17,2 | 18,2 | 18,6 | 16,2 | 16,9 | 18,1 | 19,8 | 20,9 | 22,6 |
| GDP per capita (EUR) | 3.675,3 | 3.798,1 | 3.922,7 | 4.133,5 | 4.346,8 | 4.555,0 | 4.762,0 | 5.017,4 | 5.281,5 |
| GDP per capita (USD) | 4.726,5 | 5.044,2 | 5.211,4 | 4.584,5 | 4.813,6 | 5.143,1 | 5.619,1 | 5.945,6 | 6.417,0 |
| Real GDP (constant prices YoY, %) | -0,8 | 2,3 | 1,1 | 3,1 | 3,1 | 2,6 | 3,1 | 3,5 | 3,2 |
| Private consumption (YoY, %) | -0,7 | 0,8 | 1,4 | 1,8 | 2,3 | 2,5 | 2,8 | 2,7 | 2,9 |
| Fixed investment (YoY, %) | 4,0 | -3,0 | 8,2 | 2,9 | 10,8 | -2,8 | 4,0 | 4,6 | 3,8 |
| Industrial production (YoY, %) | -5,2 | 6,6 | 1,8 | 3,5 | 4,4 | 3,1 | 4,5 | 5,0 | 3,6 |
| Unemployment rate (ILO, average, %) | 28,0 | 27,4 | 27,5 | 27,7 | 25,4 | 20,6 | 18,7 | 16,5 | 15,7 |
| **Prices** | | | | | | | | | |
| CPI inflation (average % YoY) | 2,1 | -0,1 | -0,9 | -1,0 | -1,1 | 1,2 | 1,4 | 1,8 | 2,0 |
| CPI inflation (end-year % YoY) | 1,8 | -1,2 | -0,4 | -1,3 | -0,3 | 1,3 | 1,9 | 2,1 | 2,2 |
| PPI inflation (average % YoY) | 1,3 | -2,2 | -0,2 | 0,6 | -2,1 | 2,9 | 2,4 | 2,4 | 0,0 |
| Net wage rates (% YoY, nominal) | 1,2 | 0,1 | 0,4 | 0,0 | 0,9 | 1,8 | 2,9 | 3,0 | 2,8 |
| **Fiscal balance (% of GDP)** | | | | | | | | | |
| State budget balance | -2,0 | -2,2 | -2,1 | 0,7 | 1,2 | 2,6 | 0,5 | 0,2 | 0,0 |
| Public debt | 43,4 | 44,5 | 45,0 | 45,5 | 43,7 | 40,6 | 39,5 | 38,4 | 37,5 |
| **External balance** | | | | | | | | | |
| Export of goods and services (EURbn) | 4,337 | 4,620 | 4,754 | 5,080 | 5,432 | 6,228 | 6,744 | 7,082 | 7,400 |
| Import of goods and services (EURbn) | -7,481 | -7,419 | -7,927 | -7,794 | -7,985 | -8,922 | -9,639 | -9,928 | -10,176 |
| Merchandise trade balance (EURbn) | -3,977 | -3,630 | -4,026 | -3,677 | -3,600 | -3,835 | -4,067 | -4,046 | -3,976 |
| Merchandise trade balance (% of GDP) | -29,7 | -26,5 | -28,8 | -25,2 | -23,5 | -23,9 | -24,3 | -22,9 | -21,4 |
| Remittances (EURbn) | 1,070 | 1,111 | 1,181 | 1,216 | 1,247 | 1,335 | 1,386 | 1,433 | 1,476 |
| Current account balance (EURbn) | -1,159 | -0,728 | -1,033 | -0,796 | -0,742 | -0,773 | -0,916 | -1,017 | -0,997 |
| Current account balance (% of GDP) | -8,6 | -5,3 | -7,4 | -5,4 | -4,9 | -4,8 | -5,5 | -5,8 | -5,4 |
| Net FDI (EURbn) | 0,3 | 0,2 | 0,4 | 0,2 | 0,2 | 0,3 | 0,4 | 0,5 | 0,5 |
| FDI (% of GDP) | 1,9 | 1,3 | 2,9 | 1,7 | 1,6 | 2,1 | 2,6 | 2,7 | 2,7 |
| FDI cover (%) | 22,3 | 24,0 | 38,8 | 31,3 | 32,4 | 43,9 | 47,1 | 46,8 | 50,2 |
| Gross international reserves (EURbn) | 3,328 | 3,614 | 4,001 | 4,400 | 4,873 | 5,398 | 5,763 | 6,012 | 5,895 |
| Import cover (months of imports) | 5,3 | 5,8 | 6,1 | 6,8 | 7,3 | 7,3 | 7,2 | 7,3 | 7,0 |
| **Debt indicators** | | | | | | | | | |
| Gross external debt (EURbn) | 6,985 | 7,134 | 7,232 | 7,805 | 8,317 | 8,456 | 8,446 | 8,436 | 8,516 |
| Government (EURbn) | 3,687 | 3,867 | 4,316 | 4,444 | 4,536 | 4,165 | 4,125 | 4,095 | 4,075 |
| Private (EURbn) | 3,298 | 3,267 | 2,916 | 3,361 | 3,781 | 4,291 | 4,321 | 4,341 | 4,441 |
| Gross external debt (% of GDP) | 52,1 | 52,1 | 51,7 | 53,4 | 54,4 | 52,8 | 50,4 | 47,8 | 45,8 |
| Gross external debt (% of exports) | 161,1 | 154,4 | 152,1 | 153,6 | 153,1 | 135,8 | 125,2 | 119,1 | 115,1 |
| **Exchange rates and money growth** | | | | | | | | | |
| USD/BAM (end-year) | 1,48 | 1,42 | 1,61 | 1,79 | 1,87 | 1,64 | 1,70 | 1,59 | 1,55 |
| USD/BAM (average) | 1,52 | 1,47 | 1,47 | 1,76 | 1,77 | 1,73 | 1,66 | 1,65 | 1,61 |
| 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) | -0,7 | 9,0 | 9,2 | 11,9 | 13,7 | 13,7 | 11,5 | 8,6 | 8,9 |
| Broad money M2 (% YoY) | 3,4 | 7,9 | 7,3 | 8,0 | 8,3 | 9,5 | 8,5 | 7,4 | 7,5 |
| Domestic credit (% YoY) | 4,1 | 0,5 | 2,8 | 2,4 | 2,0 | 7,1 | 6,5 | 5,0 | 6,9 |
| EURIBOR 3M interest rate (average %) | 0,58 | 0,22 | 0,21 | -0,02 | -0,18 | -0,33 | -0,32 | -0,30 | 0,10 |

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

## SELECTED BANKING SECTOR DATA

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Balance sheet** | | | | | | | | | |
| Assets (EURm) | 11.414 | 11.794 | 12.299 | 12.756 | 13.344 | 14.440 | 15.062 | 15.724 | 16.533 |
| Assets (%, YoY) | 1,9 | 3,3 | 4,3 | 3,7 | 4,6 | 8,2 | 4,3 | 4,4 | 5,1 |
| Assets (% of GDP) | 85,1 | 86,1 | 87,9 | 87,3 | 87,3 | 90,1 | 89,9 | 89,1 | 89,0 |
| Gross loans (EURm) | 8.151 | 8.194 | 8.423 | 8.624 | 8.795 | 9.419 | 10.028 | 10.527 | 11.257 |
| Gross loans (%, YoY) | 4,1 | 0,5 | 2,8 | 2,4 | 2,0 | 7,1 | 6,5 | 5,0 | 6,9 |
| Gross loans (% of GDP) | 60,8 | 59,8 | 60,2 | 59,0 | 57,5 | 58,8 | 59,9 | 59,7 | 60,6 |
| Deposits (EURm) | 6.814 | 7.285 | 7.861 | 8.452 | 9.077 | 10.057 | 10.882 | 11.563 | 12.311 |
| Deposits (%, YoY) | 2,6 | 6,9 | 7,9 | 7,5 | 7,4 | 10,8 | 8,2 | 6,3 | 6,5 |
| Deposits (% of GDP) | 50,8 | 53,2 | 56,2 | 57,8 | 59,4 | 62,8 | 65,0 | 65,5 | 66,3 |
| Loan-to-deposit ratio (%) | 119,6 | 112,5 | 107,1 | 102,0 | 96,9 | 93,7 | 92,2 | 91,0 | 91,4 |
| Capital adequacy ratio (%) | 17,0 | 17,8 | 16,3 | 14,9 | 15,8 | 15,7 | 16,3 | 16,5 | 16,8 |
| **Performance** | | | | | | | | | |
| Net interest income (EURm) | 389 | 385 | 383 | 398 | 411 | 424 | 443 | 473 | 506 |
| Net interest income (%, YoY) | -1,8 | -1,0 | -0,5 | 3,9 | 3,3 | 3,3 | 4,3 | 6,8 | 7,2 |
| Total operating income (EURm) | 610 | 618 | 623 | 642 | 680 | 728 | 738 | 781 | 830 |
| Total operating income (%, YoY) | -1,5 | 1,2 | 0,8 | 3,1 | 6,0 | 7,0 | 1,4 | 5,8 | 6,2 |
| Pre-provision profit (EURm) | 207 | 184 | 213 | 206 | 222 | 288 | 285 | 312 | 348 |
| Pre-provision profit (%, YoY) | -0,8 | -11,1 | 15,8 | -3,6 | 8,1 | 29,4 | -1,0 | 9,5 | 11,7 |
| Provision charges (EURm) | 130 | 192 | 117 | 171 | 91 | 94 | 95 | 92 | 89 |
| **Profitability and efficiency** | | | | | | | | | |
| Net interest margin (%) | 3,4 | 3,3 | 3,2 | 3,2 | 3,1 | 3,1 | 3,0 | 3,1 | 3,1 |
| Pre-tax ROAA (%) | 0,7 | -0,1 | 0,8 | 0,3 | 1,0 | 1,4 | 1,3 | 1,4 | 1,6 |
| Pre-tax ROAE (%) | 4,8 | -0,5 | 5,6 | 1,9 | 7,0 | 9,8 | 8,9 | 9,5 | 10,2 |
| Cost-to-income ratio (%) | 66,0 | 70,2 | 65,7 | 67,9 | 67,3 | 60,5 | 61,4 | 60,1 | 58,0 |
| Operating expense (% of assets) | 3,6 | 3,7 | 3,4 | 3,5 | 3,5 | 3,2 | 3,1 | 3,0 | 3,0 |
| **Credit quality and provisioning** | | | | | | | | | |
| NPL ratio (%) | 13,5 | 15,1 | 14,2 | 13,7 | 11,8 | 10,0 | 9,0 | 8,6 | 8,0 |
| NPL coverage (%) | 65,9 | 66,7 | 69,7 | 71,2 | 74,4 | 76,7 | 77,2 | 78,6 | 78,8 |
| Provision charges (% of loans) | 1,6 | 2,3 | 1,4 | 2,0 | 1,0 | 1,0 | 1,0 | 0,9 | 0,8 |
| Provision charges (% of PPP) | 62,8 | 104,1 | 55,1 | 83,1 | 41,1 | 32,6 | 33,4 | 29,6 | 25,6 |

Source: CBBH, banking agencies, Addiko research

***NPL ratio fell to 9.3% in 1H18***

Overall loans increased by 4.4% in the year to July with the strongest positive contribution coming from retail (+5.1% ytd) thanks to employment and wage growth, lower interest rates and strong consumer credit. Furthermore, corporate lending increased by 3.0% ytd amid improving economic outlook. Public sector also contributed positively with a 7.5% ytd increase mostly on higher bank's claims on social security funds. Loan book quality manifested further improvement as NPL ratio continued its downward path reaching 9.3% in 1H18 (vs. 10.0% at YE17). In terms of funding, deposit collection recorded further growth in July (+6.6% ytd) with positive contribution from all sectors. Retail deposits increased 3.8% ytd on improving labour market and remittances. Corporate contributed positively as well with 7.1% ytd (vs. 17.6% yoy in 2017) deposit growth amid improved liquidity, while public deposits soared 20.1% ytd (vs. 29.5% yoy in 2017) due to favourable fiscal trends. Regarding profits, in 1Q18 banking sector recorded 11.9% lower other operating income, which alongside stagnating NII (+1.1% yoy) and 2.3% higher opex led to 8.1% decrease in pre-tax profit (EUR58m).

***Credit growth remains strong***

With better-than-expected corporate and notably public lending, we upgraded our 2018 credit growth forecast by 1.0pp to 6.5% yoy. Credit activity will be supported by further decline in interest rates, higher employment and wages, as well as investment recovery. In 2019, we see 5.0%-alike credit growth given stronger private consumption and business optimism. On funding, as ytd numbers exceeded our expectations, we revised our deposit collection forecast by 1.2pp to 8.2% yoy, while in 2019 we expect deposit growth decelerating towards 6.5% yoy. We keep our FY18 NPL ratio projection at 9.0% supported by NPL sales, write-offs, recovery and better debt collection. We see pre-tax profits at a similar level amid stronger disbursements, steady provisioning and opex.

# Moving Into Higher Gear

**With 1H18 data largely in line with our expectations, we keep above-consensus 4.0% GDP growth forecast for 2018 on soaring investment activity and stellar tourist season. In 2019, we expect GDP growth to decelerate towards 3%. Higher capital outlays alongside the second tranche of EPCG buy-back will keep budget deficit around 4.5% of GDP. We see average CPI inflation in 2018 at 3.0% followed by a slowdown to 2.6% in 2019 as administrative hikes fade away.**

***Strong growth is set to continue***

After GDP growth accelerated to 4.5% yoy in 1Q18, high frequency data suggest strong 4%-alike growth will continue in Q2 and next quarters. After a 3.2% yoy growth in Q1, retail sales growth accelerated to 3.8% yoy in April-July driven by record high employment (+2.8% yoy), 7.8% higher foreign tourist nights, re-leveraging and strong consumer optimism. Moreover, investment activity growth (+31.2% in Q1) will continue as construction jumped 35.7% yoy in Q2, and robust industrial output (+20.1% yoy in April-July) suggests much stronger electricity exports. Meanwhile, goods trade deficit increased to EUR818m in April-July (+15.1% yoy) as 17.2% higher exports could not offset 15.4% higher imports. The 3mma goods import cover also increased slightly to 13.7% (+45bp yoy).

***2018 GDP growth seen at 4.0%***

We keep above-consensus 2018 GDP growth forecast at 4.0% on significant investment in Bar-Boljare highway and FDIs in tourism and energy sectors followed by tobacco and aluminium. Private consumption buoyed by record employment, re-leveraging and tourist season will be partly subdued by fiscal measures (public wage/childcare cuts) and stagnant wages. Despite strong goods exports growth and record tourism FC receipts, net exports contribute negatively due to strong import-intensive investment demand. In 2019, we see GDP growth slowing to 3.0% on moderating private consumption and public capex growth as the highway project finalization likely slips in 2020. The key risks on the upside are on exports in case of even stronger tourist season and finalization of the key energy grid for hefty electricity exports to Italy, construction activity and one-notch rating upgrades on sharply reduced fiscal and (re)financing risks, progress in EU talks and improvement in competitiveness, GDP growth potential and external position on the wings of FDIs. Downside risks mainly stem from unstable external backdrop and higher domestic contingent liabilities.

***Budget deficit elevated by public capex***

The 7M18 budget data show 35.0% yoy lower deficit (EUR68m or 1.5% of 2018e GDP) thanks to 12.6% higher tax intake on better tax compliance, cyclically strong VAT intake (+15.9% yoy) partly due to 2pp VAT hike (21%). Despite various excise hikes in 2018, excise revenues barely grew 1.5% yoy amid tax evasion, prompting the MinFin to cut excises on tobacco. State budget outlays (+6.4% yoy) are solely driven by 67.6% higher capex, since current expenditure (+3.4% yoy) fell behind nominal GDP growth and has become fully-funded. With only half of the planned capex in 7M18 a sign of under-execution, we lower 2018 budget deficit forecast to 3.5% of GDP as intensified capex in 2H18, second EUR52m tranche of EPCG buy-back and some public wage hikes offset fiscal tax/savings measures. While we see deficit cut to 2% of GDP in 2019 on the first full-year interest bill savings (after the recent restructure of short-term debt) and slowing highway project dynamics, the shortfall stays above plan, being difficult to arrest spending ahead of 2020 general elections, potential cost overruns in the final phase of highway construction and overspending at the local level. That said, public debt will peak around 70% in 2018-2019 and fall in 2020 when the highway project is complete.

***2018 average CPI inflation seen at 2.8%***

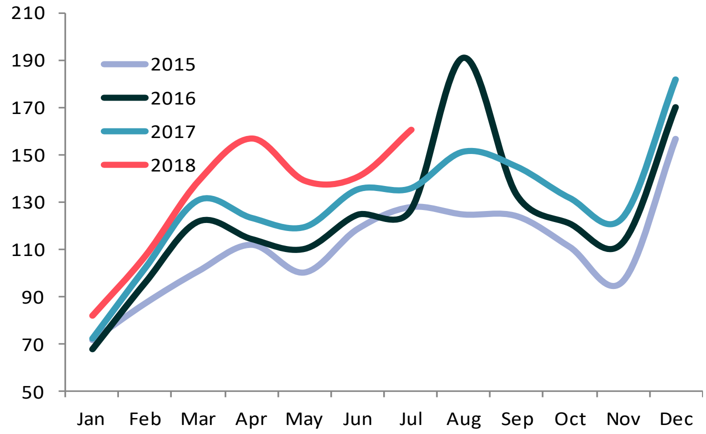
CPI inflation eased to 2.8% yoy in August from a 3.4% yoy peak in June-July driven by higher VAT, alcohol and tobacco excises, plus higher energy, transport and food prices, alongside strong foreign tourist and domestic demand. With the expected deceleration in Q4 after the peak tourist season and tobacco excise reduction last month, we see average inflation in 2018 at 2.8%. Next year, we see CPI inflation slowing to 2.5% as administrative hikes fade away. Upside risks mainly stem from persistently higher oil prices and even stronger foreign tourist demand-pull pressures.

***C/A gap widening continued in 1H18***

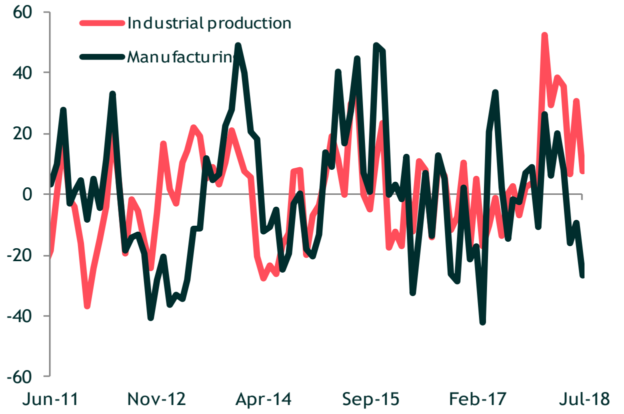
After hitting 16.4% of GDP in 2017, C/A deficit widened further 1H18 by 8.1% yoy to EUR613m. That said, goods trade gap rose 10.4% in 1H18 as soaring exports (+25.9% yoy) from a low base could not offset 12.9% higher imports, while services surplus jumped 23.3% yoy on the back of 12.7% higher tourist income and soaring transport services surplus (+194.8% yoy). Net FDI temporarily fell 30.4% yoy to EUR154m (FDI cover just 25.1%), albeit largely due to EPCG re-privatization, with the gross FDI dynamics (+47% yoy) for sure a better indication of short-term outlook. We see 2018 C/A gap slightly higher (17% of GDP) as stronger investment-driven import demand offsets higher tourism FC receipts, goods exports and remittances. On our estimates, C/A deficit will fall to 16% of GDP in 2019 as (energy-driven) export growth exceeds that of imports at wider margin amid lower expensive capital goods imports (related to energy projects) and slower highway project dynamics. With FDI cover up to 90% in 2019 from 70% in 2017, the gradual BoP de-risking just adds to stabilization of the overall economic imbalances.

# Montenegrin data trends

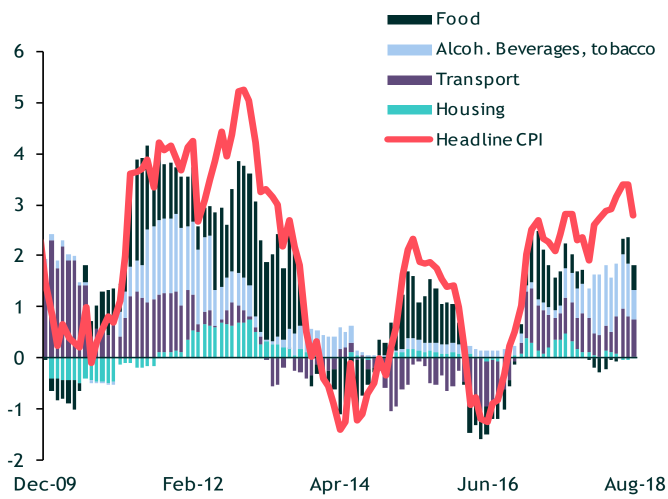
**Budget revenue movements (EURm)**



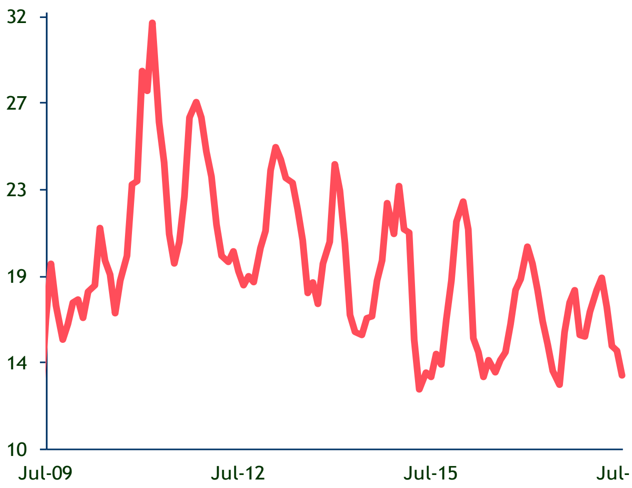

**Industrial production (%, yoy)**



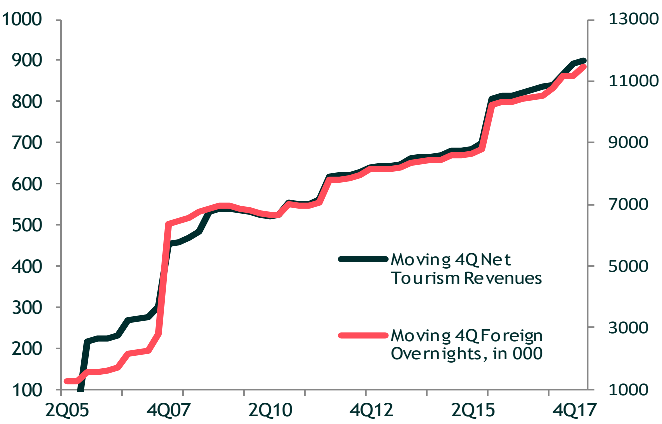

**CPI by key contributions (pps)**



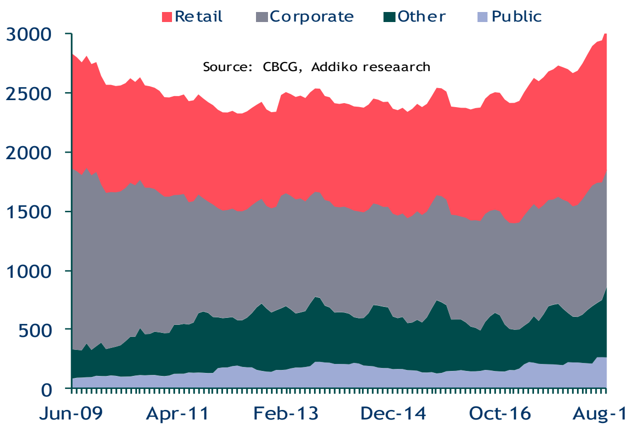

**Merchandise import cover (%, 3mma)**




**Tourism**




**Gross loans by sector (EURm)**




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

## SELECTED ECONOMIC FORECASTS

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Activity** | | | | | | | | | |
| Nominal GDP (EURbn,current prices) | 3,2 | 3,4 | 3,5 | 3,7 | 4,0 | 4,2 | 4,5 | 4,8 | 5,0 |
| Nominal GDP (USDbn) | 4,1 | 4,5 | 4,6 | 4,1 | 4,4 | 4,8 | 5,3 | 5,7 | 6,1 |
| GDP per capita (EUR) | 5.114 | 5.415 | 5.564 | 5.875 | 6.355 | 6.807 | 7.277 | 7.683 | 8.104 |
| GDP per capita (USD) | 6.577 | 7.191 | 7.391 | 6.516 | 7.037 | 7.686 | 8.587 | 9.104 | 9.846 |
| Real GDP (constant prices YoY, %) | -2,7 | 3,5 | 1,8 | 3,4 | 2,9 | 4,3 | 4,0 | 3,0 | 3,0 |
| Private consumption (YoY, %) | -3,9 | 1,6 | 2,9 | 2,2 | 5,4 | 3,5 | 2,5 | 2,7 | 3,0 |
| Fixed investment (YoY, %) | -2,4 | 10,7 | -2,5 | 11,9 | 27,5 | 15,8 | 11,0 | 7,2 | 0,0 |
| Industrial production (YoY, %) | -6,2 | 10,7 | -10,5 | 9,2 | -3,3 | -4,3 | 15,0 | 5,0 | 4,5 |
| Unemployment rate (ILO, average %) | 19,9 | 19,5 | 18,0 | 17,6 | 17,7 | 16,1 | 15,8 | 15,4 | 15,0 |
| **Prices** | | | | | | | | | |
| CPI inflation (average % YoY) | 4,1 | 2,2 | -0,7 | 1,5 | -0,3 | 2,4 | 2,8 | 2,5 | 2,4 |
| CPI inflation (end-year % YoY) | 5,1 | 0,3 | -0,3 | 1,4 | 1,0 | 1,9 | 2,8 | 2,3 | 2,5 |
| PPI inflation (average % YoY) | 1,8 | 1,7 | 0,2 | 0,3 | -0,1 | 0,4 | 1,2 | 1,5 | 0,0 |
| Net wage rates (% YoY, nominal) | 0,7 | -1,7 | -0,5 | 0,7 | 3,8 | 2,5 | 0,5 | 1,9 | 2,4 |
| **Fiscal balance (% of GDP)** | | | | | | | | | |
| State budget balance (ESA-95) | -6,5 | -6,0 | -2,9 | -8,3 | -3,5 | -5,4 | -3,5 | -2,5 | -1,5 |
| Public debt | 53,4 | 57,6 | 58,6 | 62,3 | 64,4 | 65,1 | 73,7 | 73,2 | 70,6 |
| Gross public funding needs | n/a | 9,5 | 5,1 | 14,0 | 21,5 | 16,6 | 14,7 | 22,1 | 20,4 |
| **External balance** | | | | | | | | | |
| Export of goods and services (EURbn) | 1,338 | 1,390 | 1,388 | 1,539 | 1,605 | 1,765 | 1,944 | 2,083 | 2,218 |
| Import of goods and services (EURbn) | -2,109 | -2,066 | -2,074 | -2,214 | -2,494 | -2,773 | -3,026 | -3,219 | -3,354 |
| Merchandise trade balance (EURbn) | -1,384 | -1,329 | -1,376 | -1,464 | -1,658 | -1,860 | -2,046 | -2,173 | -1,745 |
| Merchandise trade balance (% of GDP) | -43,5 | -39,5 | -39,8 | -40,0 | -41,9 | -43,9 | -45,2 | -45,4 | -34,6 |
| Tourism receipts (EURbn) | 0,643 | 0,666 | 0,682 | 0,813 | 0,836 | 0,922 | 0,995 | 1,053 | 1,137 |
| Current account balance (EURbn) | -0,486 | -0,383 | -0,429 | -0,401 | -0,642 | -0,692 | -0,736 | -0,760 | -0,760 |
| Current account balance (% of GDP) | -15,3 | -11,4 | -12,4 | -11,0 | -16,2 | -16,3 | -16,3 | -15,9 | -15,1 |
| Net FDI (EURbn) | 0,5 | 0,3 | 0,4 | 0,6 | 0,4 | 0,5 | 0,6 | 0,7 | 0,6 |
| FDI (% of GDP) | 14,5 | 9,6 | 10,2 | 16,9 | 9,4 | 11,4 | 14,0 | 14,2 | 12,3 |
| FDI cover (%) | 95,0 | 84,6 | 82,5 | 154,4 | 57,9 | 70,0 | 85,9 | 89,4 | 81,6 |
| Gross international reserves (EURbn) | 0,318 | 0,395 | 0,514 | 0,641 | 0,780 | 0,877 | 1,413 | 1,785 | 2,164 |
| Import cover (months of imports) | 1,8 | 2,3 | 3,0 | 3,5 | 3,8 | 3,8 | 5,6 | 6,7 | 7,7 |
| **Debt indicators** | | | | | | | | | |
| Gross external debt (EURbn) | 4,959 | 5,093 | 5,353 | 5,559 | 6,121 | 6,634 | 7,274 | 7,727 | 8,246 |
| Government (EURbn) | 1,295 | 1,352 | 1,646 | 2,061 | 2,187 | 2,358 | 2,477 | 2,567 | 2,680 |
| Private (EURbn) | 3,665 | 3,742 | 3,707 | 3,498 | 3,934 | 4,276 | 4,797 | 5,161 | 5,566 |
| Gross external debt (% of GDP) | 155,9 | 151,5 | 154,8 | 152,1 | 154,8 | 156,6 | 160,6 | 161,6 | 163,5 |
| Gross external debt (% of exports) | 370,6 | 366,4 | 385,6 | 361,2 | 381,3 | 375,9 | 374,2 | 371,0 | 371,8 |
| **Exchange rates and money growth** | | | | | | | | | |
| EUR/USD (end-year) | 1,32 | 1,38 | 1,21 | 1,09 | 1,05 | 1,19 | 1,15 | 1,23 | 1,21 |
| EUR/USD (average) | 1,29 | 1,33 | 1,33 | 1,11 | 1,11 | 1,13 | 1,18 | 1,19 | 1,22 |
| Money supply M1 (% YoY)* | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | 0,0 |
| Broad money M3 (% YoY)* | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | 0,0 |
| Domestic credit (% YoY) | -0,7 | 3,1 | -1,9 | 0,8 | 1,3 | 11,8 | 10,0 | 7,8 | 0,0 |
| ECB reference rate (end-year %) | 0,75 | 0,25 | 0,05 | 0,05 | 0,00 | 0,00 | 0,00 | 0,00 | 0,50 |
| EURIBOR 3M interest rate (average, %) | 0,58 | 0,22 | 0,21 | -0,02 | -0,18 | -0,33 | -0,32 | -0,30 | 0,10 |

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

## SELECTED BANKING SECTOR DATA

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|---|
| **Balance sheet** | | | | | | | | | |
| Assets (EURm) | 2.808 | 2.959 | 3.136 | 3.472 | 3.790 | 4.182 | 4.585 | 4.906 | 5.224 |
| Assets (%, YoY) | -0,1 | 5,4 | 6,0 | 10,7 | 9,2 | 10,3 | 9,6 | 7,0 | 6,5 |
| Assets (% of GDP) | 88,3 | 88,0 | 90,7 | 95,0 | 95,9 | 98,7 | 101,2 | 102,6 | 103,6 |
| Gross loans (EURm) | 2.342 | 2.414 | 2.367 | 2.386 | 2.416 | 2.701 | 2.970 | 3.202 | 3.388 |
| Gross loans (%, YoY) | -0,7 | 3,1 | -1,9 | 0,8 | 1,3 | 11,8 | 10,0 | 7,8 | 5,8 |
| Gross loans (% of GDP) | 73,6 | 71,8 | 68,5 | 65,3 | 61,1 | 63,7 | 65,6 | 67,0 | 67,2 |
| Deposits (EURm) | 1.981 | 2.098 | 2.308 | 2.625 | 2.872 | 3.267 | 3.602 | 3.893 | 4.133 |
| Deposits (%, YoY) | 9,0 | 5,9 | 10,0 | 13,7 | 9,4 | 13,8 | 10,2 | 8,1 | 6,2 |
| Deposits (% of GDP) | 62,3 | 62,4 | 66,7 | 71,8 | 72,6 | 77,1 | 79,5 | 81,4 | 81,9 |
| Loan-to-deposit ratio (%) | 118,2 | 115,1 | 102,6 | 90,9 | 84,1 | 82,7 | 82,5 | 82,2 | 82,0 |
| Capital adequacy ratio (%) | 14,7 | 14,4 | 16,2 | 15,5 | 16,1 | 17,6 | 18,3 | 18,3 | 18,1 |
| **Performance** | | | | | | | | | |
| Net interest income (EURm) | 106 | 104 | 111 | 117 | 122 | 125 | 136 | 142 | 149 |
| Net interest income (%, YoY) | -0,1 | -1,6 | 6,6 | 5,3 | 4,2 | 2,4 | 8,8 | 4,8 | 4,9 |
| Total operating income (EURm) | 178 | 156 | 158 | 171 | 175 | 189 | 204 | 213 | 223 |
| Total operating income (%, YoY) | -19,5 | -12,0 | 1,2 | 8,3 | 1,9 | 8,2 | 7,8 | 4,8 | 4,4 |
| Pre-provision profit (EURm) | 65 | 48 | 46 | 52 | 53 | 59 | 68 | 71 | 74 |
| Pre-provision profit (%, YoY) | -43,2 | -26,7 | -2,6 | 11,5 | 2,6 | 11,3 | 14,4 | 5,3 | 4,5 |
| Provision charges (EURm) | 121 | 44 | 21 | 53 | 44 | 22 | 11 | 14 | 15 |
| **Profitability and efficiency** | | | | | | | | | |
| Net interest margin (%) | 3,8 | 3,6 | 3,6 | 3,5 | 3,4 | 3,1 | 3,1 | 3,0 | 3,0 |
| Pre-tax ROAA (%) | -2,0 | 0,1 | 0,8 | -0,1 | 0,3 | 0,9 | 1,3 | 1,2 | 1,2 |
| Pre-tax ROAE (%) | -18,7 | 1,0 | 6,0 | -0,4 | 2,0 | 7,4 | 10,8 | 10,7 | 10,9 |
| Cost-to-income ratio (%) | 63,5 | 69,6 | 70,7 | 69,8 | 69,6 | 68,7 | 66,8 | 66,7 | 66,6 |
| Operating expense (% of assets) | 4,0 | 3,8 | 3,7 | 3,6 | 3,3 | 3,3 | 3,1 | 3,0 | 2,9 |
| **Credit quality and provisioning** | | | | | | | | | |
| NPL ratio (%) | 17,6 | 18,4 | 16,8 | 12,6 | 10,3 | 7,3 | 6,2 | 5,7 | 5,4 |
| NPL coverage (%) | 40,0 | 39,1 | 39,5 | 39,5 | 41,3 | 42,9 | 44,9 | 46,0 | 51,0 |
| Provision charges (% of loans) | 5,1 | 1,9 | 0,9 | 2,2 | 1,8 | 0,9 | 0,4 | 0,5 | 0,5 |
| Provision charges (% of PPP) | 185,7 | 92,5 | 45,6 | 103,2 | 82,2 | 37,2 | 16,8 | 19,5 | 20,0 |

Source: CBCG, Addiko research

***Pre-tax profit doubled in 1H18***

Overall loans increased by 13.1% ytd in the year to August (vs. 11.8% yoy in 2017), with all sectors contributing positively, but the strongest boost came from the volatile growth of 'other' sectors (43.3% ytd). Retail lending increased by 8.0% ytd, driven by cash loans growth amid increased employment and strong consumer optimism. Corporate loans rose 4.6% driven by strong construction activity, while public sector surged 18.4%. Due to increased credit activity, NPL ratio fell to 6.8% in August (vs. 7.3% in 2017). At the same time, deposit collection increased by 8.1% ytd, driven by strong growth from both corporate (16.5% ytd) and retail (6.7% ytd) side, on hefty tourism inflows and improving labour market, while public sector deposits keep stagnating (-0.8% ytd). Regarding profitability, pre-tax profit surged 97.1% yoy to EUR33m in 1H18 thanks to strong operating income growth (8.6% yoy) and substantially lower provisioning costs (-80.2% yoy).

***Strong credit growth expected in 2018 and 2019***

With lending dynamics in line with our expectations, we keep our 10.0% yoy growth, while in 2019 we see credit growth at 7.8% yoy. Credit growth remains supported by another record tourist season, rising employment, soaring construction activity, falling interest rates and high bank liquidity. We see NPL ratio declining towards 6.2% level as banks will continue selling of their non-performing portfolios or transferring them to the factoring companies, while rising credit activity will also support further NPL ratio decline. With stronger-than-expected ytd deposit dynamics, we lift our 2018 deposit growth forecast to 10.2%, while next year we expect deposit deceleration towards 8.1% yoy amid high base effects and strong investments outlook. Concerning profits, we expect 2018 to be another record year for Montenegrin banks, on the account of much lower impairments and solid NII growth given rising credit activity.

## 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 |

Addiko Bank

## Disclosures Appendix

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