SEE Outlook Quarterly

by Economic
Research
Department

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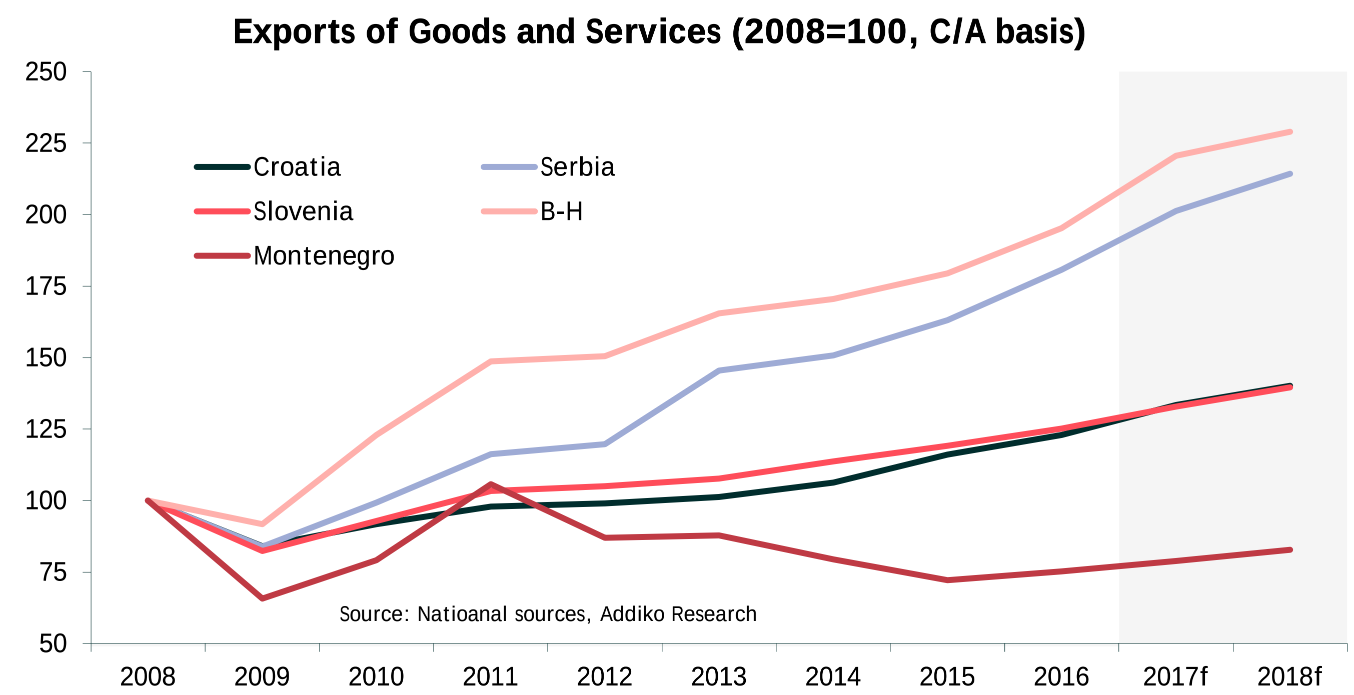
Addiko Bank

SEE Quarterly

Addiko Bank

19 July 2017

NOT TAKING THE FOOT OFF THE GAS YET



FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017

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Consensus Economics Forecast Accuracy Award Winner 2014 Croatia

EXECUTIVE SUMMARY

Bottom LINE: In Croatia and Serbia, we cut 2017 GDP growth forecast with the former down to Agrokor restructuring, and the latter mainly due to overall soft 1H17 performances. In Bosnia-Herzegovina and Montenegro, we kept growth forecast of 3.2% for both unchanged, while in Slovenia we lift 2017 GDP forecast to 4.4%. The 2H17 should see growth acceleration across SEE, driven by private consumption, steady euro zone's demand, investments and employment growth. In 2018, we expect 3%+ GDP growth dynamics for the SEE region (on average) to be maintained on robust tourism and EU demand, stronger investments, faster EU funding, SMEs endurance, further improvement in the labor markets and fiscal flexibility if necessary. Inflation is set to increase in 2017 in all countries, with the weakest price pressures seen in Croatia (0.8% on average) due to subdued food inflation amid price wars for Agrokor's retail space. We see modestly wider budget gaps in Croatia and Montenegro, deficit narrowing in Serbia and Slovenia, and flattish deficit in Bosnia-Herzegovina.

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

*EUR/USD

KEY POINTS:

1. In Slovenia, we upgraded 2017 growth forecast to 4.4% on faster global/euro-zone growth, signs of stronger capex rebound, robust confidence, supportive fiscal and monetary policies and strong employment growth. In Croatia, we lowered growth expectations by 0.5pp to 3.0% in our first risk-adjusted forecast exercise for downside risks from Agrokor restructuring, though largely balanced out by robust foreign and local demand. In Serbia, we cut our 2017 GDP forecast by 0.7pp to 2.5% due to soft 1H17 performance, weaker agricultural season and stronger investment-related imports. In Bosnia-Herzegovina, we keep our 3.2% growth forecast unchanged on the back of stronger private consumption, employment and wage growth, re-leveraging, and higher remittances. In Montenegro, we keep GDP growth forecast at 3.2%, with risks on the upside from stronger investment in 2H17.

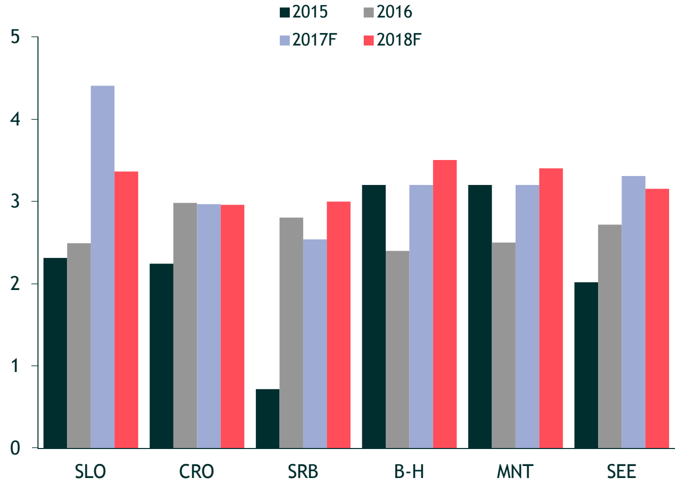
2. As for fiscal performance, we expect Slovenian budget deficit below 1% of GDP in 2017 due to strong GDP growth, first-time positive impact from BAMC activity and interest savings. In Croatia, we see healthcare cost overruns, public wage hikes (above the planned 2% increase), stronger EU co-sponsored investment spending and higher defense outlays lifting the budget gap to 1.4% of GDP. While we expect Serbian budgetary outlays to accelerate in 2H17 on stronger public capex and the expected wage and pensions hikes, we still cut our FY17 budget deficit forecast by 0.9pp to -0.8% of GDP on the back of strong fiscal outperformance in 1H17 on strong tax intake and public capex under-execution.

3. In Slovenia, we expect inflation to inch up in 2H17 on stronger consumer demand, tighter labour market, 3%+wage growth and closing output gap for an average 1.5% increase. In Croatia, our inflation forecast for 2017 is cut to 0.8% on slower-than-expected food price recovery given price wars for the entroubled Agrokor's retail space, while energy price pressures have receded recently. In Serbia, we see average inflation at 3.4% in 2017 as weather-inflicted food prices boosted inflation early this year, while stronger demand, commodity prices, expected wage and pension hikes and tobacco excise duty hike in July will drive inflation going forth.

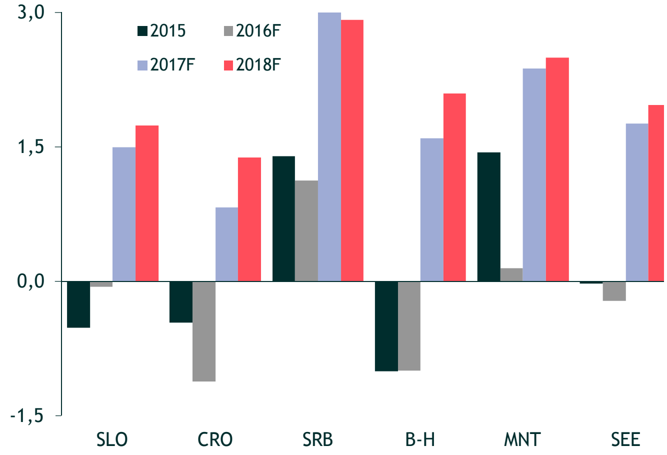
4. We expect the ECB to renew hints of QE taper to zero in 1H18, stressing that, even once QE program is over, interest rates will remain close to record lows for longer. We thus see Slovenian yields in sync with higher core yields outlook, but given fairly cautious QE tapering dynamics and the strength as well as health of Slovenian economy, we do not see strong impact on its bonds. We see the CNB in accommodative mode, focused on maintaining ample kuna liquidity in its ongoing support to lending availability and anchoring short-end rates around record lows. With 80%+ of the gross funding needs covered to date, steady local investors' appetite and reduced excessive fiscal and political risks, we see 30bp-alike compression potential in H2 provided Agrokor restructuring goes smoothly and reforms gain momentum after the cabinet reshuffle. In Serbia, we see the NBS key rate at 4.00% flat in 2H17, followed by one rate hike in 2Q18 due to smaller risks to Fed tightening and low core inflation at home. In addition, we see good appetite for Serbian debt ahead, as positive rating outlook (S&P) outshine external risks and potential market jitters, and the MinFin is eyeing inclusion of RSD debt in a few EM indices.

SEE data trends

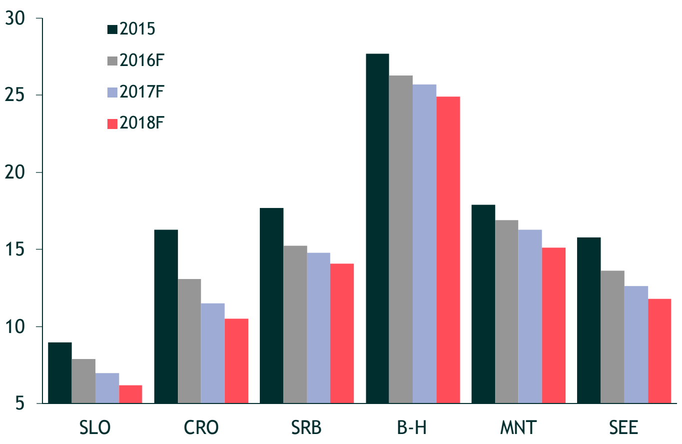
Real GDP growth (%)



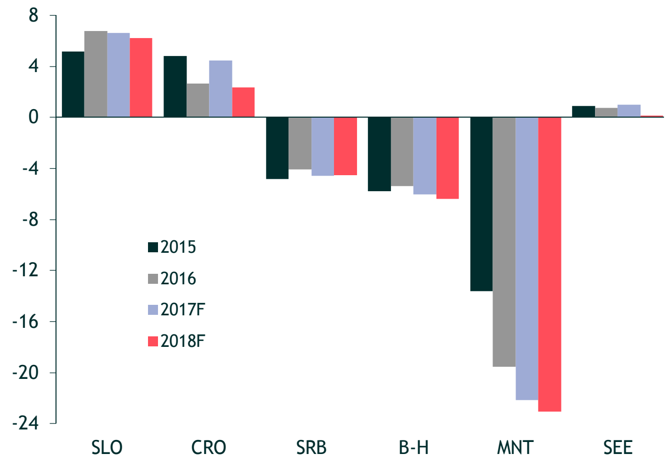
CPI inflation (average, %, YoY)



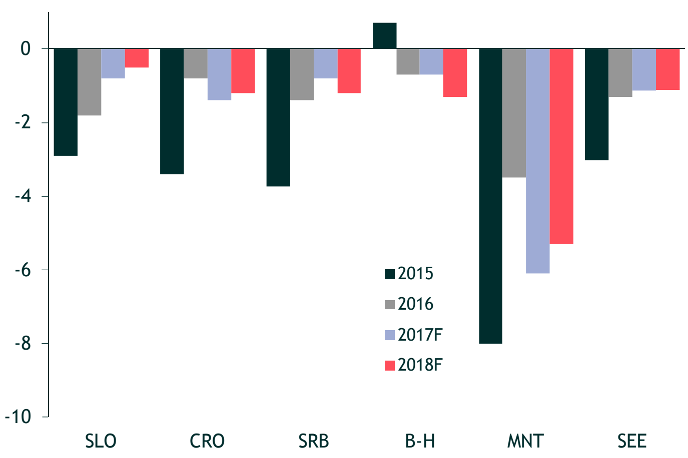
Unemployment rate (ILO, average, %)



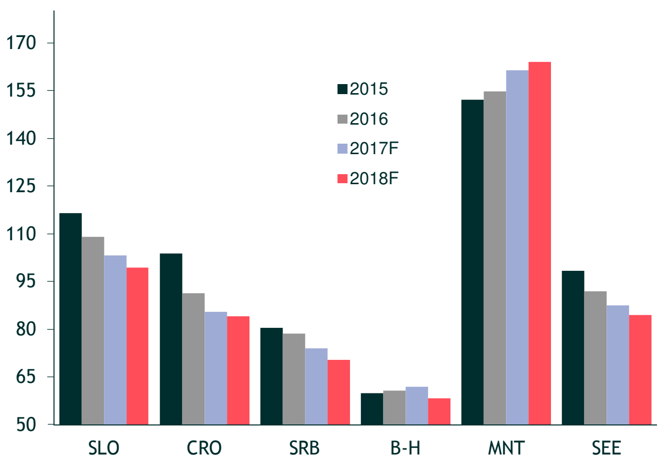
Current account balance (% of GDP)



Government balance (% of GDP)



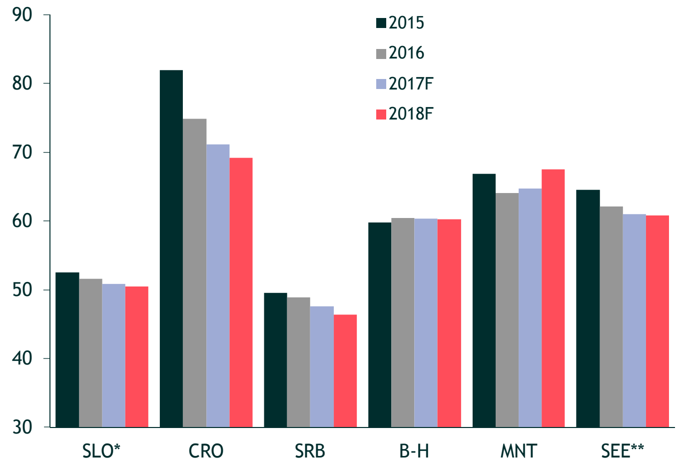
Gross foreign debt (% of GDP)



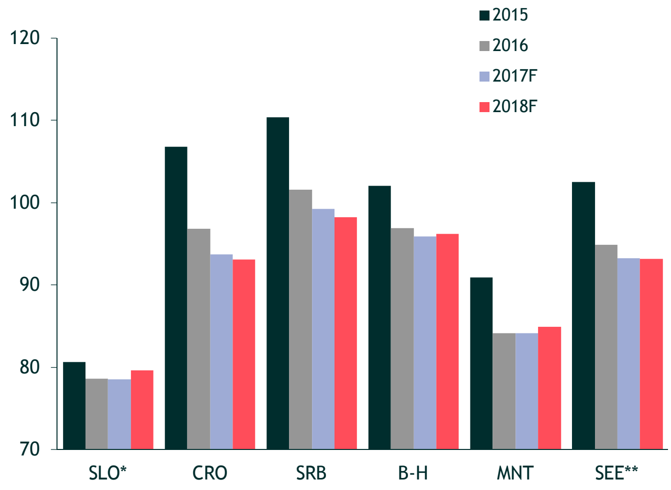
Source: National sources, Addiko research

SEE banking sector trends

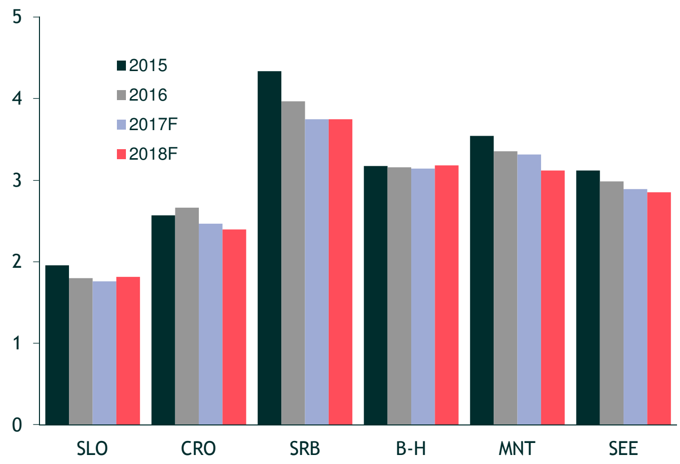
Gross loans (% of GDP)



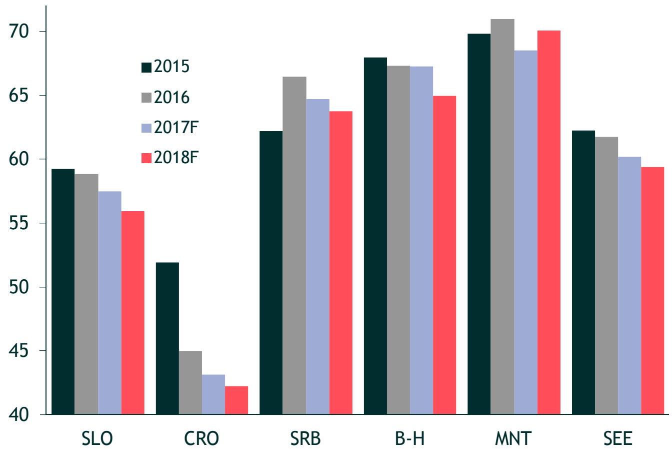
Loan-to-deposit ratio (%)



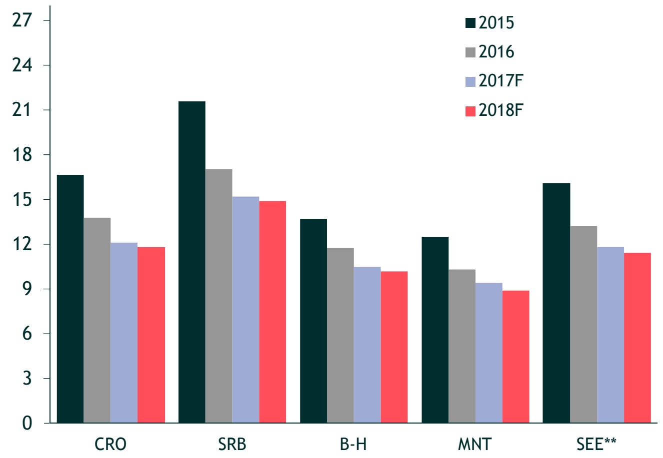
Net interest margin (%)



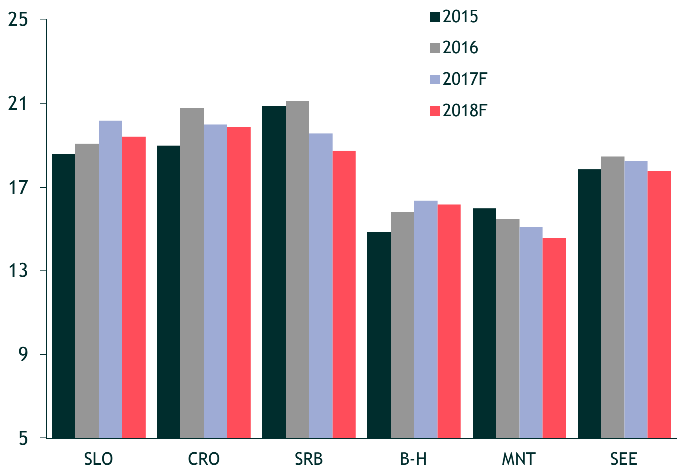
Cost-to-income ratio (%)



NPL ratio (%)



Capital adequacy ratio (%)



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

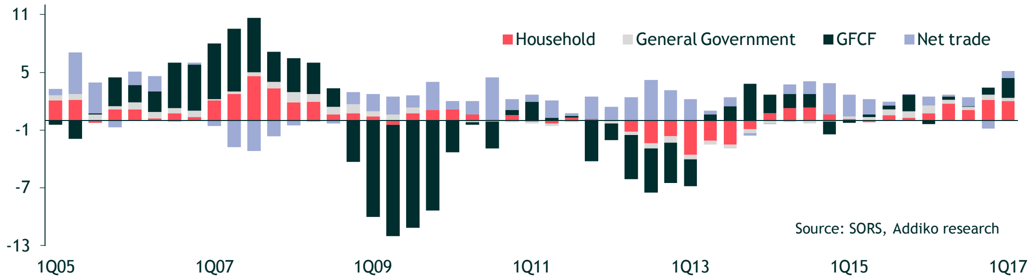
Enjoying the Sweet Spot

We again lift our 2017 growth forecast to 4.4% on stronger-than-expected domestic as well as external demand accompanied by re-leveraging and broad-based investment demand acceleration. While the budget deficit and public debt continue to fall, fiscal stance is becoming slightly expansionary into 2018, as reform efforts have been probably back loaded after mid-2018 parliamentary elections. Superior macro/fiscal picture versus EMU peripherals, improved rating prospects and readily available domestic banks' bid suggest ongoing Slovenian bonds outperformance despite the global reflationary pressures.

GDP growth accelerates in 1H17...

Primarily driven by domestic demand, Q1 GDP growth (1.5% qoq, 5.0% yoy, prev. 3.6% yoy) outshone expectations, with soaring investment due to resurgent construction and private equipment capex thanks to a rebound in EU funding, significant capex replacement needs and stronger lending after hefty NPL sales. Private spending is fuelled by new employment, wage growth and expectations, re-leveraging, cheaper debt service and housing market recovery. Net trade also surprised on the upside thanks to a larger-than-anticipated pick-up in the euro zone's (import) demand, competitiveness outperformance of the euro zone and movement up the value chain. Following a breath-taking Q1 pace, GDP growth is set to slow only slightly in Q2 to about 1% qoq driven by persistent external and domestic demand strength. Though we forecast the recent cyclical strength to diminish somewhat, we also envisage the pace of sequential growth to stay above average from hereafter and in any case stronger than before.

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



... and Slovenia outperforms CEE peers

Faster global growth, signs of stronger capex rebound, robust confidence, supportive fiscal and monetary policies, and solid jobs growth create conditions for external demand momentum to carry on in 2H17. Since late 2016 the consensus has upgraded 2017 euro zone growth by 0.5pp and 0.3pp for 2018, as the economy has not been impacted by political risks, which creates upside risks to the biggest growth engine - exports. Beyond foreign demand, competitiveness has improved in terms of unit labor costs, export market shares or integration into high value-added euro zone's supply chains. Private spending is set to grow at 4% yoy pace on record sentiment, strong employment, rising disposable income and re-leveraging. Robust overall demand outlook, stronger bank lending underscored by easier SMEs' access to credit, new EU funding cycle (25%+ of EUR4.9bn financial envelope already planned, EUR1bn for competitiveness of SMEs), stronger construction, record firms' profits and low interest rates all support acceleration in investments, including export capacity expansion. Despite strong import-intensive local demand, resilient exports ensure positive net trade contribution in 2017 and 2018. In that vein, we see Slovenia in early stages of recovery from investments, and stronger supply side driving potential growth higher. We lift GDP forecasts to 4.4% and 3.4% for 2017 and 2018, respectively, from 3.2% and 3.0% earlier. If any, downside risks may arise from political uncertainty, early ECB tightening (in 2018) and soaring imports amid strong demand.

Inflation is normalizing, but remains below EMU average

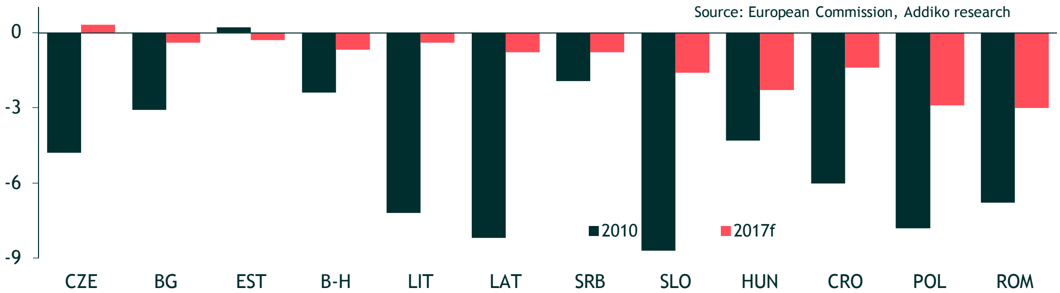
Despite weaker CPI data of late, we expect inflation to inch up in 2H17 on stronger consumer demand, tighter labor market, 3%+wage growth and closing output gap. Inflation path though will likely improve at sub-standard pace given lower oil prices of late, stronger euro and general downward pressure on prices amid higher transparency and competitions via automatization. Reflective of the absence of upward pipeline pressures, non-energy industrial goods inflation and prices for consumer durables stay muted. Stronger euro FX outlook is the last piece of low core inflation puzzle. That said, we see headline CPI inflation accelerating towards 1.5% yoy by end-2017 off June's 0.9% yoy low for the FY17 average in the 1.5% region and about 1% for core inflation. The sluggish recovery in core inflation is unlikely to allow a quick ECB policy shift, but it is consistent with moving away from a level of accommodation that is no longer necessary to fight deflation risks.

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

We expect C/A surplus to moderate in 2017-2018 in sympathy with stronger domestic demand, commodity prices normalization and maturing de-leveraging pressures in the economy. Stronger goods export growth, higher tourism earnings and accelerating EU transfers will nevertheless keep C/A surplus at high levels in the medium term. As long as net external debt is falling and banks' liquidity is ample, we see a further improvement in the net international investment further above -30% of GDP, which is substantially better than the Baa3 median of about -40% of GDP and highlights much lower external vulnerabilities compared with pre-crisis phase.

With ongoing near-record C/A surpluses and about 12% of GDP fiscal reserve upon the second USD1.1bn bonds swap (in 2017) with cheaper Eurobonds and a net EUR1.1bn issuance, funding position is extremely positive, and the average debt maturity is lengthened significantly. With huge ECB accommodativeness still in place, Slovenia may still exploit solid risk appetite in pre-funding for 2018. Meanwhile, sell-off ambitions for NLB are not just watered down, but the approaching election cycle, the government's intransigence on buying controlling stakes in 'strategic' SOEs and onerous regulation do not inspire investors. Taking the authorities' foot off the regulatory brakes in case of SOEs privatization, incentivizing bank consolidation and competitiveness reforms are of utmost importance to boost FDI stock and deepen integration into global value chains, both comparatively weak by international standards.

Slovenia: fiscal deficits (% of GDP)



Fiscal easing behind the scenes...

A 73.5% yoy lower budget gap (EUR134m) in the year to May is driven by buoyant tax revenue (+8.8% yoy) and social contributions against -1.8% yoy lower spending. While revenues reflect stronger-than-expected tax-rich local demand and employment, current spending subduedness largely due to EU contribution cuts and interest expenditure savings thanks to USD bond buybacks (46% of total exposure so far). Strong GDP growth, first-time positive impact from BAMC activity and the aforementioned interest savings will in our view do enough to offset higher public wage bill (+5.0% yoy) and entitlement spending, EU-co-funded capex , and finally send this year's budget deficit below 1% of GDP. However, we see less ambitious consolidation in 2018, despite further upgrade in GDP forecast and the full impact from interest savings of 0.3% of GDP FX-adjusted or higher should stronger GDP growth and stronger euro provide leeway for further USD bond buybacks within to the debt rule. Further fiscal consolidation in the election year 2018 (and beyond) is under threat given increased political posturing in yet-to-be-negotiated reversal of past years' spending freezes with trade unions. The sub-1% headline still hides the structural deficit widening close to 2% of GDP on large change in the output gap, soaring public capex to 2013 levels and higher entitlement spending, 2.7% pension indexation and higher bonuses. This not only effectively leads to a bout of fiscal easing but in the absence of real estate taxation, we may see zero structural deficit target by 2020 compromised.

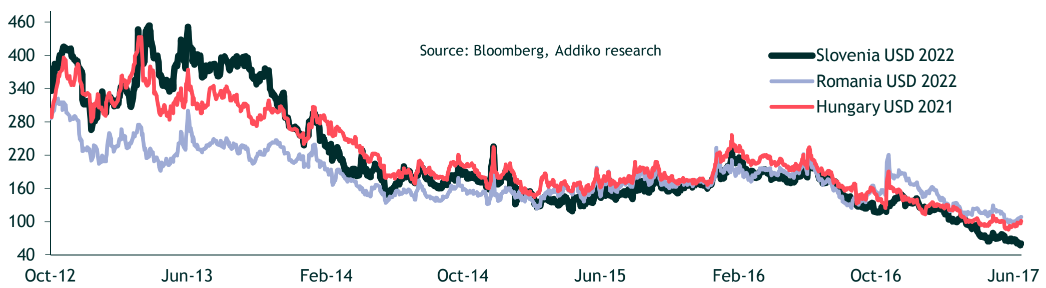
... but public and interest costs stay on a firm downward trend

After the last year's decline just below 80% of GDP on strong deficit reduction, we expect public debt to fall further this year and next to 72% of GDP in 2018 on stronger GDP growth, persistently low budget gaps, record low interest cost and deployment of hefty fiscal reserve (~12% of GDP). This also brings adjusted net public debt close to 60% of GDP in 2018, and should the recoveries by the BAMC exceed those in embedded haircuts (68% on average) applied in the bad asset transfer some years ago, this may pose positive risks for even lower debt. As mentioned before, pre-funding operations for 2018 will be likely combined by further USD bond buybacks and lengthening of the euro yield curve. Another positive development is further reduction in the government debt interconnectedness with the banking sector. The pace of public debt cuts could be stronger should reform-driven fiscal consolidation gains momentum, and if sales revenues from privatization (NLB, Telekom Slovenije) and the expected BAMC assets resolution (potentially EUR300-400m a year) are applied to debt reduction. Further bank and corporate (both SOE and private ones) restructuring, with an overall ambitious low NPL targets, are equally important to reduce risks to public finances over the medium term.

Trump, fading EU political risks and disinflation lower yields...

The growing doubts about Trump's fiscal plans, market-friendly outcome in French presidential elections, 'EUphoria' unfolding and unwelcome disinflationary trends in the euro zone have supported bond markets incl. Slovenian longer maturities. Robust primary market sentiment has only compounded the downtrend, and the latest tones from Germany and the ECB imply that EU Government bonds still offer more value over the summer even with spreads back at year-to-date lows. That said, Slovenia outperformed Italy and Spain, facing the risk of snap elections and banking issues, but underperformed Portugal who benefits from strong improvement in growth-to-fiscal metrics. For Slovenia, GDP growth upgrades for 2017-2018, faster-than-expected public debt stabilization, accommodative ECB, much cheaper debt service and the recent S&P's rating upgrade are all supporting investor sentiment going forth.

Slovenian spreads in tandem with peers

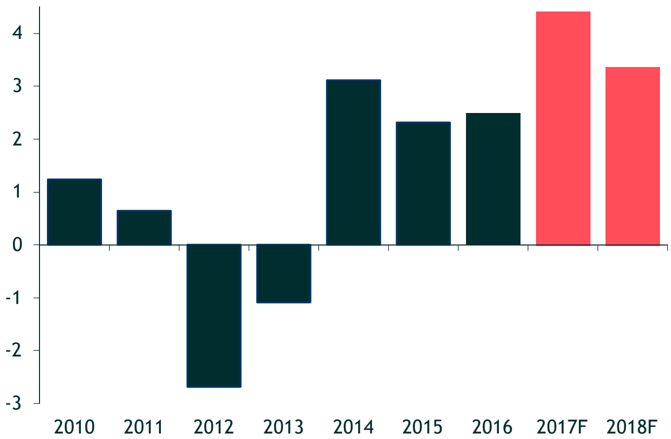


... as ECB hints about monetary normalization

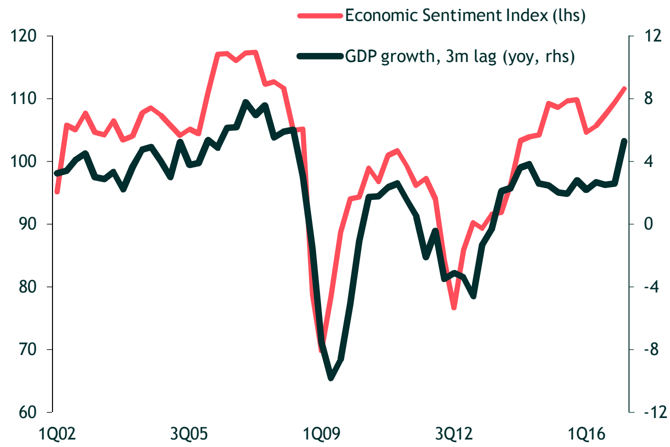
We expect the ECB to renew hints of QE taper to zero in 1H18, despite the modest tightening of financial conditions that such hints induce already. But the ECB may not fully commit to such action just yet and will likely launch open-ended QE buying strategy, stressing that, even once QE program is over, interest rates will remain close to record lows for longer as inflation outlook undershoots. In that vein, we see Slovenian yields in sync with higher core yields outlook, but given fairly cautious QE tapering dynamics and the strength as well as health of Slovenian economy, we do not see strong impact on its bonds. With the almighty monetary QE medicine at its exit rout, Slovenian spreads may though not easily avoid 25-50bp widening through risk-off episodes, in our view. Worth following going forth are Slovenia's key policy challenges, including entitlement reforms and delays in the sale of NLB, which according to a promise to the EC needs to be closed just a quarter away from the peak election campaign and might have political consequences. Also, prefunding for 2018 can be done opportunistically without material pressures on rates given the fully funded 2017 and strong cash buffer. That said, positive risks for bond performance include further USD bond buybacks on optimism after S&P upgrade a newly found fiscal leeway that would further lower interest outlays. In the medium term, we see Slovenian bonds outperforming on superior macro/fiscal over performance relative to EMU peripherals, as domestic banks' (holding just 15% of state debts) bid stays strong in the wake of ample liquidity and still sub-normal domestic lending activity.

Slovenia's data trends

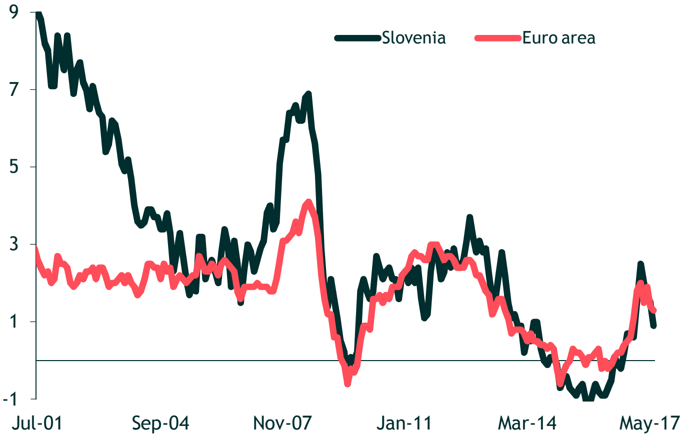
Real GDP growth (% YoY)



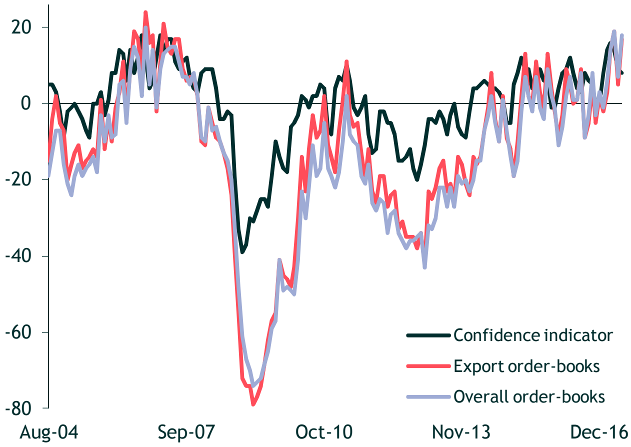
Economic confidence vs. GDP growth



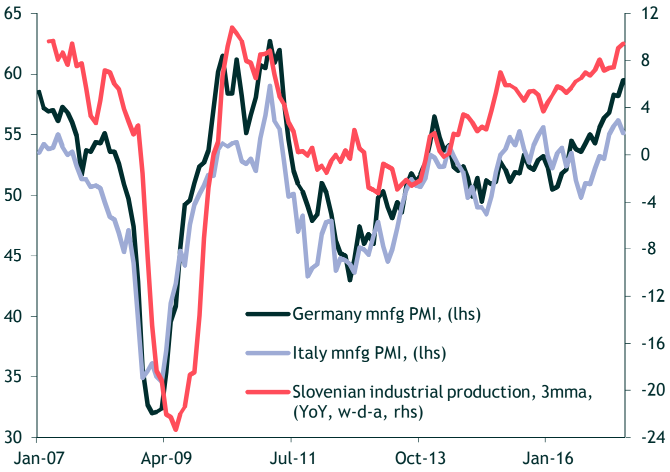
CPI inflation dynamics (% YoY)



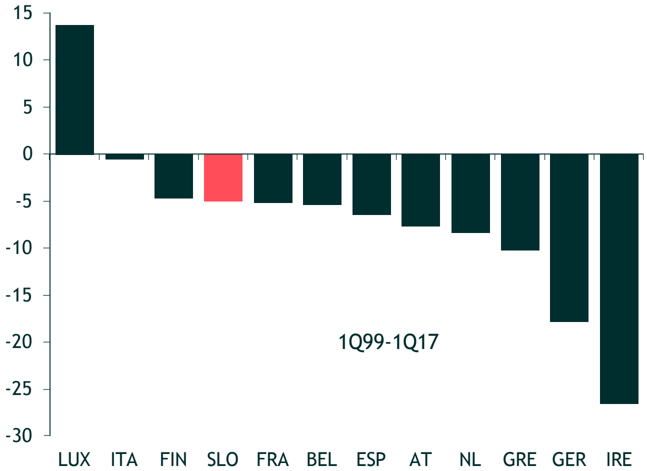
Business sentiment in manufacturing



PMI vs Industrial production - Slovenia



Unit labour cost for the total economy



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

SELECTED ECONOMIC FORECASTS

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Activity									
Nominal GDP (EURbn, current prices)	36,3	36,9	36,0	35,9	37,3	38,6	39,8	42,1	44,3
Nominal GDP (USDbn)	48,1	51,4	46,3	47,7	49,6	42,8	44,0	46,6	48,7
GDP per capita (EUR)	17.693	17.972	17.502	17.435	18.105	18.705	19.268	20.386	21.343
GDP per capita (USD)	23.471	25.028	22.508	23.156	24.052	20.746	21.337	22.567	23.477
Real GDP (constant prices YoY, %)	1,2	0,6	-2,7	-1,1	3,1	2,3	2,5	4,4	3,4
Private consumption (YoY, %)	1,1	0,0	-2,4	-4,1	1,9	0,4	2,8	3,7	3,2
Fixed investment (YoY, %)	-13,3	-4,9	-8,8	3,2	1,4	1,0	-3,1	7,8	5,8
Industrial production (YoY, %)	7,1	1,3	-0,8	-0,9	1,7	5,1	7,7	10,8	7,0
Unemployment rate (ILO, average %)	7,3	8,2	8,9	10,1	9,7	9,0	7,9	7,0	6,2
Prices									
CPI inflation (average % YoY)	1,8	1,8	2,6	1,8	0,2	-0,5	-0,1	1,5	1,7
CPI inflation (end-year % YoY)	1,9	2,3	2,7	0,7	0,2	-0,5	0,5	1,5	1,9
PPI inflation (average % YoY)	2,1	4,5	0,9	0,3	-0,6	-0,2	-1,5	1,9	2,1
Net wage rates (% YoY, nominal)	3,9	2,1	0,4	0,6	0,8	0,7	1,9	3,2	3,0
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-8,7	-6,7	-4,1	-15,1	-5,4	-2,9	-1,8	-0,8	-0,5
Public debt	58,2	46,6	53,9	71,0	80,9	83,1	79,7	75,8	72,4
Gross public funding needs	7,0	10,5	8,2	19,5	14,6	6,4	8,1	8,8	8,4
External balance									
Export of goods and services (EURbn)	23,285	25,948	26,363	27,010	28,520	29,905	31,401	33,347	35,015
Import of goods and services (EURbn)	22,823	25,516	24,934	24,569	25,641	26,569	27,690	29,584	31,329
Merchandise trade balance (EURbn)	-0,748	-0,974	-0,081	0,708	1,181	1,476	1,537	1,413	1,335
Merchandise trade balance (% of GDP)	-2,1	-2,6	-0,2	2,0	3,2	3,8	3,9	3,4	3,0
Tourism receipts (EURbn)	1,925	1,975	2,008	2,043	2,060	2,098	2,190	2,292	2,357
Current account balance (EURbn)	-0,043	0,068	0,930	1,732	2,179	1,698	2,108	2,780	2,744
Current account balance (% of GDP)	-0,1	0,2	2,6	4,8	5,8	4,4	5,3	6,6	6,2
Net FDI (EURbn)	0,1	0,6	0,5	0,0	0,6	1,3	0,9	1,0	1,0
FDI (% of GDP)	0,3	1,7	1,3	0,1	1,6	3,3	2,2	2,3	2,2
FDI cover (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0,803	0,767	0,722	0,669	0,837	0,760	1,400	2,100	2,750
Import cover (months of imports)	0,4	0,4	0,3	0,3	0,4	0,3	0,6	0,9	1,1
Debt indicators									
Gross external debt (EURbn)	42,123	41,669	42,872	41,658	46,314	46,627	44,805	44,955	45,425
Government (EURbn)	8,190	8,748	11,092	15,459	22,416	24,824	22,953	23,553	24,003
Private (EURbn)	30,273	28,534	25,709	23,457	21,815	19,587	18,395	17,902	18,122
Gross external debt (% of GDP)	116,2	112,9	119,1	116,0	124,1	120,9	112,7	106,7	102,6
Gross external debt (% of exports)	180,9	160,6	162,6	154,2	162,4	155,9	142,7	134,8	129,7
Exchange rates and money growth									
EUR/USD (end-year)	1,34	1,30	1,32	1,38	1,21	1,09	1,05	1,10	1,14
EUR/USD (average)	1,33	1,39	1,29	1,33	1,33	1,11	1,11	1,11	1,10
Money supply M1 (% YoY)*	13,5	1,5	4,4	0,1	18,5	24,9	17,1	11,5	14,6
Broad money M3 (% YoY)*	2,4	3,5	-1,4	-1,3	6,1	4,6	7,1	3,3	4,6
Domestic credit (% YoY)	1,6	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,2	4,5
ECB reference rate (end-year %)	1,00	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00
EURIBOR 3M interest rate (average %)	0,81	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33
SLO 5Y yield (average %)	3,03	3,96	4,55	4,35	2,14	0,84	0,20	0,15	0,35
SLO 10Y yield (average %)	3,84	4,98	6,01	5,87	3,28	1,67	0,82	1,10	1,45

* 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

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Balance sheet									
Assets (EURm)	50.319	48.748	46.125	40.344	38.714	37.383	37.052	37.274	37.647
Assets (%, YoY)	-2,5	-3,1	-5,4	-12,5	-4,0	-3,4	-0,9	0,6	1,0
Assets (% of GDP)	138,8	132,1	128,1	112,3	103,7	96,9	93,2	88,5	85,0
Net loans (EURm)	34.450	32.875	30.964	24.338	21.540	20.275	20.535	21.407	22.370
Net loans (%, YoY)	1,6	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,2	4,5
Net loans (% of GDP)	95,0	89,1	86,0	67,8	57,7	52,6	51,6	50,8	50,5
Deposits (EURm)	23.507	24.170	23.856	22.550	24.426	25.140	26.133	27.256	28.098
Deposits (%, YoY)	-0,3	2,8	-1,3	-5,5	8,3	2,9	3,9	4,3	3,1
Deposits (% of GDP)	64,8	65,5	66,3	62,8	65,4	65,2	65,7	64,7	63,5
Loan-to-deposit ratio (%)	146,6	136,0	129,8	107,9	88,2	80,6	78,6	78,5	79,6
Capital adequacy ratio (%)	11,3	11,8	11,4	13,7	17,9	18,6	19,1	20,2	19,4
Performance									
Net interest income (EURm)	1.038	1.018	886	708	832	746	670	656	685
Net interest income (%, YoY)	11,3	-2,0	-12,9	-20,1	17,5	-10,4	-10,1	-2,1	4,4
Total operating income (EURm)	1.474	1.447	1.566	1.091	1.231	1.158	1.128	1.128	1.142
Total operating income (%, YoY)	3,4	-1,9	8,2	-30,3	12,8	-6,0	-2,6	0,0	1,3
Pre-provision profit (EURm)	709	670	823	370	544	472	464	480	504
Pre-provision profit (%, YoY)	7,3	-5,4	22,8	-55,0	47,0	-13,3	-1,5	3,3	5,0
Provision charges (EURm)	810	1.207	1.599	3.809	650	313	85	78	86
Profitability and efficiency									
Net interest margin (%)	2,0	2,1	1,9	1,6	2,1	2,0	1,8	1,8	1,8
Pre-tax ROAA (%)	-0,2	-1,1	-1,6	-8,0	-0,3	0,4	1,0	1,1	1,1
Pre-tax ROAE (%)	-2,4	-13,3	-20,3	-92,9	-2,7	3,7	8,4	8,4	8,2
Cost-to-income ratio (%)	51,9	53,7	47,4	66,1	55,8	59,3	58,8	57,5	55,9
Operating expense (% of assets)	1,5	1,6	1,6	1,7	1,7	1,8	1,8	1,7	1,7
Credit quality and provisioning									
NPA ratio (%)	7,3	11,4	15,0	13,7	11,5	9,9	5,5	4,9	4,5
NPA coverage (%)	65,7	58,6	60,4	91,6	58,2	59,7	52,5	73,1	90,2
Provision charges (% of loans)	1,6	2,4	3,4	8,8	1,6	0,8	0,2	0,2	0,2
Provision charges (% of PPP)	114,3	180,1	194,3	1.029,2	119,5	66,4	18,3	16,3	17,1

Source: BSI, Addiko research

NPL to fell further amid economic growth and SME NPL resolution

With de-leveraging in a maturing phase, lending activity increased modestly in the year to April, with net loans up by 0.7% to date on the back of stronger private lending. Retail loans rose 2.2% ytd on sound employment growth, consumer optimism and low interest rates, while corporate credit finally entered positive territory (+1.3% ytd) supported by domestically-orientated firms. On the other hand, public sector contributed negatively (-6.3% ytd) given more favorable bond issuance and cross-border credit. Since ytd performance meets expectations, we keep 4.2% yoy credit growth forecast for 2017, followed by 4.5% for 2018, driven by lending to private sector. In 2017, we see retail lending on strong footing supported by rising employment and wage growth, low-interest rate environment, consumer confidence and real-estate market recovery. Externally-oriented companies still prefer cheaper external financing, intercompany trade credit or bond financing, but rising private consumption and investment activity will support increasing credit activity in domestically-oriented firms and resurgent construction sector. NPL ratio fell to 5.2% in 1Q17 (vs. 5.5% at YE16), and we expect it to fall further given the economic growth and SME NPL resolution.

Profitability is under pressure amid lower NII

In terms of funding, deposit grew 1.3% ytd in April despite ever lower interest rates solely thanks to 1.7% ytd higher household deposit intake on the back of strong labor market. On the other hand, corporate and public sector deposits contributed negatively with former down 0.4% ytd amid stronger capex, while the latter sank 6.0% ytd. Looking forward, we see deposit intake accelerating to 4.3% yoy in 2017 on bright labor market outlook and slower public deposits outflow, while investment acceleration leads to moderate deceleration of corporate deposits intake. LDR ratio fell by 0.5pp to 78.1% in 4M17, and we expect it to stay around this level in the medium term. As for profits, record low interest rate environment with no further space for passive interest rate reduction will weigh on NII, while NFC growth is limited. However, lower opex and provision charges will lead to steady pre-tax profit rise in the next years in our baseline scenario.

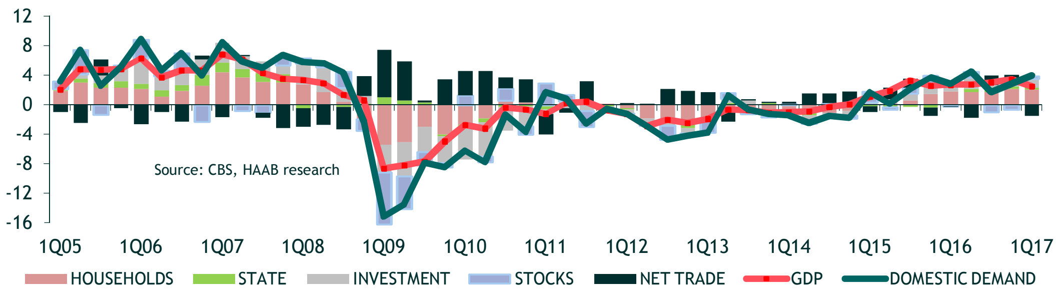
Starting a New Chapter

We lower 2017 GDP growth forecast by 'just' 0.5pp to 3.0% on Agrokor, with downside risks largely balanced out by robust foreign and local demand. Encouragingly though, Croatia has exited the Excessive Deficit Procedure, public debt will decline again, and political stability is maintained as a key pre-condition for structural and competitiveness reforms down the road. While credit rating prospects have certainly improved, rating firms may want to wait how Agrokor restructuring plays out, which in any case we see as a strong medium-term positive for the economy's competitiveness. This alongside stronger reform momentum after local elections is important for a successful market re-entry and a possible rating (outlook) upgrade in the near future.

Growth to accelerate on domestic demand, as exports surprise on the upside

Despite Agrokor scares, short-term economic growth kept its decent pace (3.4% yoy in Q1, seasonally adjusted), driven by private consumption on the back of tourist spending, wage tax cuts, new employment and re-leveraging. Investments in fact surprised on the upside on stronger firms' optimism, EU funding, record SME profits and resurgent construction. Net trade surprised on the downside due to sanguine service exports, soaring service imports, while astonishing goods export growth was insufficient to offset that of goods imports, a flip side of stronger domestic demand. Looking ahead, we see GDP growth in Q2 around 2.5% yoy as Agrokor-related uncertainty weighed on industrial output and investment by those firms with stronger ties with Agrokor. Elsewhere, foreign demand, tourism and EU funding have gained momentum in Q2, which will certainly shield GDP growth from the genuine Agrokor factors.

Croatia: contributions to GDP (in pps)



We maintain above-consensus growth forecasts, despite Agrokor

We lower 2017 GDP growth forecast by 'just' 0.5pp to 3.0% in our first risk-adjusted forecast exercise for downside risks from Agrokor restructuring, though largely balanced out by robust foreign and local demand. The contagion from Agrokor and economically intertwined firms' restructuring (including downsizing), is high mainly via investment and (less so) consumer channels, which may shave ca.1pp off GDP growth in 2017-2018, but we do not pencil in adverse effects due to persistent uncertainty. Beyond Agrokor's 1.5% share in GDP, one can hardly estimate multiple effects via a supplier network (3-4 times?), let alone guess what part of the network can adapt to new market conditions and who is irreversibly endangered. Thankfully, the recent HDZ-led cabinet reshuffle with a new junior partner, centrist HNS on board reduces the risk of snap elections and business uncertainty, and raises the prospects of the key reforms in public sector, healthcare and education, and red tape cuts. In our baseline scenario, we expect another record tourist season, personal consumption, improving labor market and stronger-than-expected goods exports to have a decisive role in our above-consensus call for 2017. While the lagged effects of Agrokor restructuring may curb GDP growth in 2018 as well, we see the underlying 3% growth story intact on robust tourism and EU demand, stronger construction activity, faster EU fund absorption, increased SMEs endurance and fiscal flexibility if necessary.

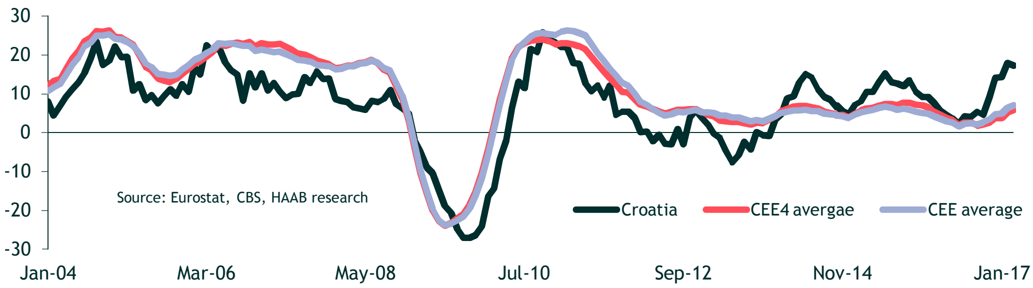
Inflation normalizing after years of deflation

Our inflation forecast for 2017 is cut to 0.8% on slower-than-expected food price recovery given price wars for entroubled Agrokor's retail space, while energy price pressures have receded somewhat. Looking ahead, stronger domestic demand, wage pressures (from stronger labor market, tax cuts, public wage hikes, scarcer labor force) and the ongoing base effects bode well for CPI stabilization inside 0.5-1%, though Agrokor traditional suppliers' growing exposure to discounters, recent oil price developments, stronger kuna and the stronger euro (against the USD) in import prices pose downside risks to our forecast. If any, upside risks stem from seasonally higher service prices (including leisure costs) during another record tourist season as well as post-election administrative (e.g. electricity) price hikes. In 2018, we see base effects and some normalization in food and energy prices lifting CPI just below 1.5%.

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

The euro zone's composite (manufacturing/service) PMIs' strongest level in nearly six years, driven by strong gains in manufacturing and steady new orders, points to a double-digit (10%+ yoy) goods exports growth in 2H17. Even stronger EU/global demand, Croatia's deeper inroads into global value chains and market share gains will continue to drive exports well into 2018 and the ongoing outperformance of most CESEE peers. Meanwhile, stronger consumer demand as well as private equipment capex leads to stronger imports as well, leading to 0.5pp higher goods trade deficit this year. Despite that, record tourism FC receipts as well as EU transfers, and, moreover, non-resident banks' profit slump amid hefty Agrokor-related provisioning (~1.5% of GDP) will see C/A surplus reach 4.5% of GDP in 2017. Consequently lower foreign borrowing needs, intensified (external) de-leveraging (as part of Agrokor restructuring, NPL sales and funding sources restructuring) and steady banks' net foreign assets will result in further improvement in net international position and in turn external debt slump.

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



CNB maintains easing bias in support of lending activity

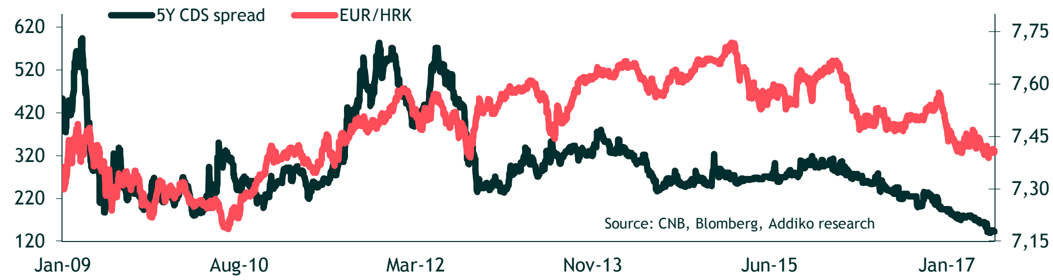
Notwithstanding the ECB' (slow) policy normalization increasingly contemplated, we expect the CNB to remain in accommodative mode, focused on maintain ample kuna liquidity levels (4%+ of GDP) in its ongoing support to lending availability. With stable FX outlook after some Agrokor-driven volatility, the recent three FX interventions (EUR476m) have just added to monetary expansion. That said, we think the CNB's credibility to hitherto strong downward shift in the kuna yield curve, support to the kuna bond market and pent up demand for kuna credit vindicate further easing in 2H17 via beefed up REPO facility and collateral pooling, mandatory reserve rate cuts and/or FX transactions. One step further in support of increasingly contemplated fixed-rate kuna credit offerings by banks would be the CNB's interest rate swaps with banks, but we gather the CNB is focused on liquidity cost cuts, and kuna credit is anyhow promoted by the existing provisions for FX-linked lending. From a risk perspective, monetary easing is allowed by strong banks' external positions, comfortable FX outlook and substantial fiscal risk mitigation underscored by the EDP suspension. What's more, liquidity easing goes hand in hand with fiscal incentives for removing NPLs and the recent relaxation of risk classification rules (in line with IFRS), allowing strong reduction of provisions and cost of risk as well as debt collection, further restructuring of funding and in turn cheaper bank lending.

Kuna showing enviable stability

The kuna briefly succumbed to political and Agrokor-related instability before heading south on the wings of hefty tourism-related FC inflow, soaring goods exports and the new EUR530m Agrokor restructuring loan. High C/A surplus, positive banks' net foreign assets, fading fiscal risk risks and stronger EU funds absorption have also underpinned the local currency. Given steady FX development, record interbank excess liquidity above 4% of GDP and monetary easing bias, short-end rates remained at record low, which supported the first 15Y HRK3bn benchmark issue. Meanwhile, still plenty of liquid refreshment from the likes of the ECB, unconvincing Fed and strong EM fixed income flows has supported EM/CESEE debt, despite a synchronized global reflation/recovery and the recent hints on earlier ECB QE taper. Croatian bonds outperformed recently given the EDP exit, reduced political risks as PM Plenkovic succeeded in constructive cabinet reshuffle as well as constructive tone around Agrokor restructuring.

Notwithstanding favorable seasonal patterns in the midst of another record tourist season and supportive C/A trends, we expect the EUR/HRK will gradually rise from the current levels. Namely, the market's guesswork over final Agrokor-related provisioning needs (later in the year and in 1Q18) may have an influence on banks' bids in early Q3 with risks to demand for FX skewed to the upside. In the event of unwanted volatility, we think the CNB's FX reserves (1.7x gross external funding needs) give them more than a substantial firepower if the need will be. We also expect Croatia's non-interrupted affordable access to financial markets and the record C/A surplus this year (not least due to Agrokor-related de-leveraging and write-offs) to contribute to further build up in FX reserve and, hence, financial stability. All considered, we see the EUR/HRK inside 7.35-7.55 during H2 before stabilizing in the 7.50 area in early 2018.

Croatia: 5Y CDS spreads and EUR/HRK



Further spread tightening on the cards

The CNB easing with multi-billion liquidity creation potential via REPO, subdued bank lending and stable FX combined, we see short-end rates around record lows. Namely, despite stronger kuna credit and refinancing of FX credit, new disbursements are still too low to push MM rates higher. While long-term yields may exhibit volatility over Agrokor risks, market jitters going into key Fed/ECB meetings in September when we learn more about respective QE tapering, we have medium-term positive outlook. Meanwhile, only disorderly Agrokor restructuring including material government's financial involvement may provoke a temporary CDS volatility by 100-150bp. Thankfully, with 80%+ of the gross funding needs covered to date, steady local investors' appetite ahead of hefty (re)financing operations in November, and reduced excessive fiscal and political risks, we see further spread compression ahead. Having widened 30bp at the peak of Agrokor crisis in early Q2, Croatian long-term spreads saw 50bp+ compression thereafter (as foreseen in our Q2 SEE report), with 30bp-alike compression potential in H2 provided Agrokor restructuring goes smoothly and reforms gain momentum after the cabinet reshuffle. We take comfort from bullish EM yields story driven by global macro conditions, further inflows into the asset class amid still ample monetary stimulus, including a structural bid from global portfolios.

Public finances in better health...

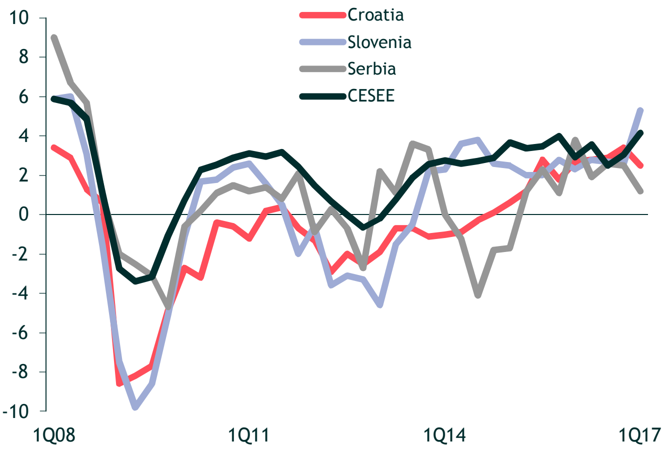
Notwithstanding some volatility in the budget deficit in 1Q17 due to late Easter and PIT cuts, Croatian fiscal accounts remain in reasonably good shape, in our view. According to preliminary data, stronger-than-expected revenues in 1H17 (+2.7% yoy) are driven by VAT (+5% yoy) and CIT (+16% yoy) intake, 4% higher personal income contributions and EU transfers, despite 9% lower PIT courtesy of wage tax cuts, and lower SOEs dividend payments. While tax-rich domestic demand may yet surprise on the upside on the wings of another stellar tourist season and the full scope of fiscalization this year, not all the trends can be extrapolated further in H2 given that the collapse of Agrokor will certainly hit corporate profits (notably that of banks) and partly employment upon Agrokor universe right-sizing. Despite hitherto prudence in spending, we finally expect healthcare cost overruns, public wage hikes (above the planned 2% increase), stronger EU co-sponsored investment spending and higher defense outlays to lift the budget gap to 1.4% of GDP. This figure does not include potential contingent liabilities during Agrokor restructuring, let alone the exposure to a number of court cases for anti-market practices. In our base case with stronger nominal GDP growth, lower interest rates and stronger kuna, we expect public debt to decline close to 82% of GDP, a welcome development as high debt is largely behind one of the highest interest cost to revenue ratios in the EU at about 8%.

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

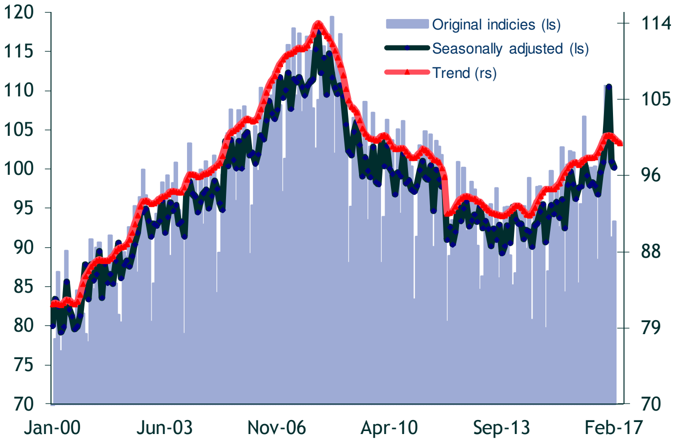
The focus in EC's last country-specific recommendations is on fiscal policy, asking for discipline for medium-term budgetary objective (-1.75% in 2017 and 2018), which reassures investors of close external monitoring. That said, we expect durable fiscal consolidation according to the 1/20th rule (one twentieth of the difference between actual debt and the EU-allowed 60%/GDP maximum on average over 3 years) will require a number of supply-side improvements. Among them we'd expect shifting the tax burden from factors of production (wage and profits) to property by launching a much-contested value-based property tax for households, further pension reforms, public sector reforms (incl. healthcare), better judiciary process in NPL resolution, privatization and red tape cuts. That said, the government sends the right kind of noise on improvement in business climate, education reforms and timid steps in SOEs restructuring and privatization, helping to restore credibility. Since risks to our medium-term outlook are skewed to the downside (as mentioned above) and potential growth prospects have not improved markedly, we do not take public debt (downward) trajectory for granted yet. All said, to support 3%-alike GDP growth, priority should be given to empowering credit channel via permanent incentives for NPL workouts, equity capital raising and improving insolvency mechanism, and striking the right balance between entitlement reforms without stifling economic activity. All of it with the aim to build up 5%/GDP-alike primary surplus in the next years, arrest sovereign risk premium and anchor public debt on sustainable levels.

Croatia's data trends

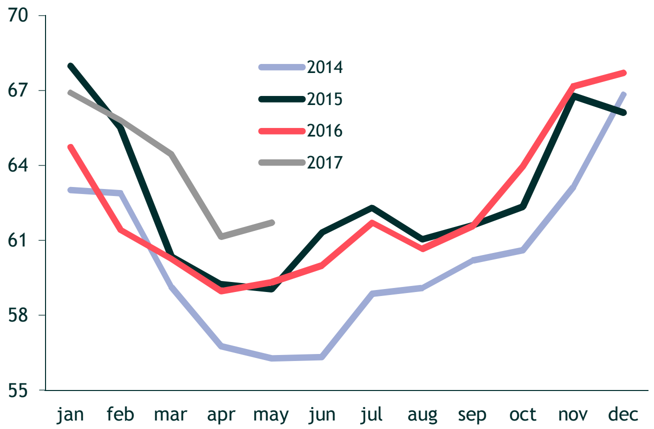
CRO growth in line with CESEE



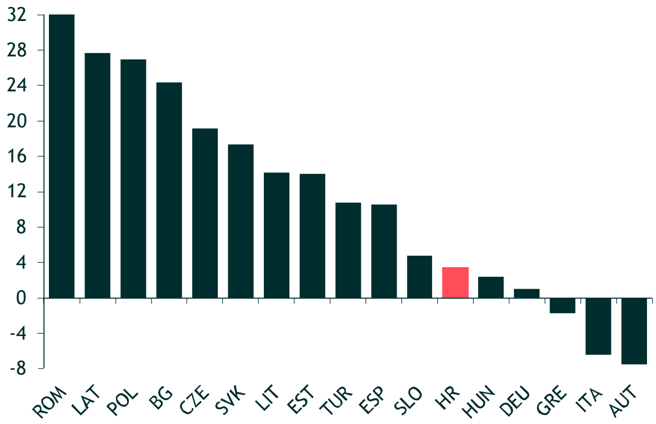
Industrial production, 2010=100



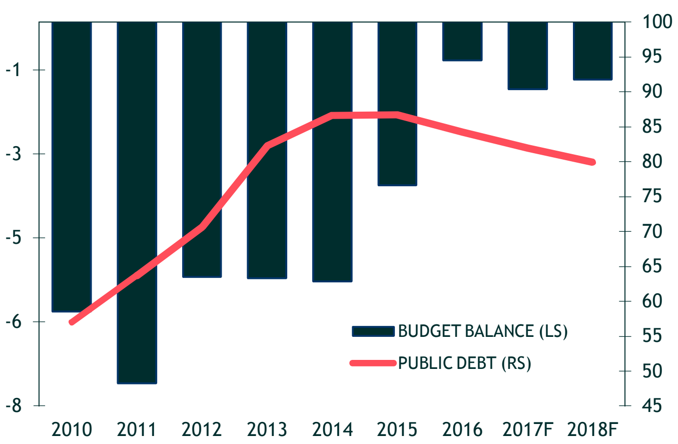
Merchandise import cover (% 3mma)



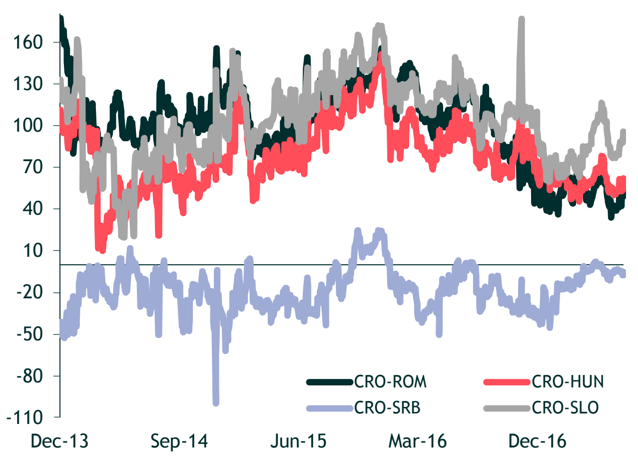
Change in export shares vs EU countries, 2016-2008,(%)



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

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Activity									
Nominal GDP (HRKbn, current prices)	328,0	332,6	330,5	329,6	328,1	333,8	343,2	358,2	375,8
Nominal GDP (EURbn)	45,0	44,7	44,0	43,5	43,0	43,9	45,6	48,0	50,5
Nominal GDP (USDbn)	59,6	62,2	56,5	57,8	57,1	48,6	50,4	53,2	55,5
GDP per capita (EUR)	10.191	10.453	10.300	10.225	10.147	10.352	10.750	11.330	11.904
GDP per capita (USD)	13.882	14.542	13.233	13.571	13.475	11.479	11.897	12.542	13.094
Real GDP (constant prices YoY, %)	-1,7	-0,3	-2,2	-1,1	-0,5	2,2	3,0	3,0	3,0
Private consumption (YoY, %)	-1,5	0,3	-3,0	-1,9	-1,6	1,0	3,3	3,1	2,9
Fixed investment (YoY, %)	-15,2	-2,7	-3,3	1,4	-2,8	3,8	5,1	5,8	6,4
Industrial production (YoY, %)	-1,4	-1,2	-5,5	-1,7	1,4	2,5	5,0	2,5	3,0
Unemployment rate (ILO, average %)	11,6	13,7	15,9	17,3	17,3	16,3	13,1	11,5	10,5
Prices									
CPI inflation (average % YoY)	1,1	2,3	3,4	2,2	-0,2	-0,5	-1,1	0,8	1,4
CPI inflation (end-year % YoY)	1,8	2,1	4,7	0,3	-0,5	-0,6	0,2	0,5	1,4
PPI inflation (average % YoY)	4,3	6,4	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,4
Net wage rates (% YoY, nom., €)	1,3	-0,2	-0,4	-0,1	-0,4	1,5	2,9	3,6	3,7
Fiscal balance (% of GDP)									
State budget balance	-6,0	-7,5	-5,3	-5,3	-5,4	-3,4	-0,8	-1,4	-1,2
Public debt	57,0	63,7	70,7	82,2	86,6	86,7	84,2	82,0	79,9
Gross public funding needs	n/a	n/a	n/a	16,3	19,9	20,0	14,9	18,0	18,7
External balance									
Export of goods and services (EURbn)	17,007	18,126	18,336	18,768	19,679	21,511	22,785	24,726	25,972
Import of goods and services (EURbn)	17,158	18,301	18,111	18,573	18,828	20,411	21,421	23,153	24,629
Merchandise trade balance (EURbn)	-5,924	-6,382	-6,296	-6,587	-6,512	-6,974	-7,345	-7,945	-8,558
Merchandise trade balance (% of GDP)	-13,2	-14,3	-14,3	-15,1	-15,1	-15,9	-16,1	-16,5	-17,0
Tourism receipts (EURbn)	6,230	6,617	6,859	7,203	7,402	7,962	8,635	9,291	9,705
Current account balance (EURbn)	-0,482	-0,298	-0,015	0,446	0,891	2,102	1,198	2,148	1,168
Current account balance (% of GDP)	-1,1	-0,7	0,0	1,0	2,1	4,8	2,6	4,5	2,3
Net FDI (EURbn)	0,8	1,1	1,2	0,8	0,7	0,3	1,9	1,4	1,9
FDI (% of GDP)	1,8	2,5	2,8	1,9	1,6	0,6	4,3	2,9	3,7
FDI cover (%)	170,2	375,1	8.286,0	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	10,660	11,195	11,236	12,908	12,688	13,707	13,514	14,494	15,564
Import cover (months of imports)	7,5	7,3	7,4	8,3	8,1	8,1	7,6	7,5	7,6
Debt indicators									
Gross external debt (EURbn)	46,908	46,397	45,297	45,958	46,664	45,534	41,662	41,138	42,236
Government (EURbn)	11,096	11,449	12,705	14,647	15,841	18,049	16,230	17,230	17,980
Private (EURbn)	35,812	34,949	32,592	31,312	30,823	27,485	25,433	23,909	24,257
Gross external debt (% of GDP)	104,2	103,7	103,0	105,6	108,5	103,8	91,4	85,6	83,7
Gross external debt (% of exports)	275,8	256,0	247,0	244,9	237,1	211,7	182,8	166,4	162,6
Exchange rates and money growth									
USD/HRK (end-year)	5,57	5,82	5,47	5,55	6,30	6,99	7,17	6,85	6,60
USD/HRK (average)	5,50	5,34	5,85	5,71	5,75	6,86	6,80	6,74	6,77
EUR/HRK (end-year)	7,39	7,53	7,55	7,64	7,66	7,64	7,56	7,54	7,52
EUR/HRK (average)	7,29	7,43	7,52	7,57	7,63	7,61	7,53	7,46	7,45
Money supply M1 (% YoY)	1,7	7,3	0,9	11,5	9,6	11,4	18,1	7,8	5,5
Broad money M4 (% YoY)	1,87	5,65	3,57	4,00	3,16	5,15	4,71	2,90	2,40
Domestic credit (% YoY, euros)	6,09	4,01	-2,55	-0,36	-2,61	-1,68	-5,07	0,17	2,18
ZIBOR 3M interest rate (average %)	2,58	3,19	3,55	1,54	0,99	1,27	0,90	0,61	0,30
HRK 1Y yield (average %)	4,19	3,72	3,93	2,54	1,86	1,50	0,96	0,43	0,35
HRK 10Y yield (average %)	6,34	#DIV/0!	6,46	5,47	#DIV/0!	4,09	3,60	2,73	2,46

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

SELECTED BANKING SECTOR DATA

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Balance sheet									
Assets (EURm)	53.386	55.395	54.123	54.564	54.719	54.512	54.689	54.963	55.512
Assets (%, YoY)	4,2	3,8	-2,3	0,8	0,3	-0,4	0,3	0,5	1,0
Assets (% of GDP)	118,6	123,8	123,1	125,4	127,2	124,3	120,0	114,4	110,0
Gross loans (EURm)	37.173	38.665	37.678	37.543	36.561	35.946	34.125	34.183	34.929
Gross loans (%, YoY)	6,1	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	0,2	2,2
Gross loans (% of GDP)	82,6	86,4	85,7	86,3	85,0	81,9	74,9	71,2	69,2
Deposits (EURm)	29.215	29.139	30.001	31.014	31.881	33.666	35.237	36.462	37.513
Deposits (%, YoY)	0,3	-0,3	3,0	3,4	2,8	5,6	4,7	3,5	2,9
Deposits (% of GDP)	64,9	65,1	68,2	71,3	74,1	76,7	77,3	75,9	74,3
Loan-to-deposit ratio (%)	127,2	132,7	125,6	121,0	114,7	106,8	96,8	93,7	93,1
Capital adequacy ratio (%)	18,5	19,2	20,6	21,0	21,0	19,0	20,8	20,0	19,9
Performance									
Net interest income (EURm)	1.485	1.540	1.449	1.360	1.366	1.405	1.457	1.478	1.482
Net interest income (%, YoY)	13,6	3,7	-5,9	-6,2	0,5	2,9	3,6	1,5	0,2
Total operating income (EURm)	2.204	2.249	2.015	1.923	1.922	1.910	2.153	2.246	2.256
Total operating income (%, YoY)	5,3	2,0	-10,4	-4,5	0,0	-0,6	12,7	4,3	0,4
Pre-provision profit (EURm)	1.093	1.127	972	920	934	919	1.184	1.277	1.303
Pre-provision profit (%, YoY)	3,1	3,1	-13,7	-5,4	1,6	-1,7	28,9	7,8	2,0
Provision charges (EURm)	510	500	501	780	645	1.534	355	483	467
Profitability and efficiency									
Net interest margin (%)	2,8	2,8	2,6	2,5	2,5	2,6	2,7	2,5	2,4
Pre-tax ROAA (%)	1,1	1,2	0,9	0,3	0,5	-1,1	1,5	1,4	1,5
Pre-tax ROAE (%)	8,0	8,4	6,2	1,9	3,9	-8,8	11,8	10,8	11,3
Cost-to-income ratio (%)	50,4	49,9	51,7	52,2	51,4	51,9	45,0	43,2	42,2
Operating expense (% of assets)	2,1	2,1	1,9	1,8	1,8	1,8	1,8	1,8	1,7
Credit quality and provisioning									
NPL ratio (%)	11,2	12,4	13,9	15,7	17,1	16,7	13,8	12,1	11,8
NPL coverage (%)	38,8	41,4	42,6	46,2	51,0	56,9	63,6	91,1	82,2
Provision charges (% of loans)	1,4	1,3	1,3	2,1	1,7	4,2	1,0	1,4	1,4
Provision charges (% of PPP)	46,7	44,4	51,5	84,8	69,0	167,0	30,0	37,8	35,8

Source: CNB, Addiko research

Lending activity started recovering

After being in red for five years, credit activity started recovering and increased 1.3% in the year to May. The strongest positive contribution came from 1.5% ytd stronger retail lending, in line with strong consumer sentiment, ever lower interest rates, household consumption acceleration, employment growth and wage hikes. Corporate lending followed with 1.4% ytd increase on business optimism, accelerating capex, increased lending availability to SMEs and record profits. Finally, lending to Public increased 1.4% to date. Despite the recent positive performance, we cut our 2017 lending growth forecast by 1.8pp to just 0.2% yoy as banks use the opportunity of write-offs recognized as tax deductible cost in 2017 (solely) in order to clean up balance sheets. This is especially the case in corporate with 28.5% NPL ratio in 1Q17. While the exact impact is hard to estimate, Agrokor restructuring poses downside risks to new lending as CoR will soar ahead. We still see NPL ratio down to 12.1% from 13.9% at the end of 1Q17, since the volume of tax-deductable write-offs to the tune of EUR2bn (followed by NPL sales) will in our view offset Agrokor-related NPL increase.

Pre-tax profit set to suffer amid Agrokor related reservations increase

After a 4.7% increase in 2016, total deposits fell 1.3% in the year to May, reflecting AuM flows as banks continue with deposit rate cuts to safeguard profits, as well as external de-leveraging. That said, corporate and retail deposits fell 3.3% and 0.9% to date, respectively. However, we expect deposit collection will resume in 2H17 due to strong collection of corporate deposits in the aftermath of another record tourist season and solid household deposit collection on the back of ongoing wage growth and employment increase. We thus keep our deposit collection forecast for the 2017 intact at 3.5% which is a 1.2pp deceleration compared to the 2016 mainly due to ever lower passive interest rates and increased AuM flows. Meanwhile, despite low interest rate environment banks managed to increase net interest income by 1.7% yoy in the 1Q17 as funding cost slump (-29.9% yoy) offset 10.1% yoy lower interest income. While total operating income increased by 15.2%, pre-tax profit fell three falt as some banks already increased their reservations sharply due to Agrokor related uncertainties. The latter is the main reason behind our expectations of negative pre-tax profit in 2017.

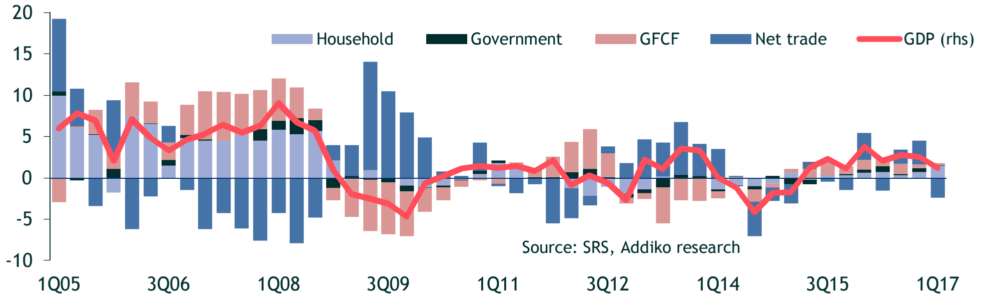
Better Days Ahead After First-Half Standstill

We cut our 2017 GDP forecast by 0.7pp to 2.5% due to soft 1H17 performance, softer agricultural season and stronger investment-related imports. For 2018 we kept growth forecast unchanged at 3.0% on the back of renewed fiscal expansion, private spending acceleration and investment. We see 2017 average CPI at 3.4% driven with stronger demand, commodity prices, expected wage and pension hikes and tobacco excise duty hike. In 2018 we see average CPI at 3.0% as one-offs from 2017 disappear. We see good appetite for Serbian debt ahead, as positive rating outlook (S&P) outshine external risks and potential market jitters.

Looking through H1 slowdown.

After 2.8% growth in 2016, GDP barely rose in 1Q17 by 1.2% yoy, mainly reflecting much slower investments (+1.3% yoy in Q1 from 5.0% in 2016) as the cold snap and a typical pre-election standstill kept public capex on hold. Moreover, export growth eased to 8.7% yoy from 11.9% in 2016 as frozen Danube River affected certain export routes. Meanwhile, stronger consumer and energy demand boosted imports (+10.9% yoy in Q1 from 6.8% in 2016), leading to a strong negative contribution from net exports. Q1 growth was chiefly driven by 1.9% yoy stronger private consumption (+0.8% in 2016) amid private job creation, rising wages, cheaper debt service and re-leveraging. While Q2 brought about a turnaround in industrial output and exports, the economy's performance looks mixed given that prolonged cabinet reshuffle hit public capex, net exports remain a drag on equipment import acceleration, and operating problems in Fiat and electricity board EPS speak for themselves, we see Q2 GDP growth 'only' in the 2.0-2.3% region, again driven by consumption.

Serbia: contributions to GDP (pps, %)



2017 GDP forecast lowered to 2.5%

Given soft 1H17 performance, softer agricultural season and stronger investment-related imports, we cut 2017 GDP forecast by 0.7pp to 2.5%. This nevertheless implies solid growth acceleration in 2H17, with private consumption in the driver's seat on further employment/wage growth, cheaper debt service, re-leveraging and catch-up on delayed spending on durable goods. We also see investment comeback thanks to resurgent public capex and quieter politics upon the cabinet setup, firms' re-leveraging and stable capacity-enhancing FDIs. Despite further upgrade to exports forecast on even brighter external demand outlook, stronger domestic demand increasingly driven by investments will keep imports high and reduce net trade contribution to growth. The risks to our view stem from public capex under-execution, higher than expected inflation impact on real incomes and weaker intra-SEE trade amid Agrokor restructuring. We finally kept our 2018 growth forecast unchanged at 3.0% given renewed fiscal expansion, further acceleration in private spending and investment as the new EUR2.5bn highway construction takes place. Competitiveness reforms including labour tax cuts and SOE reforms, above-trend euro zone growth and sentiment-driven surge in investments (as new PM Brnabic continues with the reform agenda and the EU bid takes shape) all pose upside risks. If any, faster Fed tightening is the major risk on the downside.

The C/A deficit is set to widen to 4.6%/GDP as domestic demand boosts import

The current account deficit almost doubled in 4M17 to EUR825m as wider goods trade gap offset better service balance. That said, goods trade gap rose 29.3% as the cold snap affected export growth despite stronger EU demand and stronger consumer and increasingly investment domestic demand is boosting imports, acting as a structural impediment for a positive net exports contribution also going forth. Services surplus rose 10.9% yoy on higher roaming charges and stronger tourism activity. Finally, primary income deficit widened 27% yoy on stronger non-residents' profit repatriation, whereas secondary income increased slightly on 6.7% yoy higher remittances thanks to strong improvement in the major source labour markets and higher EU funding. All considered we expect some 0.5pp C/A gap widening to 4.6% of GDP in 2017 followed by flattish outcome in 2018.

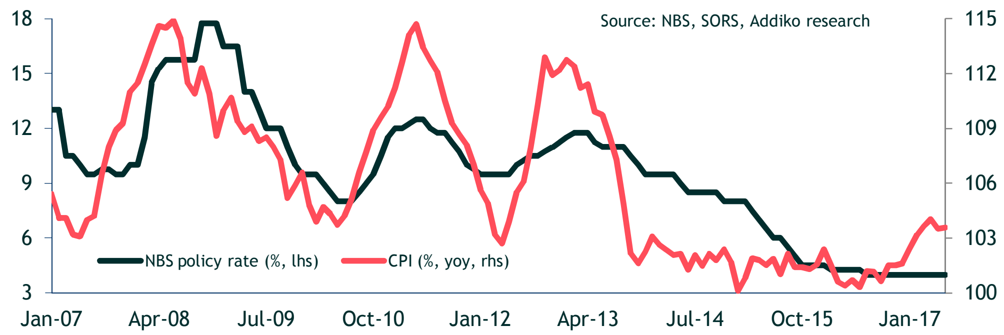
Net portfolio outflows decreased recently

Net FDI increased 5.0% yoy in 4M17 to EUR622m mainly on the back of stronger reinvested profits in manufacturing, construction and telecommunication services. At the same time, net portfolio outflows were lower by EUR220m (-42.7% yoy) in the year to April, reflecting relatively stronger appetite for Serbian debt even during risk-off episodes, e.g. in response to Fed tightening. We expect still hefty FDI inflow of about 5% of GDP this year, mainly in manufacturing to cover the entire C/A deficit, which supports investment growth and (via newly built production capacity) in turn stronger export as well as potential GDP growth.

Inflation boosted with one-off effects

Inflationary pressures have increased substantially this year, as the headline CPI inflation hit 4.0% yoy in April, only to moderate to 3.6% yoy in June. However, such movements largely owe to one-off effects such as weather-inflicted food prices, adding 0.9pp to headline CPI in the year to May (compared to -0.2pp in 5M16). Inflation was also driven by fuel prices and tobacco excise hike in January. Meanwhile, core inflation hovers around 2%, closer to the bottom of the CPI target band. Going forth, price pressures arise from stronger demand, commodity prices, expected wage and pension hikes and tobacco excise duty hike in July. It also seems harsh winter weather has had stronger impact on agricultural output and food prices this year. All in, we see average CPI at 3.4% in 2017, followed by 3.0% average CPI in 2018 as one-offs from 2017 disappear.

Serbia CPI inflation and NBS policy rate



Key policy rate expected to stay unchanged through the 2H17

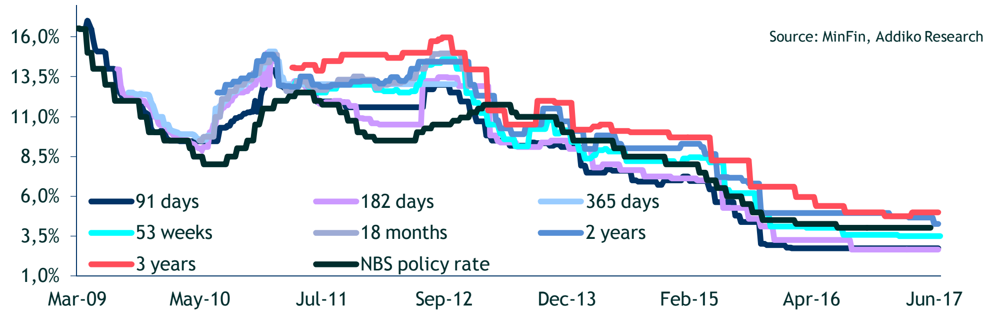
The NBS shied away from easing for the twelfth month in July and kept the key rate unchanged at 4.00% as uncertainty regarding the future Fed/ECB policy stance persists, lending activity recovers and inflation pressures increased. Meanwhile, the NBS continued withdrawing interbank liquidity excess through 1W repo operations (RSD1.200bn to date), while short-end dinar rates stay stably low and unchanged on a to-date basis.

Given smaller risks to Fed tightening and low core inflation at home, we see the NBS key rate at 4.00% flat in 2H17, followed by one rate hike in 2Q18 instead of three hikes and at least one quarter later than we assumed in Q2 SEE report. Meanwhile, despite hawkish ECB of late, we do not see rate hikes until late 2018 but rather gradual QE exit. Moreover, the NBS policy is still far more dependent on the Fed than the ECB. Given fiscal overperformance, short-term narrowing of external imbalances, calmer politics and more resolute policy-making, and consequently lower country risk premium, we see solid investors interest for Serbian asset ahead. With Serbian money market driven by US investor sentiment, upside risks to our NBS' rates view stem from stronger Fed tightening, unlikely in our view, as the almighty fiscal expansion waits to be detailed. Stronger than expected inflation at home and abroad that would see the ECB tighten sooner acts in the same direction.

The EUR/RSD at the lowest levels since 2015

Fiscal over performance, unconvincing Fed, reduced EU political risks, resurgent exports, positive banks' net foreign asset position and in turn stronger non-residents' portfolio inflows, and stronger FX-linked lending. all stand behind the dinar appreciation of late. Despite hefty NBS' EUR490m frequent FX reserve purchases since the end of April, the EUR/RSD is currently trading just above 120, the strongest level since 2015. Moreover, stronger inflationary pressures suggest that NBS would not be fond of weaker RSD spillover to prices. Looking ahead, we expect the EUR/RSD within 119.5-123, with the higher end of the band more likely by the end of the year, fine-tuned by NBS interventions. Improving macro (stronger GDP growth ahead, lower budget gap in 2017) and rating prospects, stronger banks' net foreign asset position, evolving dinarization story (stronger RSD T-bill issuance in 2H17, rising demand for RSD loans) and stronger RSD impact on positive public debt evolution all support our constructive RSD outlook. Needless to say, should inflation accelerate too fast, the NBS has enough ammo through FX reserves to stop weak RSD spillover to prices and weaker consumption on negative income and balance sheet effects.

Serbia: T-bill/notes yields



FY17 budget deficit seen below 1%/GDP

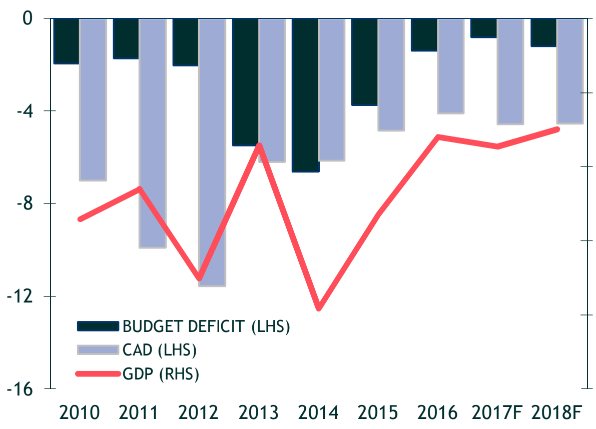
After strong fiscal consolidation in 2016 (budget deficit -2.3pp to -1.4%/GDP), fiscal accounts improved further in 1H17, with the 5M17 surplus of RSD23bn or 0.5% of GDP (unofficially RSD40bn in 1H17!). Such performance mainly owes to 7.2% yoy revenue growth, driven by 8.5% yoy stronger tax intake courtesy of tax-rich local demand and better tax compliance. Meanwhile, expenditures barely rose 0.5% yoy amid 22.4% public capex slump due to delayed investment caused by harsh weather and pre-election standstill. Interest cost fell 2.0% yoy and unemployment safety net fell 10.7% yoy. That said, we expect outlays to accelerate in 2H17 on stronger public capex and the expected wage and pension hikes in 4Q17. Given the strong fiscal outperformance to date, we cut our FY17 budget gap forecast by 0.9pp to -0.8% of GDP.

Serbian risk premium at the 10Y low

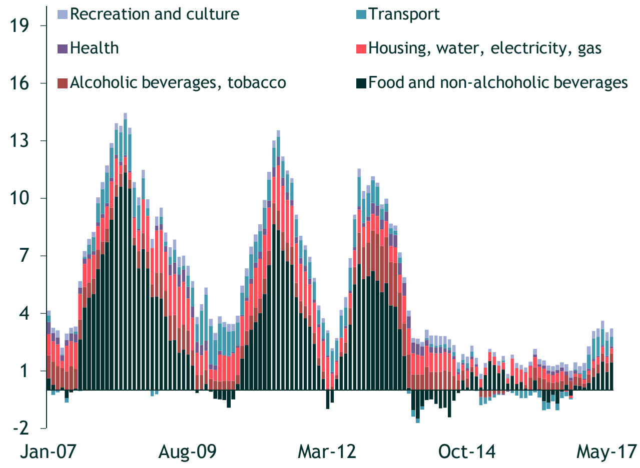
The MinFin increased T-bill/T-bond stock in Q2 by RSD33bn (EUR0.3bn) at flattish rates on a to-date basis. The MinFin also lengthened the average T-bill/T-bond maturity by lowering the stock of <3Y debt (by -RSD36bn) and shifting into the 3-7Y maturity more so in H2 with just 35% of the issue plan met in H1 albeit reflecting much better fiscal outcome to date and maneuvering space to reject costly bids. Meanwhile, Serbian risk premium fell to 10Y lows and while fiscal over performance, EM risk appetite and stable politics support the ratings, we see rating agencies on the sidelines until PM Brnabic re-affirms the merits of a new IMF stand-by (which the NBS backs), presses on with reform agenda (especially in SOE restructuring), EU talks regain momentum and temporary growth slowdown has passed. All said, we see good appetite for Serbian debt ahead, as positive rating outlook (S&P) outshine external risks and potential market jitters, and the MinFin is eyeing inclusion of RSD debt in a few EM indices. The authorities may thus create conditions for stronger RSD issuance in order to lower problematic FX exposure that would also underpin the dinar. Looking ahead, we see gradual RSD rates normalization in line with gradual Fed and in turn NBS tightening, as spread tightening potential is limited by Fed/ECB policy uncertainty and already tight liquidity premium over CESEE issuers. While a large benchmark Eurobond would relieve pressure on RSD rates and boost FX reserves, we'd again expect Serbia to opt for cheaper IFI or bilateral funding, and partly (re)finance USD750m maturity (in November) locally. Upside risks to rates include delays in EU/Kosovo talks and the global risk-off reversal albeit domestic banks could compensate somewhat for stronger offshore investors' withdrawal from the local market debt.

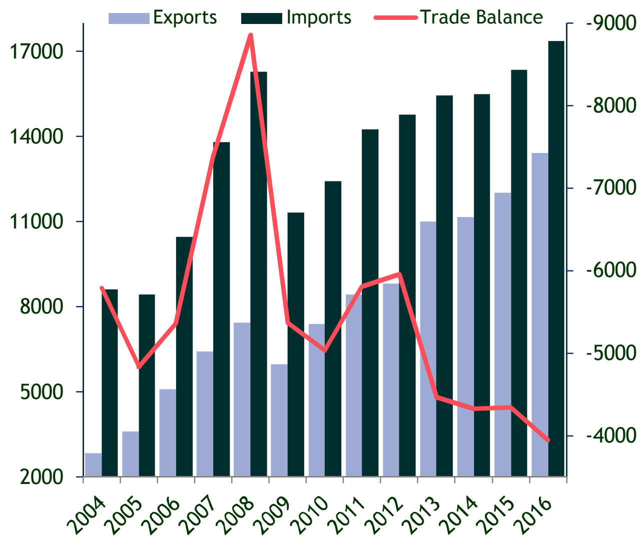
Serbia's data trends

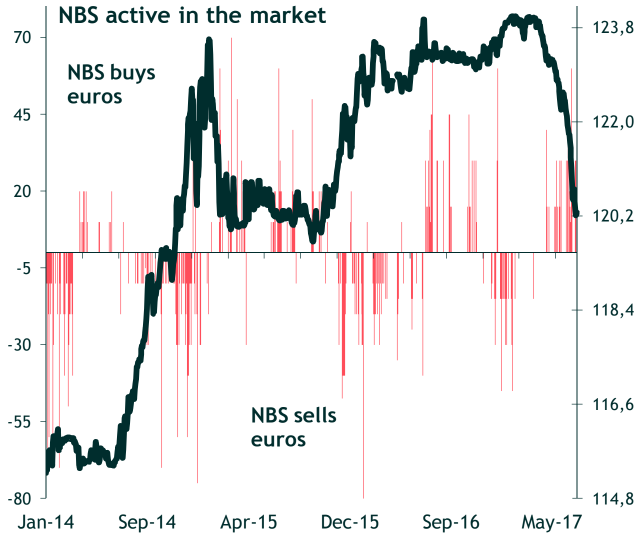
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



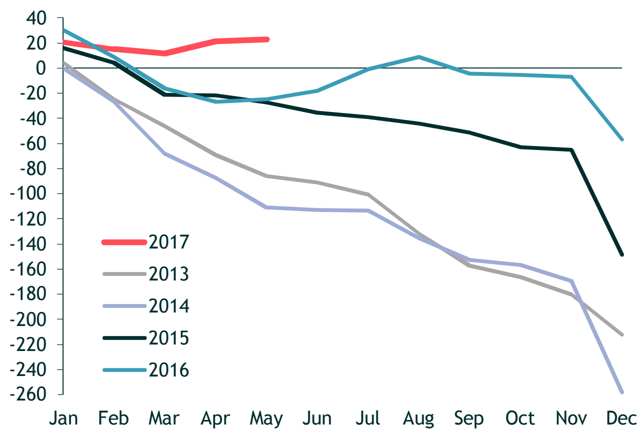
CPI contribution - key categories (pps)



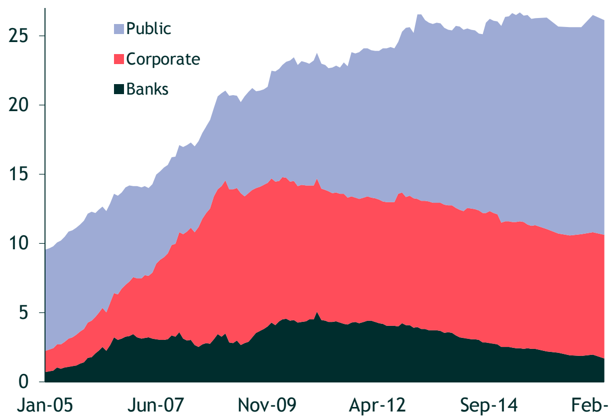




Consolidated government budget balance (RSDbn)



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



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

SELECTED ECONOMIC FORECASTS

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Activity									
Nominal GDP (RSDbn,current prices)	3.067	3.408	3.584	3.876	3.908	3.982	4.127	4.360	4.614
Nominal GDP (EURbn)	29,8	33,4	31,5	33,9	32,3	32,8	33,5	35,6	37,9
Nominal GDP (USDbn)	39,4	46,5	40,7	45,5	44,1	36,6	37,1	39,1	41,5
GDP per capita (EUR)	4.082	4.620	4.401	4.783	4.521	4.619	4.750	5.059	5.389
GDP per capita (USD)	5.400	6.423	5.650	6.353	6.177	5.155	5.260	5.558	5.889
Real GDP (constant prices YoY, %)	0,6	1,4	-1,0	2,6	-1,8	0,7	2,8	2,5	3,0
Private consumption (YoY, %)	-0,6	0,9	-2,1	-0,4	-1,3	0,4	0,8	2,0	2,5
Fixed investment (YoY, %)	-6,5	4,6	13,2	-12,0	-3,6	5,5	5,0	3,5	5,4
Industrial production (YoY, %)	1,2	2,5	-2,2	5,5	-6,5	8,4	4,8	3,9	4,4
Unemployment rate (ILO, average %)	19,2	23,0	23,9	22,1	19,2	17,7	15,3	14,8	14,1
Prices									
CPI inflation (average % YoY)	6,5	11,0	7,8	7,8	2,1	1,4	1,1	3,4	2,9
CPI inflation (end-year % YoY)	10,2	7,0	12,2	2,2	1,7	1,5	1,6	3,4	2,7
PPI inflation (average % YoY)	12,7	14,2	5,6	3,6	0,7	0,2	-0,4	1,7	2,1
Net wage rates (% YoY, nominal,	-7,9	1,1	-1,8	-1,8	-4,6	-4,1	1,0	1,7	2,1
Fiscal balance (% of GDP)									
State budget balance	-1,9	-1,7	-2,0	-5,5	-6,6	-3,7	-1,4	-0,8	-1,2
Public debt	41,8	45,4	56,2	59,6	70,4	74,7	72,9	70,1	69,4
Gross public funding needs	9,9	10,2	10,6	16,1	17,6	17,0	14,4	16,5	14,4
External balance									
Export of goods and services (EURbn)	n/a	n/a	11,498	13,937	14,451	15,618	17,314	19,283	20,539
Import of goods and services (EURbn)	n/a	n/a	16,993	17,782	18,096	18,899	19,895	22,032	23,698
Merchandise trade balance (EURbn)	n/a	n/a	-5,634	-4,159	-4,111	-4,006	-3,476	-3,656	-4,131
Merchandise trade balance (% of GDP)	n/a	n/a	-17,9	-12,3	-12,7	-12,2	-10,4	-10,3	-10,9
Remittances, net (EURbn)	n/a	n/a	1,989	2,217	1,931	2,155	1,953	2,148	2,191
Current account balance (EURbn)	-2,082	-3,305	-3,640	-2,098	-1,985	-1,590	-1,370	-1,630	-1,727
Current account balance (% of GDP)	-7,0	-9,9	-11,5	-6,2	-6,1	-4,9	-4,1	-4,6	-4,6
Net FDI (EURbn)	n/a	n/a	0,7	1,3	1,2	1,8	1,9	1,7	1,8
FDI (% of GDP)	n/a	n/a	2,1	3,8	3,8	5,5	5,6	4,6	4,8
FDI cover (%)	n/a	n/a	18,4	61,9	62,3	113,2	135,8	101,6	104,9
Gross international reserves (EURbn)	10,002	12,058	10,915	11,189	9,907	10,377	10,868	10,894	10,979
Import cover (months of imports)	n/a	n/a	7,7	7,6	6,6	6,6	6,6	5,9	5,6
Debt indicators									
Gross external debt (EURbn)	23,786	24,125	25,645	25,747	25,741	26,358	26,358	26,398	26,718
Government (EURbn)	9,076	10,773	12,185	13,166	14,198	15,289	15,289	15,389	15,789
Private (EURbn)	14,710	13,352	13,460	12,581	11,543	11,069	11,069	11,009	10,929
Gross external debt (% of GDP)	79,9	72,2	81,4	75,9	79,7	80,4	78,6	74,1	70,4
Gross external debt (% of exports)	n/a	n/a	223,0	184,7	178,1	168,8	152,2	136,9	130,1
Exchange rates and money									
USD/RSD (end-year)	79,28	80,87	86,18	83,13	99,46	111,64	117,93	111,00	107,19
USD/RSD (average)	77,91	73,34	88,12	85,17	88,54	108,88	111,17	111,41	111,30
EUR/RSD (end-year)	105,5	104,6	113,7	114,6	121,5	121,8	123,5	122,1	122,2
EUR/RSD (average)	103,0	102,0	113,7	114,3	121,0	121,5	123,1	122,4	121,6
Money supply M1 (% YoY)	-10,9	16,9	-3,3	24,8	5,2	16,4	18,7	8,0	7,0
Broad money M3 (% YoY)	2,6	11,2	0,7	3,7	3,0	5,0	9,9	4,4	3,5
Domestic credit (% YoY, euros)	15,3	8,9	0,8	-5,2	-2,3	2,4	1,0	3,4	3,7
NBS policy rate (average %)	9,13	11,54	10,14	11,00	8,79	6,08	4,15	4,00	4,15
NBS policy rate (end-year %)	11,50	9,75	11,25	9,50	8,00	4,50	4,00	4,00	4,25
6M BELIBOR interest rate (average %)	11,00	13,13	12,00	10,40	8,53	6,43	3,65	3,75	4,06

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

SELECTED BANKING SECTOR DATA

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Balance sheet									
Assets (EURm)	24.015	25.211	25.322	24.827	24.545	25.060	25.690	26.384	27.202
Assets (%, YoY)	6,6	5,0	0,4	-2,0	-1,1	2,1	2,5	2,7	3,1
Assets (% of GDP)	80,7	75,4	80,3	73,2	76,0	76,5	76,6	74,1	71,7
Gross loans (EURm)	15.621	17.013	17.148	16.255	15.879	16.253	16.412	16.972	17.593
Gross loans (%, YoY)	15,3	8,9	0,8	-5,2	-2,3	2,4	1,0	3,4	3,7
Gross loans (% of GDP)	52,5	50,9	54,4	47,9	49,1	49,6	49,0	47,7	46,4
Deposits (EURm)	11.897	13.099	13.310	13.634	13.967	14.728	16.159	17.096	17.903
Deposits (%, YoY)	4,0	10,1	1,6	2,4	2,4	5,4	9,7	5,8	4,7
Deposits (% of GDP)	40,0	39,2	42,2	40,2	43,2	44,9	48,2	48,0	47,2
Loan-to-deposit ratio (%)	131,3	129,9	128,8	119,2	113,7	110,4	101,6	99,3	98,3
Capital adequacy ratio (%)	19,9	19,1	19,9	20,9	20,0	20,9	21,2	19,6	18,8
Performance									
Net interest income (EURm)	1.052	1.131	1.025	1.044	1.063	1.075	1.006	989	1.020
Net interest income (%, YoY)	-1,7	7,6	-9,4	1,9	1,8	1,1	-6,4	-1,6	3,1
Total operating income (EURm)	1.541	1.590	1.484	1.435	1.489	1.520	1.393	1.445	1.489
Total operating income (%, YoY)	-3,5	3,2	-6,7	-3,3	3,8	2,1	-8,4	3,8	3,0
Pre-provision profit (EURm)	563	617	571	504	529	574	467	510	540
Pre-provision profit (%, YoY)	-5,8	9,6	-7,5	-11,6	4,8	8,6	-18,7	9,2	5,9
Provision charges (EURm)	316	313	339	510	490	494	294	292	294
Profitability and efficiency									
Net interest margin (%)	4,5	4,6	4,1	4,2	4,3	4,3	4,0	3,8	3,8
Pre-tax ROAA (%)	1,1	1,2	0,9	-0,1	0,1	0,3	0,7	0,8	0,9
Pre-tax ROAE (%)	5,1	5,9	4,3	-0,3	0,6	1,6	3,5	4,3	4,6
Cost-to-income ratio (%)	63,5	61,8	66,1	65,3	64,7	62,2	66,5	64,7	63,7
Operating expense (% of assets)	4,2	4,0	3,6	3,7	3,9	3,8	3,6	3,6	3,5
Credit quality and provisioning									
NPL ratio (%)	16,9	19,0	18,6	21,4	21,5	21,6	17,0	15,2	14,9
NPL coverage (%)	47,2	51,0	50,0	50,9	54,9	62,3	67,8	66,1	66,2
Provision charges (% of loans)	2,2	1,9	2,0	3,1	3,1	3,1	1,8	1,8	1,7
Provision charges (% of PPP)	56,2	50,7	59,4	101,1	92,8	86,0	62,9	57,3	54,4

Source: NBS, Addiko research

Lending activity boosted with retail

Lending activity increased by 1.0% ytd in the 5M17 (vs. 1.0% in 2016) with the positive contribution coming solely from retail segment that has expanded by 5.5% ytd driven by cash loans on the back of moderate wage increase, private employment gains and record low interest rates. Corporate lending that barely entered positive territory in the 2016 (+0.2%) faced a 1.6% ytd decline in 5M17 as banks continued their balance sheet cleansing from NPLs. Public lending negative performance continued as public enterprises and government rather opt for cheaper cross-border/IFI loans. However, we have marginally upgraded our 2017 lending expectations by 0.2pp to 3.4% as we expect that strong retail lending will continue while corporate lending will be boosted in the rest of the year with the expected investment acceleration. Moreover, cleaner banks' balance sheets, and increased interbank competition all bode well for lending activity in the rest of the year. Furthermore, the NPL share has fallen to 13.8% at the end of March which is the lowest level in the past seven years and reflects further banking sector efforts to the resolve the issue of still relatively high NPL levels.

Strong NPL sales lowered banks' risk costs

As for funding, deposit growth decelerated from 9.7% in 2016 to 0.6% ytd in 5M17 on the back of 1.2% ytd fall in collection of corporate deposits. Furthermore, notwithstanding ongoing private employment gains and moderate wage growth, collection of retail deposits also faced deceleration in the 5M17 (from 6.3% in 2016 to 1.0% ytd). Meanwhile, collection of public deposits decelerated from 13.6% in 2016 to just 2.6% ytd in 5M17, but we expect to see their rebound later this year as government is eying new bond issuance, above the expected maturity of USD750m according to the current information. All that being said, our model currently implies somewhat lower deposit collection this year of 5.8%. On profits, while NII decreased by 2.1% yoy in the 1Q17, 34.9% yoy increase in non-interest income was enough to increase TOI by 7.9% yoy in the 1Q17. Furthermore, provision charges saw 42.3% yoy decline as banks lowered their risk costs through strong NPL sales and write-offs. All said, pre-tax profit increased by 54.9% in the 1Q17 and we see similar performance going forth as ongoing efforts to resolve NPLs will further lower banks provisions.

Economy Rides Through Political Turmoil

We keep our 3.2% GDP growth forecast unchanged on the back of stronger private consumption and back-loading of public capex in the rest of the year that suffered as IMF loans is still on hold. Meanwhile, we expect C/A deficit to re-widen to 5.3% of GDP for the FY17 due to higher trade deficit, while record tourist season and brighter euro zone labor market favor services balance and remittances. Inflation is set to increase by 1.6% yoy on average in 2017, before accelerating to 2.5% in 2018.

GDP growth accelerated to 2.7% yoy in Q1

GDP growth accelerated in 1Q17 to 2.7% yoy (prev. 2.6% yoy) with the strongest positive contribution coming from financial, retail and real estate sector. High frequency data suggest solid GDP print in Q2 as well as exports surged 17.2% yoy in April-May (vs. 17.4% yoy in Q1) reflecting stronger EU and in turn SEE demand. Imports rose 10.2% yoy (vs. 12.9% yoy in Q1) on the back of stronger domestic demand and higher commodity imports, lifting the import cover by 371bp to 60.2% on a 3mma basis. Private consumption has continued strong performance, with retail sales up 4.7% yoy over April-May (vs. 5.9% yoy in Q1), while indirect tax collection surged 8.2% yoy in Q2 (vs. 3.5% yoy in Q1). However, industrial output slowed somewhat to 1.5% yoy in April-May (vs. 2.9% in Q1) on weaker energy and non-durable goods production. Finally, contraction works fell 3.5% yoy in 1Q17, implying still weak investment activity.

Private consumption remained the main driver of growth

With solid numbers to date, we keep GDP growth forecast for 2017 unchanged at 3.2% on the back of stronger private consumption, employment and wage growth, re-leveraging, and higher remittances. Also, 17.6% yoy higher foreign tourist overnights in the year to April point to a record tourist season. Our baseline scenario assumes public capex acceleration in 2H17 as we expect the country to meet the IMF requirements for the second EUR76m tranche (delayed since January) to solve liquidity issues. Failure to adopt necessary conditions, e.g. a new law on excise taxes in May, has resulted in the IMF and a few IFI loan disbursements (including the EBRD's one) worth around EUR800m, partly intended for Vc motorway construction. The risks to our base case prevail on the downside and stem from complicated political system that hampers the adoption of IMF requests and other commitments embarked in the Reform Agenda. Potential liquidity issues with Agrokor-related firms also create uncertainty, which may shave 0.5pp off our GDP forecasts for 2017 and 2018.

IMF likely to weaken its conditionality

We expect parliamentary majority will be secured to meet the IMF's requirements (Law on Excise tax and Deposit insurance) in the next months and unblock ample IMF/IFI funding. That said, Reform Agenda introduced in 2015 focus mostly on public finance, business climate and labor market and has indeed brought some momentum to reforms not seen in a decade, but many delays have occurred since. Considering general elections are scheduled in October next year, it is not impossible from IMF and EU to weaken their conditionality from "full implementation" to "meaningful progress".

We see consolidated budget deficit at 0.7% of GDP this year

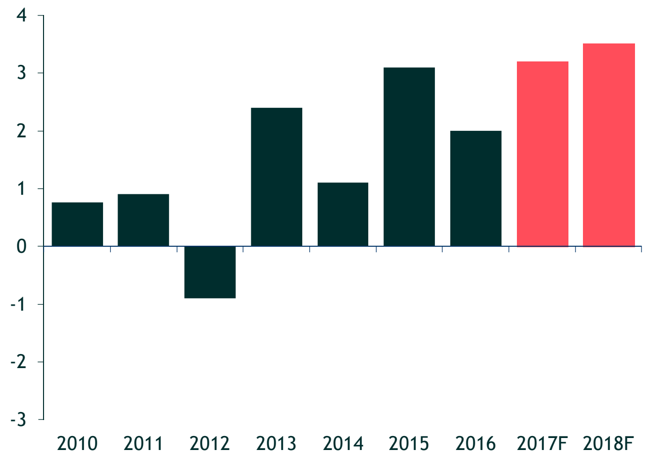
Both entities based 2017 budgets on three IMF tranches in 2017 and due to aforementioned freeze in disbursement, they have not received any. This just forced local treasuries to raise debt domestically on higher costs on average. Namely, the RS sold EUR70m in 1-10Y bonds and EUR41m in T-bills in the year to July, while the Federation B-H avoided expensive bond issuance thanks to more favorable bank credit, and issued EUR81m in T-bills. Even without the IMF help, debt service is manageable in 2017, albeit thanks to the unplanned EUR116m repayment of old USSR debt this month. However, on the longer horizon B-H budget is unsustainable without IMF funds given limited availability of other sources of financing and high public debt servicing needs (cca 5%/GDP). In our base case, we see consolidated budget deficit at 0.7% of GDP this year and slight re-widening in the medium term amid public capex acceleration.

C/A deficit set to re-widen to 5.3%/GDP for the FY17

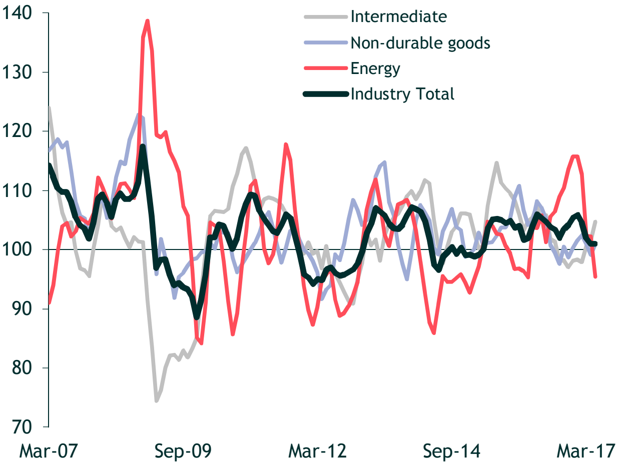
C/A deficit increased 8.3% yoy to EUR168m in 1Q17 mainly due to re-widening of the trade deficit on stronger domestic demand and higher commodity imports, while remittances surged 13.4% yoy. We expect C/A deficit to re-widen to 5.3% of GDP for the FY17 due to higher trade deficit amid stronger domestic demand, while the record tourist season and brighter euro zone labor market favour services balance and remittances. Higher fuel and utility prices led to 1.4% yoy average inflation to date – in line with our expectations. In 2H17, energy prices impact will fade, while the expected excise tax hikes on petroleum products, tobacco and tolls, and stronger domestic demand will expert upward pressure on inflation. In all, we keep CPI forecast at 1.6% in 2017, before accelerating to 2.5% in 2018 on further domestic demand acceleration.

Bosnia and Herzegovina's data trends

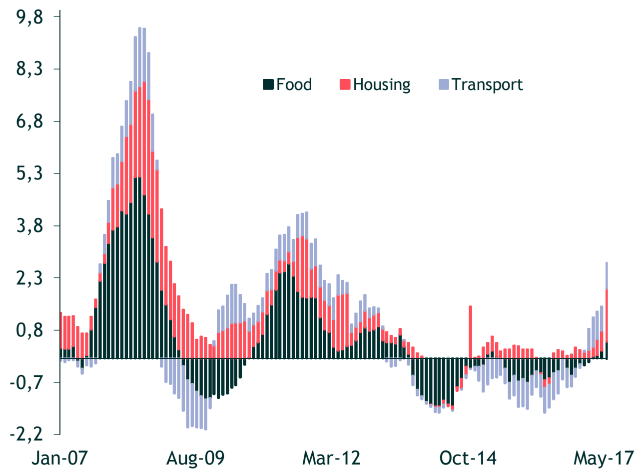
Real GDP growth (% YoY)



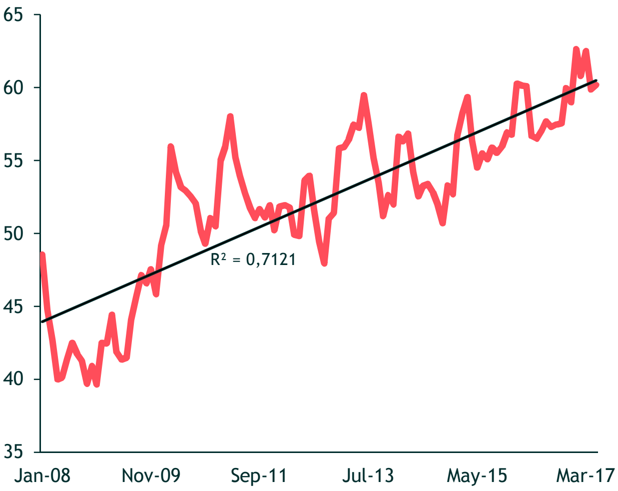
Industrial production (%, yoy, s-a, 3mma)



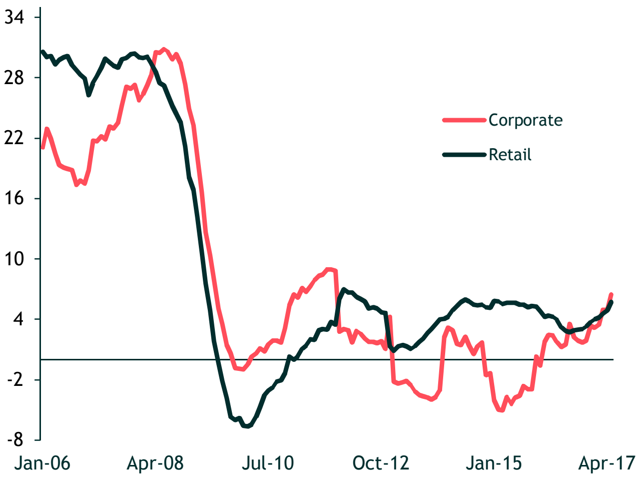
Key CPI contributions (pp)



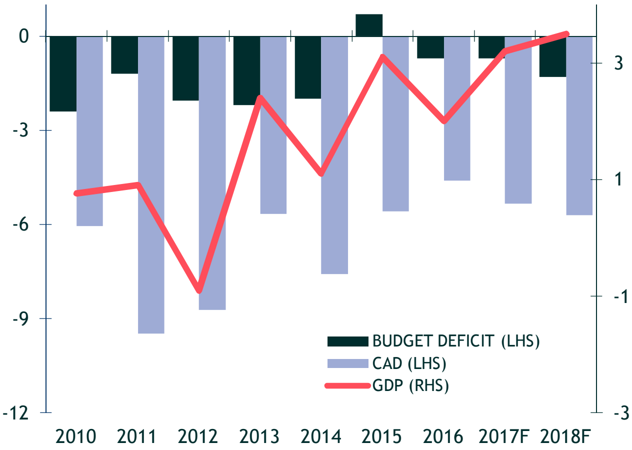
Merchandise import cover (%, 3mma)



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

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Activity									
Nominal GDP (BAMbn, current prices)	25,3	26,2	26,2	26,7	27,3	28,2	28,5	29,8	31,7
Nominal GDP (EURbn)	13,0	13,4	13,4	13,7	14,0	14,4	14,6	15,3	16,2
Nominal GDP (USDbn)	17,2	18,7	17,2	18,2	18,5	16,0	16,1	16,9	17,8
GDP per capita (EUR)	3.373,1	3.488,1	3.485,8	3.872,5	3.953,7	4.099,7	4.136,4	4.337,1	4.601,1
GDP per capita (USD)	4.474,7	4.857,5	4.482,7	5.143,0	5.252,5	4.547,0	4.580,6	4.801,1	5.061,2
Real GDP (constant prices YoY, %)	0,8	0,9	-0,9	2,4	1,1	3,1	2,0	3,2	3,5
Private consumption (YoY, %)	0,9	1,6	2,3	2,7	2,7	1,2	2,4	3,3	3,0
Fixed investment (YoY, %)	-12,2	7,9	6,3	-2,4	11,1	-4,1	4,8	5,3	7,2
Industrial production (YoY, %)	1,6	5,9	-5,3	6,6	0,3	3,1	4,5	4,2	5,3
Unemployment rate (ILO, average, %)	27,2	27,6	28,0	27,4	27,5	27,7	25,4	23,2	22,4
Prices									
CPI inflation (average % YoY)	2,1	3,7	2,1	0,1	-0,9	-1,0	-1,1	1,6	2,5
CPI inflation (end-year % YoY)	3,1	3,1	1,8	-1,2	-0,4	-1,3	-0,2	2,1	2,1
PPI inflation (average % YoY)	0,9	3,8	1,5	-2,2	-0,5	0,6	-2,1	3,4	3,8
Net wage rates (% YoY, nominal)	1,3	2,0	1,2	0,1	0,4	0,0	0,9	1,9	2,3
Fiscal balance (% of GDP)									
State budget balance	-2,4	-1,2	-2,0	-2,2	-2,0	0,7	-0,7	-0,7	-1,3
Public debt	42,8	43,1	43,4	44,5	45,0	45,4	45,7	45,2	44,9
External balance									
Export of goods and services (EURbn)	3,851	4,297	4,312	4,597	4,733	5,054	5,413	5,994	6,233
Import of goods and services (EURbn)	-6,649	-7,484	-7,483	-7,414	-7,943	-7,780	-7,994	-8,823	-9,203
Merchandise trade balance (EURbn)	-3,797	-4,131	-4,091	-3,741	-4,142	-3,810	-3,681	-4,000	-4,194
Merchandise trade balance (% of GDP)	-29,3	-30,8	-30,5	-27,4	-29,7	-26,4	-25,3	-26,2	-25,9
Remittances (EURbn)	1,015	1,027	1,070	1,097	1,163	1,216	1,247	1,353	1,377
Current account balance (EURbn)	-0,783	-1,270	-1,168	-0,773	-1,057	-0,806	-0,670	-0,812	-0,923
Current account balance (% of GDP)	-6,0	-9,5	-8,7	-5,7	-7,6	-5,6	-4,6	-5,3	-5,7
Net FDI (EURbn)	0,3	0,3	0,3	0,2	0,4	0,2	0,1	0,5	0,5
FDI (% of GDP)	2,1	2,6	1,9	1,6	3,0	1,5	0,7	2,9	3,0
FDI cover (%)	34,8	27,1	22,3	29,1	40,0	27,4	14,9	55,4	53,3
Gross international reserves (EURbn)	3,302	3,285	3,328	3,614	4,001	4,400	4,452	4,420	3,999
Import cover (months of imports)	6,0	5,3	5,3	5,8	6,0	6,8	6,7	6,0	5,2
Debt indicators									
Gross external debt (EURbn)	10,595	10,163	11,330	11,443	10,638	11,479	11,601	11,631	11,341
Government (EURbn)	3,217	3,407	3,687	3,867	4,316	4,444	4,536	4,506	4,206
Private (EURbn)	7,379	6,756	7,642	7,576	6,321	7,035	7,065	7,125	7,135
Gross external debt (% of GDP)	81,8	75,8	84,6	83,7	76,2	79,6	79,7	76,2	70,1
Gross external debt (% of exports)	275,1	236,5	262,7	248,9	224,8	227,1	214,3	194,0	181,9
Exchange rates and money growth									
USD/BAM (end-year)	1,46	1,51	1,48	1,42	1,61	1,79	1,87	1,78	1,72
USD/BAM (average)	1,47	1,40	1,52	1,47	1,47	1,76	1,77	1,77	1,78
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)	6,4	4,8	-0,7	9,0	9,2	11,9	13,7	8,0	7,2
Broad money M2 (% YoY)	7,2	5,8	3,4	7,9	7,3	8,0	8,3	6,9	6,6
Domestic credit (% YoY)	3,5	5,3	4,1	0,5	2,8	2,4	2,0	4,8	5,8
EURIBOR 3M interest rate (average %)	0,81	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33

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

SELECTED BANKING SECTOR DATA

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Balance sheet									
Assets (EURm)	10.828	11.196	11.414	11.794	12.299	12.756	13.279	13.992	14.924
Assets (%, YoY)	0,8	3,4	1,9	3,3	4,3	3,7	4,1	5,4	6,7
Assets (% of GDP)	83,6	83,5	85,2	86,3	88,1	88,4	91,3	91,7	92,2
Gross loans (EURm)	7.436	7.828	8.151	8.194	8.423	8.624	8.795	9.214	9.747
Gross loans (%, YoY)	3,5	5,3	4,1	0,5	2,8	2,4	2,0	4,8	5,8
Gross loans (% of GDP)	57,4	58,4	60,9	59,9	60,3	59,8	60,4	60,4	60,2
Deposits (EURm)	6.407	6.643	6.814	7.285	7.861	8.452	9.077	9.611	10.129
Deposits (%, YoY)	3,6	3,7	2,6	6,9	7,9	7,5	7,4	5,9	5,4
Deposits (% of GDP)	49,4	49,6	50,9	53,3	56,3	58,6	62,4	63,0	62,6
Loan-to-deposit ratio (%)	116,1	117,8	119,6	112,5	107,1	102,0	96,9	95,9	96,2
Capital adequacy ratio (%)	16,2	17,1	17,0	17,8	16,3	14,9	15,8	16,4	16,2
Performance									
Net interest income (EURm)	366	396	389	385	383	398	411	428	460
Net interest income (%, YoY)	1,1	8,2	-1,8	-1,0	-0,5	3,9	3,3	4,2	7,4
Total operating income (EURm)	609	620	610	618	623	642	680	712	760
Total operating income (%, YoY)	4,8	1,8	-1,5	1,2	0,8	3,1	6,0	4,6	6,8
Pre-provision profit (EURm)	220	209	207	184	213	206	222	233	267
Pre-provision profit (%, YoY)	15,7	-5,1	-0,8	-11,1	15,8	-3,6	8,1	4,9	14,3
Provision charges (EURm)	275	125	130	192	117	171	91	95	104
Profitability and efficiency									
Net interest margin (%)	3,4	3,6	3,4	3,3	3,2	3,2	3,2	3,1	3,2
Pre-tax ROAA (%)	-0,5	0,8	0,7	-0,1	0,8	0,3	1,0	1,0	1,1
Pre-tax ROAE (%)	-4,4	5,9	4,8	-0,5	5,6	1,9	6,9	6,9	7,6
Cost-to-income ratio (%)	63,9	66,3	66,0	70,2	65,7	67,9	67,3	67,2	65,0
Operating expense (% of assets)	-3,6	-3,7	-3,6	-3,7	-3,4	-3,5	-3,5	-3,5	-3,4
Credit quality and provisioning									
NPL ratio (%)	11,4	11,8	13,5	15,1	14,2	13,7	11,8	10,5	10,2
NPL coverage (%)	43,7	66,3	65,9	66,7	69,7	71,2	74,4	94,1	112,1
Provision charges (% of loans)	3,8	1,6	1,6	2,3	1,4	2,0	1,0	1,1	1,1
Provision charges (% of PPP)	-124,8	-60,0	-62,8	-104,1	-55,1	-83,1	-41,1	-40,5	-39,1

Source: CBBH, banking agencies, Addiko research

We upgraded our 2017 loans growth prospects to 4.8% yoy

Credit growth remained robust increasing 2.7% ytd in 4M17 with the strongest positive contribution coming from private sector. Namely, corporate lending rose 2.9% ytd as economic recovery stayed on track, while retail credit went up by 2.2% ytd driven by cash loans. After strong drop in 2016, public sector re-leveraging (+4.4% ytd) reflects the absence of second IMF tranche that was scheduled for January. Due to slightly better than expected credit activity we upgraded our 2017 growth prospects by 0.9pp to 4.8% yoy amid improving labor market outlook, record low interest rate environment and record tourist season. Given expected acceleration in public capex we see further 6%-alike credit expansion in 2018. NPL ratio fell to 11.5% (vs. 11.8% at YE16) and we see further reduction to 10.5% in this year amid NPL sales, write-offs and better debt collection, notably in corporate sector where NPL ratio is still relatively high at 14.3%.

Deposit collection remained strong

In terms of funding, deposit collection recorded further growth in year to April (+2.5% ytd) driven by 2.4% ytd higher retail deposit intake given long-term economic uncertainty and underdevelopment of other forms of saving/investment, despite declining passive interest rates. Public sector contributed positively as well with deposits up by 6.7% ytd, while corporate deposits intake stagnated on a ytd level (+0.3% ytd). That said, we see this year's deposit collection growth set to decelerate towards 6%-region (vs. 7.4% yoy in 2016) mainly due to high-base effect. Otherwise, deposit intake is still driven by rising employment, solid remittances growth, generally improving economic outlook and record tourist season. Such expectations imply LDR will slip slightly from 96.9% at YE16 to 95.5% at the end of this year. In FY16 banking sector saw record high pre-tax profit of EUR131m on the back of higher NII and lower provisioning. For this year we see steady pre-tax growth amid solid operating income growth and stable provisioning.

Domestic Demand Remains the Key Driver

We keep our view of a 3.2% GDP growth in 2017 as 1Q came out in line with our expectations, but admit certain upside risks from stronger investment in 2H17. We have upgraded 2018 growth expectations to 3,4% on the back of stronger household consumption and highway construction. In 2017 we see the average 2.4% inflation, followed by a moderate slowdown in 2018 to 2.2% on the back of diminishing of one-off effects. At the same time, highway construction will boost both budget and current account deficit with the former seen at 6.1% of GDP this year, while the latter is set to increase to as much as 22.1%.

Private consumption boosts growth

Notwithstanding harsh winter and delays in highway construction, Montenegrin economy saw a solid 3.2% yoy growth in 1Q17. The strongest positive contribution came from private consumption, followed by investment. While exports surged 40.5% yoy, this was not sufficient to offset import growth and the overall strong negative net exports contribution. The latest data suggest solid GDP print in Q2 as well, with real retail trade up 3.6% yoy in April-May (vs. 3.6% yoy in Q1), while industrial output decline eased to -5.7% yoy in April-May from -9.8% in Q1. Furthermore, while goods exports growth deteriorated to 5.3% in April-May after a strong increase in Q1, imports declined by 2.0% yoy, after soaring 18.4% yoy in Q1. In addition, foreign tourist nights jumped 22.2% yoy in April-May, and we expect highway construction activity to gain stronger momentum in Q2.

2017 GDP growth seen at 3.2%

With Q1 GDP meeting expectations, we keep 2017 GDP growth forecast at 3.2%, with risks on the upside from stronger investment in 2H17. Just as in Q1, we see private consumption as the main growth driver on the back of stellar tourist season, employment growth, wage hikes and re-leveraging, while public spending will be driven by infrastructure capex. Further investments in tourism (Porto Novi, Luštica bay) and energy will also boost the overall capex, while net export will contribute negatively as long as highway construction boosts imports. For 2018, we upgrade GDP growth forecast to 3.4% as household consumption and highway construction accelerate further, fiscal policy stays expansive, while the aforementioned investment in tourism and energy strengthen export capacity.

Highway related expenditures will keep deficit at elevated levels

The latest budget data show 26.1% yoy lower deficit during 4M17 (EUR68m or 2.4% of 2017e GDP) largely thanks to 20.0% yoy surge in tax intake (2.8% above plan) on the back of cyclical upswing and better tax compliance. Meanwhile, flattish expenditures are 14.6% lower compared to the 2017 budget plan, reflecting weather-induced delays in highway construction. That said, we keep budget deficit forecast at 6.1% of GDP for 2017 intact as highway construction gains substantial momentum in the rest of the year. Also, we expect public debt to top 70% of GDP in 2017. While highway construction will keep budget deficit elevated in 2018 at least, we see the next year's budget gap down by 0.8pp to 5.3% of GDP on the back of planned fiscal adjustment, including various excise tax hikes and wage containment, while 2pp VAT hike to 21% would certainly saw lower deficit figure.

Inflation driven with food and transport price increase

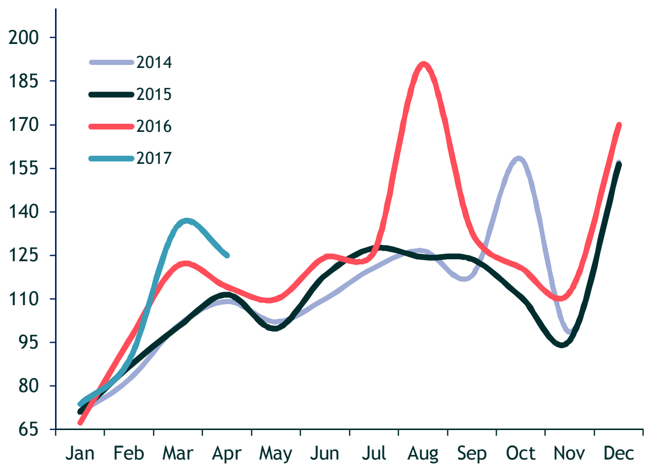
Following a bout of stagnation in 2016, food and transport inflationary pressures have increased substantially this year, shaping up a 2.5% CPI average in the year to May. Beyond weather-inflicted food prices as elsewhere in the region, transport prices are driven by fuel and accompanying excise tax hikes. Furthermore, hotel and catering services also grow substantially by 4.1% yoy in the year to May, while tobacco excise hike in April only added to the picture. In all, we see the average 2.4% inflation in 2017, followed by a moderate slowdown in 2018 to 2.2% on the back of diminishing of (food-related) one-off effects. Upside risks stem from possible VAT rate increase as well as higher tobacco, alcohol and coal excises.

Current account set to widen further

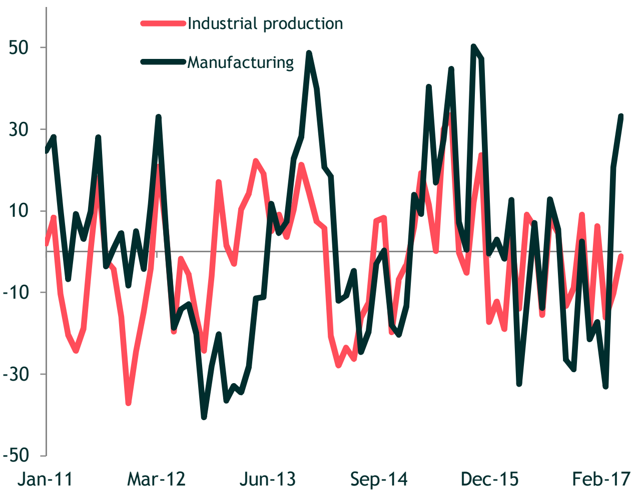
After hitting a high 19.5% of GDP in 2016, C/A gap widening continued in 1Q17. That said, goods exports surge from low base could not offset higher goods imports amid stronger domestic demand and highway related imports. In such circumstances and despite soaring tourism revenues (+35.6% yoy in 1Q17), C/A deficit increased 11.4% yoy in 1Q17. Looking at financial accounts, net FDI roughly doubled in 1Q17 to EUR0.1bn, while portfolio investments faced a small net capital inflow (following outflows in the past four years). We slightly raised our C/A gap forecast to 22.1% of GDP in 2017 as stronger domestic demand and ongoing highway construction will continue to boost imports.

Montenegrin data trends

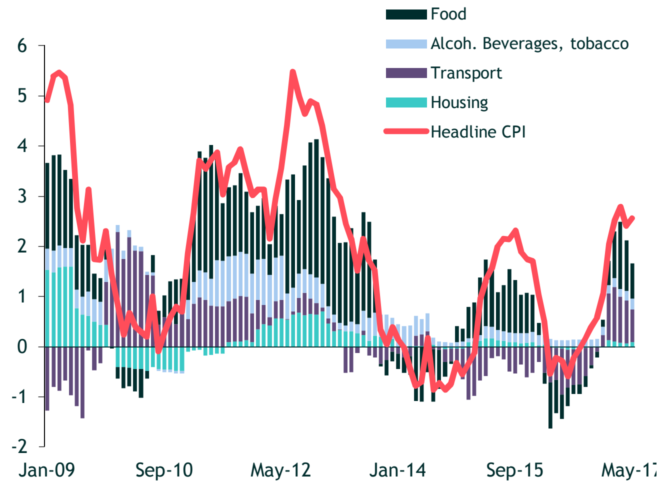
Budget revenue movements (EURm)



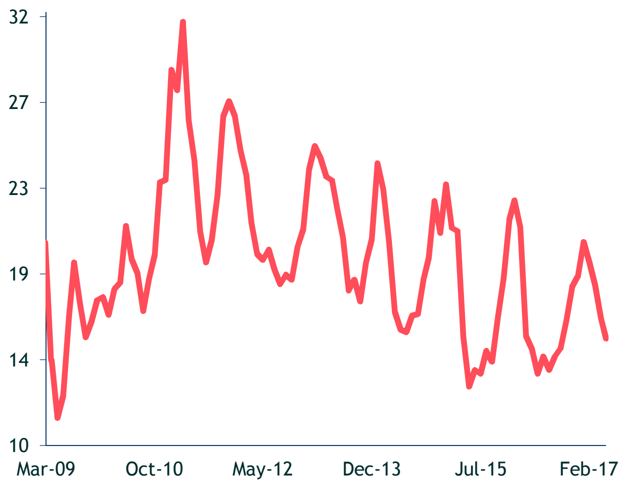
Industrial production (%, yoy)



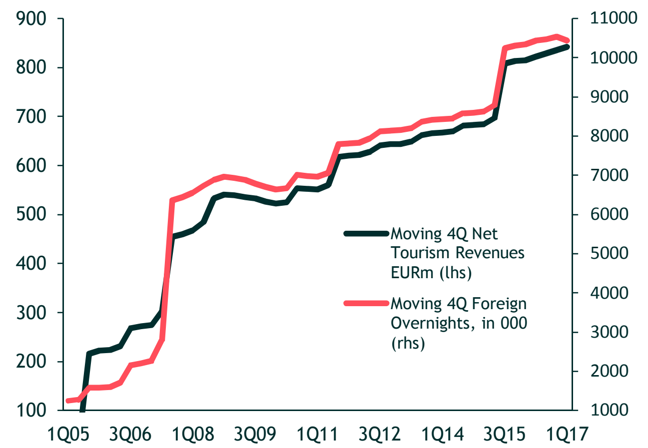
CPI by key contributions (pps)



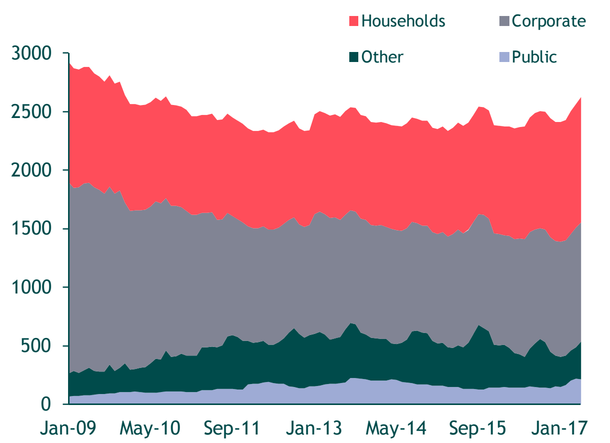
Merchandise import cover (%, 3mma)



Tourism



Gross loans by sector in EURm



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

SELECTED ECONOMIC FORECASTS

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Activity									
Nominal GDP (EURbn,current prices)	3,1	3,2	3,1	3,3	3,4	3,6	3,6	3,9	4,1
Nominal GDP (USDbn)	4,1	4,5	4,0	4,4	4,5	3,9	4,0	4,3	4,5
GDP per capita (EUR)	5.011	5.211	5.062	5.359	5.460	5.710	5.860	6.190	6.541
GDP per capita (USD)	6.648	7.257	6.510	7.117	7.253	6.333	6.490	6.852	7.195
Real GDP (constant prices YoY, %)	2,5	3,2	-2,7	3,5	1,5	3,2	2,5	3,2	3,4
Private consumption (YoY, %)	4,2	7,0	-0,7	1,6	2,9	2,2	2,6	3,1	3,3
Fixed investment (YoY, %)	-21,2	-9,6	-1,8	10,7	-2,5	11,9	26,4	29,5	27,1
Industrial production (YoY, %)	17,5	-8,7	-6,2	10,7	-10,5	9,2	-3,3	2,7	3,5
Unemployment rate (ILO, average %)	19,7	18,1	20,6	19,5	18,1	17,9	16,9	16,3	15,1
Prices									
CPI inflation (average % YoY)	0,5	3,3	4,0	1,8	-0,5	1,4	0,1	2,4	2,2
CPI inflation (end-year % YoY)	0,7	3,0	4,4	0,4	-0,6	1,7	1,0	1,9	2,1
PPI inflation (average % YoY)	-0,7	3,2	1,8	1,7	0,2	0,3	0,5	0,9	1,2
Net wage rates (% YoY, nominal)	3,5	1,0	0,7	-1,7	0,1	0,7	3,8	1,1	1,3
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-4,9	-6,7	-5,8	-6,3	-3,1	-8,0	-3,5	-6,1	-5,3
Public debt	40,7	45,6	53,4	55,2	59,9	66,4	69,9	73,6	76,2
Gross public funding needs	n/a	n/a	n/a	9,5	5,1	17,8	19,1	13,5	7,5
External balance									
Export of goods and services (EURbn)	1,158	1,383	1,389	1,390	1,388	1,539	1,593	1,695	1,837
Import of goods and services (EURbn)	-1,961	-2,100	-2,166	-2,066	-2,074	-2,214	-2,479	-2,724	-2,958
Merchandise trade balance (EURbn)	-1,267	-1,306	-1,389	-1,329	-1,376	-1,464	-1,661	-1,869	-2,067
Merchandise trade balance (% of GDP)	-40,8	-40,4	-44,1	-39,9	-40,6	-41,2	-45,6	-48,5	-50,8
Tourism receipts (EURbn)	0,552	0,619	0,643	0,666	0,682	0,813	0,836	0,903	1,011
Current account balance (EURbn)	-0,710	-0,573	-0,588	-0,487	-0,526	-0,483	-0,712	-0,853	-0,942
Current account balance (% of GDP)	-22,9	-17,7	-18,7	-14,6	-15,5	-13,6	-19,5	-22,1	-23,1
Net FDI (EURbn)	0,6	0,4	0,5	0,3	0,4	0,6	0,4	0,4	0,4
FDI (% of GDP)	17,8	12,0	14,7	9,7	10,4	17,4	10,2	9,8	9,5
FDI cover (%)	77,7	67,9	78,5	66,6	67,3	128,3	52,2	44,5	41,1
Gross international reserves (EURbn)	0,386	0,273	0,318	0,395	0,514	0,641	0,780	0,880	0,788
Import cover (months of imports)	2,4	1,6	1,8	2,3	3,0	3,5	3,8	3,9	3,2
Debt indicators									
Gross external debt (EURbn)	4,395	4,689	4,909	5,041	5,253	5,403	5,645	6,218	6,681
Government (EURbn)	1,308	1,415	1,477	1,433	1,562	1,975	2,003	2,179	2,341
Private (EURbn)	3,087	3,275	3,432	3,687	3,857	3,962	3,642	4,039	4,340
Gross external debt (% of GDP)	141,6	145,0	155,9	151,5	154,8	152,1	154,8	161,4	164,1
Gross external debt (% of exports)	379,6	339,2	353,3	362,6	378,4	351,0	354,3	366,9	363,6
Exchange rates and money growth									
EUR/USD (end-year)	1,34	1,30	1,32	1,38	1,21	1,09	1,05	1,10	1,14
EUR/USD (average)	1,33	1,39	1,29	1,33	1,33	1,11	1,11	1,11	1,10
Money supply M1 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Broad money M3 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (% YoY)	-4,8	-6,3	-0,7	3,1	-1,9	0,8	1,3	6,3	6,4
ECB reference rate (end-year %)	1,00	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00
EURIBOR 3M interest rate (average, %)	0,81	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33

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

SELECTED BANKING SECTOR DATA

	2010	2011	2012	2013	2014	2015	2016	2017F	2018F
Balance sheet									
Assets (EURm)	2.944	2.810	2.808	2.959	3.136	3.472	3.791	3.943	4.100
Assets (%, YoY)	-2,7	-4,5	-0,1	5,4	6,0	10,7	9,2	4,0	4,0
Assets (% of GDP)	94,8	86,9	89,2	88,9	92,4	97,3	100,6	98,8	100,7
Gross loans (EURm)	2.518	2.359	2.342	2.414	2.367	2.386	2.416	2.583	2.748
Gross loans (%, YoY)	-4,8	-6,3	-0,7	3,1	-1,9	0,8	1,3	6,3	6,4
Gross loans (% of GDP)	81,1	72,9	74,4	72,6	69,8	66,8	64,1	64,7	67,5
Deposits (EURm)	1.790	1.817	1.981	2.098	2.308	2.625	2.871	3.070	3.235
Deposits (%, YoY)	-1,9	1,5	9,0	5,9	10,0	13,7	9,4	6,9	5,4
Deposits (% of GDP)	57,7	56,2	62,9	63,0	68,0	73,5	76,2	76,9	79,5
Loan-to-deposit ratio (%)	140,7	129,8	118,2	115,1	102,6	90,9	84,1	84,1	84,9
Capital adequacy ratio (%)	15,9	16,5	14,7	14,4	16,2	16,0	15,5	15,1	14,6
Performance									
Net interest income (EURm)	111	106	106	104	111	117	122	128	125
Net interest income (%, YoY)	-8,2	-4,8	-0,1	-1,6	6,6	5,3	4,2	5,3	-2,3
Total operating income (EURm)	155	221	178	156	158	171	171	183	182
Total operating income (%, YoY)	-4,4	42,6	-19,5	-12,0	1,2	8,3	-0,1	6,8	-0,4
Pre-provision profit (EURm)	53	114	65	48	46	52	50	58	55
Pre-provision profit (%, YoY)	-13,0	114,7	-43,2	-26,7	-2,6	11,5	-3,9	16,0	-5,4
Provision charges (EURm)	148	124	121	44	21	53	44	48	49
Profitability and efficiency									
Net interest margin (%)	3,7	3,7	3,8	3,6	3,6	3,5	3,4	3,3	3,1
Pre-tax ROAA (%)	-3,2	-0,3	-2,0	0,1	0,8	-0,1	0,2	0,2	0,1
Pre-tax ROAE (%)	-30,0	-3,2	-18,7	1,0	6,0	-0,4	1,3	1,9	1,2
Cost-to-income ratio (%)	65,6	48,2	63,5	69,6	70,7	69,8	71,0	68,5	70,1
Operating expense (% of assets)	3,4	3,7	4,0	3,8	3,7	3,6	3,3	3,2	3,2
Credit quality and provisioning									
NPL ratio (%)	21,0	15,5	17,6	17,5	15,9	12,5	10,3	9,4	8,9
NPL coverage (%)	28,6	27,6	32,7	44,7	46,0	49,6	56,9	65,8	69,4
Provision charges (% of loans)	5,7	5,1	5,1	1,9	0,9	2,2	1,8	1,9	1,8
Provision charges (% of PPP)	277,2	108,5	185,7	92,5	45,6	103,2	87,8	83,7	89,5

Source: CBCG, Addiko research

Strong lending activity to private sector

Loan growth accelerated to 8.7% ytd in 5M17 (vs. +1.3% yoy on FY16), mainly driven by 39.9% ytd higher credits to public sector needed for financing the highway construction and outstanding liabilities. Lending to private sector recorded strong performance with retail lending increasing by 8.7% ytd given rising employment and wages, while corporate lending grew by 3.6% ytd due to tourist season preparations. As public sector lending dynamics outshone our expectations, we upgraded our credit growth forecasts for this and next year to 6.3% yoy and 6.4% yoy respectively. We see growth in this year supported by record tourist season, rising employment and wages, revival of construction activities, falling interest rates and high bank liquidity. Downside risks stem from problems with collateral execution, weak enterprise accounting practices and relatively high lending standards in the aftermath of high NPLs. Speaking of, NPL ratio fell to 9.9% in 1Q17 (vs. 10.3% in FY16) and we expect it to decline further to 9.4% in 2017 as the voluntary debt resolution framework know as ‘Podgoricki model’ has been expended to more classes of NPLs .

Deposit collection to remain robust…

Deposit collection increased by 1.3% ytd in 5M17 (vs. 9.4% yoy in FY16). The growth was mainly driven by 1.6% ytd higher household deposit intake thanks to improving labor market, while corporate deposits went up by 1.0% ytd. Public sector contributed negatively as its deposits fell 0.7% ytd. That said, we upgraded our deposits growth prospects by 0.9pp to 6.9% yoy in 2017 on the back of further employment gains, moderate wage increase and record tourist season, while in 2018 we see deposits up by 5.4% yoy supported by retail sector and tourism season. As for profitability, 1Q17 data indicates that 13.2% yoy higher TOI led to 35.2% yoy higher pre-tax profit, despite rising opex and provisions. Looking ahead, we expect strong rise of pre-tax profit in this year (+54.9% yoy to EUR9m) on the back of higher NIM and steady opex and provisioning growth. Bearing in mind large number of banks, consolidation of banking sector could have beneficial effects on financial system stability and efficiency.

ABBREVIATIONS

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

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Hrvoje Stojic, Economic Research Director (+385-1-603-0509)
Tajana Striga, Analyst (+385-1-603-3522)
Ines Antic, Junior Analyst (+385-1-603-3657)

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

Addiko Bank