SEE Outlook Quarterly

by Economic
Research
Department

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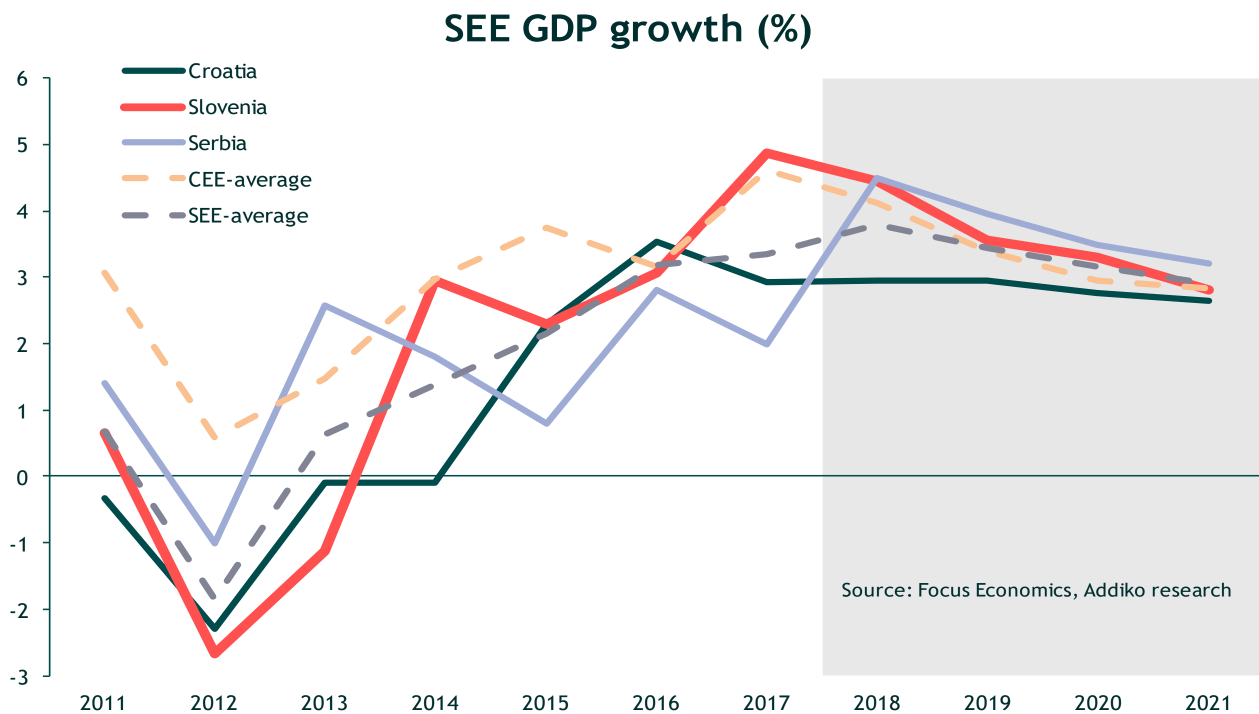
Addiko Bank

SEE Quarterly

Addiko Bank

21 December 2018

GROWTH HAS PLATEAUED, BUT WON'T COLLAPSE



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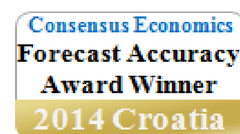
#1 BEST OVERALL FORECASTER - SLOVENIA

#1 BEST OVERALL FORECASTER - SERBIA



EXECUTIVE SUMMARY

BOTTOM LINE: We keep our 2019 GDP forecasts for SEE markets unchanged, with the region manifesting 3.5% average GDP growth. Serbia should see the strongest growth around 4%, driven by strong domestic demand. In Slovenia, we also see above-potential growth around 3.5%, leveraging on export competitiveness gains, increased private consumption and investments. In Croatia, we expect investment rebound and strong private consumption to support our 3.0% GDP growth call. Monetary conditions remain loose, while inflation will remain similar subdued on lower oil and import prices assumption, despite tighter labour markets. We see ongoing cyclical budget surpluses in most of the markets, with Serbia returning to balance and Montenegro narrowing its budget deficit as highway construction slows down.

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

*vs USD

KEY POINTS:

1. In Slovenia, we have 3.5% GDP growth call in 2019 on the back of slower but still above-potential euro zone expansion, ultra-easy financial conditions, slightly pro-cyclical fiscal policy, faster private consumption growth and strong investment. In Croatia, we reiterate above-consensus 3.0% GDP growth forecast for 2019 on brightening investment outlook, strong private consumption and fiscal easing. In Serbia, we maintain 2019 growth forecast at 4.0% on vibrant domestic demand, export market share gains, fiscal easing and ample funding conditions. In Bosnia-Herzegovina, we expect GDP growth in 2019 at 3.5% driven by private consumption, hefty infrastructure investments once the current political stalemate ends, and stronger export growth. In Montenegro, we keep 2019 GDP growth forecast at 3.0% driven by tourism and highway construction projects.

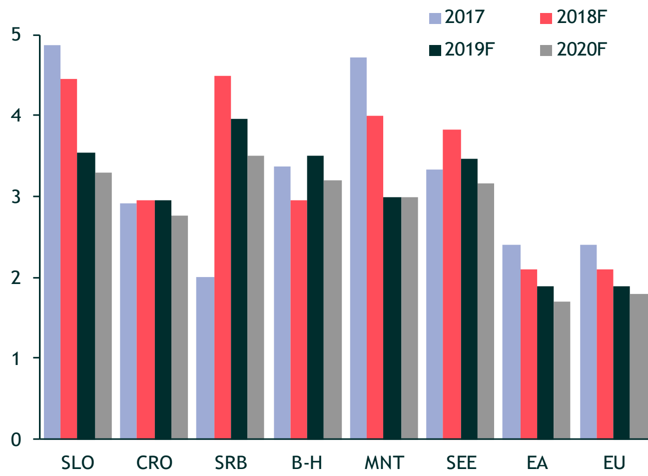
2. We see Slovenia's budget surplus around 0.5% in 2019 on strong tax-rich domestic demand, further interest rate savings and positive BAMC contribution while acknowledging the increased risks on the expenditure side of the budget due to last election's entitlement promises. In Croatia, we expect a small 0.5%-alike budget surplus in 2019 on stronger tax-rich local demand growth and firmer commitment to spending rules (ahead of ERM II) under a new Fiscal Responsibility Act, offsetting spending pressures ahead of 2019-2020 election cycle, stronger demographic spending and the lack of material reforms. After years of surpluses, we expect Serbia's 2019 budget returning to balance on steady public capex growth, wages and pension hikes, 13% higher guarantees and direct tax cuts.

3. Taking into account weaker-than-expected momentum and lower oil price assumptions, we see Slovenian CPI at 1.6% in 2019 with tighter labour markets and strong consumer demand limiting downside surprises. In Croatia, we see average CPI at 1.0% in 2019, with risks more on the downside from export-related goods prices and lower tourist prices in the event of more severe euro zone slowdown and international competition. In the absence of significant food prices supply-side shocks, we expect Serbian average CPI around 2% in 2019 with upside risks mainly stemming from stronger-than-expected administered price hikes and tightening labour markets, offset by the steady dinar development and a regular agricultural season.

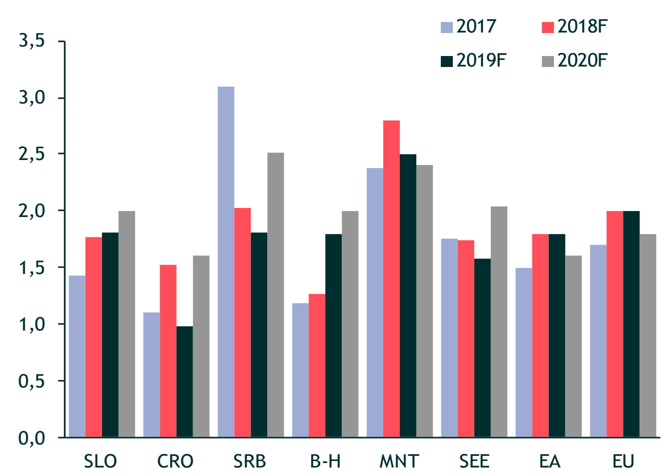
4. While the QE formally came to an end, the ECB loose monetary policy continues. Further tweaks for GDP growth and core inflation forecasts will reassure the ECB to stay on very gradual path of monetary policy normalisation, delaying rate hikes into 2020 and generously supporting duration risk via reinvestments of maturing bonds and a new wave of TLTRO at least until end-2020, in our view. Given the euro zone risks, Slovenian spreads will likely see a modest widening amid higher semi-core supply before the next bout of positive discrimination and return to 40-60bp spread range. While mandatory reserve cuts fit well into Croatia's ERM II bid, the CNB will in our view add ample liquidity mainly in response to material SME credit demand. We stay constructive on Croatian credit due to policy coherence and reform appetite under the ERM II 2020 agenda, further debt cuts, lower funding needs, stronger external position and growth potential, lower financial risks upon Agrokor restructuring and investment grade prospects. In Serbia, the NBS will likely stay on hold for a long time in the absence of core inflation recovery. Given intensified ECB's forward guidance and cautious Fed tightening, we expect the ECB policy will be a more important driver for the NBS to start hiking only in 1H20 in sync or slightly later than the ECB. Long-term dinar yields still have a little downside potential thanks to stronger growth prospects, fiscal discipline and lower funding needs, new IMF policy anchor and improved sovereign rating-relevant metrics.

SEE data trends

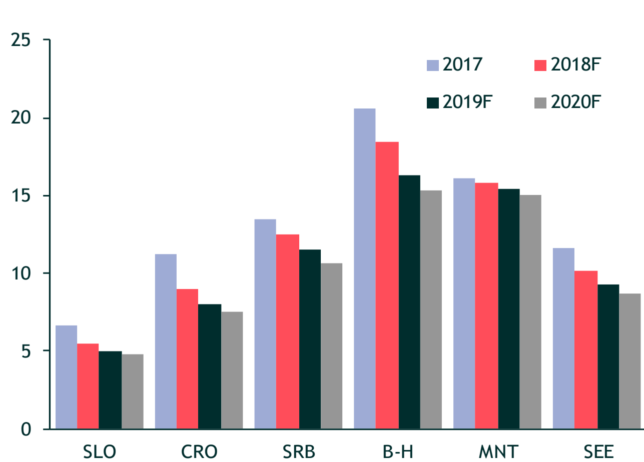
Real GDP growth (%)



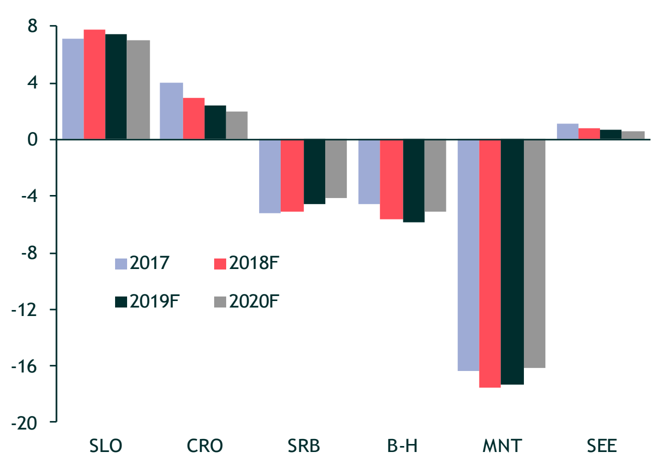
CPI inflation (average, %, YoY)



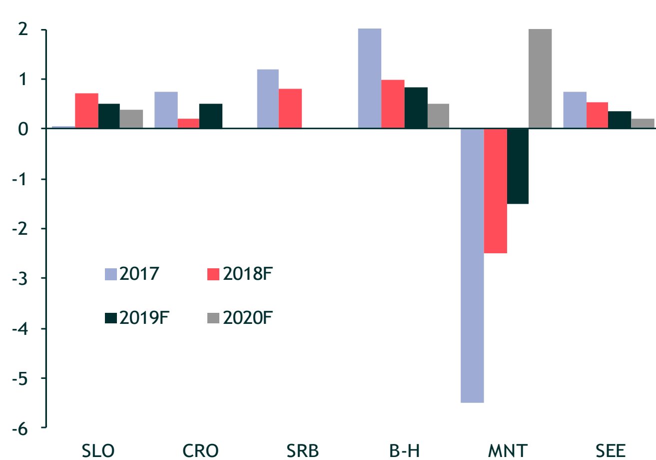
Unemployment rate (ILO average, %)



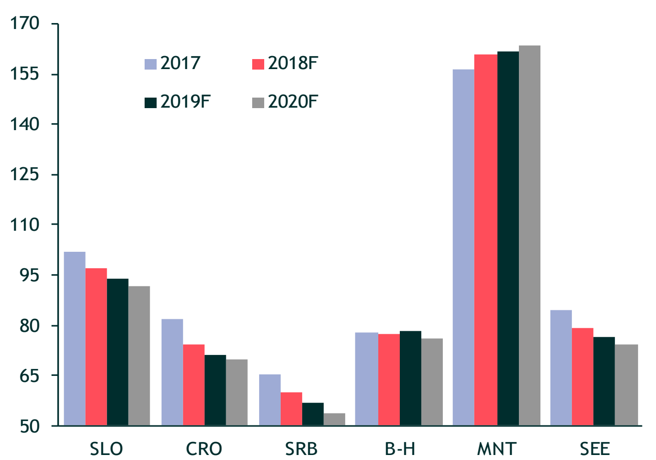
Current account balance (% of GDP)



Government balance (% of GDP)



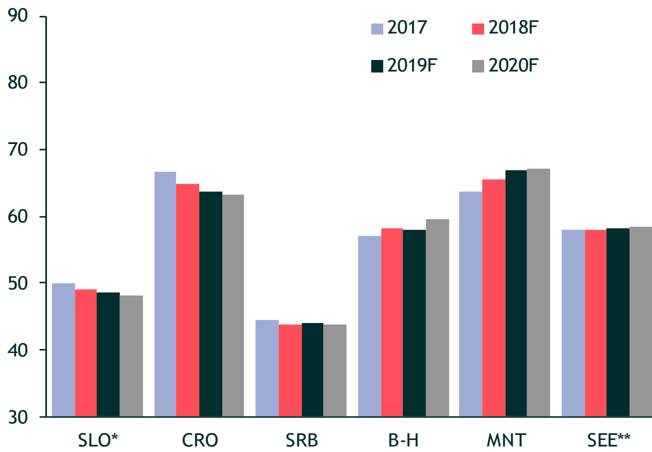
Gross foreign debt (% of GDP)



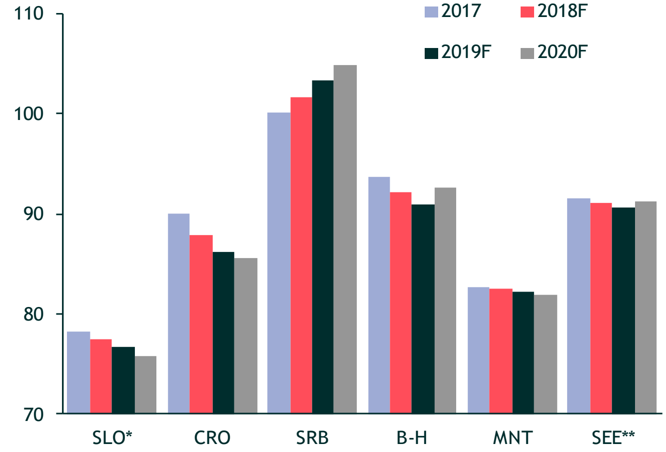
Source: National sources, Addiko research

SEE banking sector trends

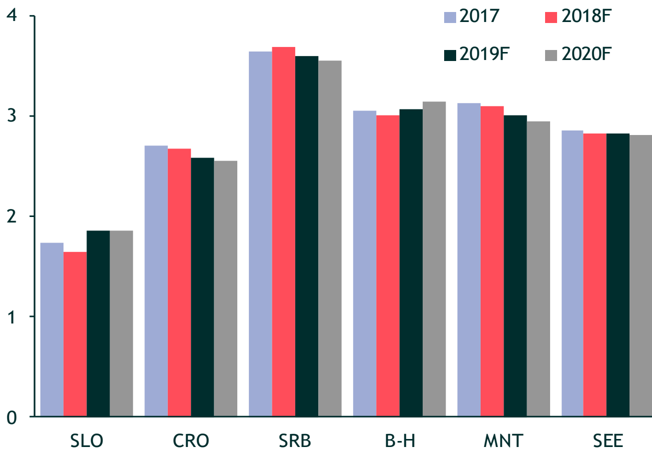
Gross loans (% of GDP)



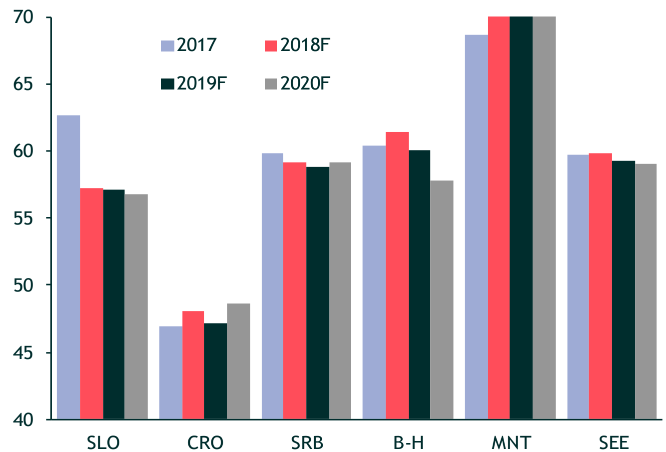
Loan-to-deposit ratio (%)



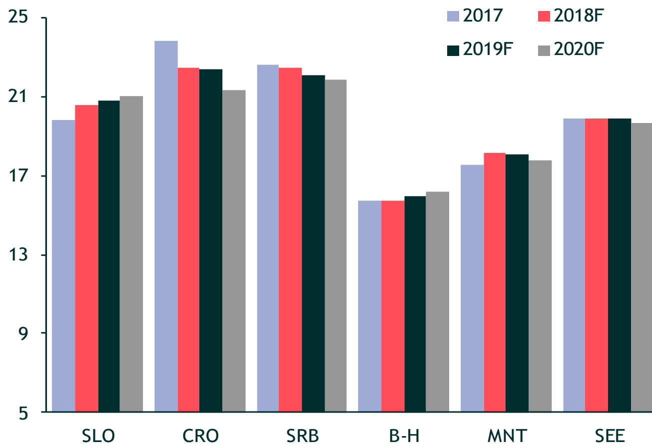
Net interest margin (%)



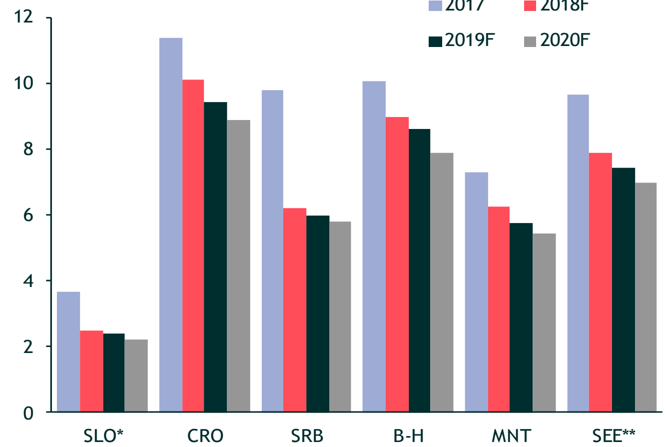
Cost-to-income ratio (%)



Capital adequacy ratio (%)



NPL ratio (%)



*Net loans; NPL excl. foreborne exposures **Slovenia excluded;
Source: central banks, Addiko research

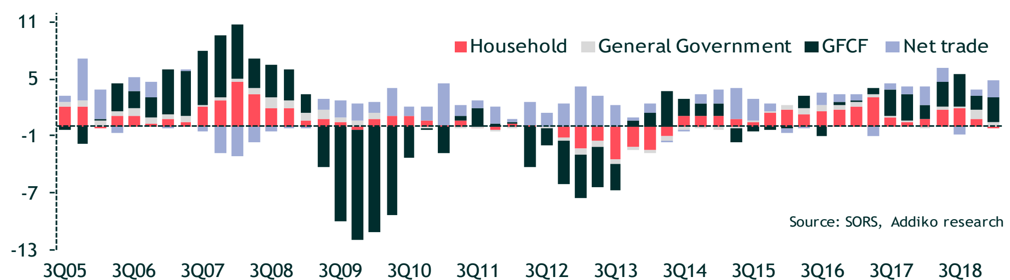
Down at Above-Trend Pace

We have above-consensus 2019 GDP growth call at 3.5% on the back of still solid (if slower) euro zone expansion, ultra-easy financial conditions, slightly pro-cyclical fiscal policy, faster private consumption growth and strong investments. While the budget stays in surplus and public debt declines further, fiscal stance has become expansionary with the structural deficit widening on the back of generous entitlement spending. Further macro/fiscal over performance, interest bill cuts and stronger rating prospects suggest ongoing Slovenian bonds outperformance despite the gradual ECB policy normalization.

Growth momentum maintained through 2018

Despite poor consumer demand showing, Q3 growth (+1.3% qoq, 5.0% yoy seasonally adjusted) outdid expectations on strong net export result and investments. As the biggest upside surprise, investments are driven by construction and equipment capex as the closest proxy of exporters' morale. Exports (+5.7% yoy) kept solid pace in deteriorating environment for the global trade impacted by protectionism and slowing euro zone growth as services exports compensated for slowing goods exports. Private consumption growth halt hard to understand given accelerating retail trade in Q3, steady job market, rising wages and households' re-leveraging. In Q4, we see ~1% qoq growth on resurgent export-led manufacturing, strong investments and normalization of consumption. Stronger Q3 print, Q1-Q2 upward revision, despite slowing Q4 growth dynamics still make 4.5%-alike FY18 GDP forecast feasible. Of note for Slovenia, German auto industry will reverse a Q3 plunge due to new emission standards, more important than Italian slowdown.

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



Growth stays strong, risks to outlook are mainly external

We maintain above-consensus 2019 GDP growth call at 3.5% on the back of still above-potential (if slower) euro zone expansion, ultra-easy financial conditions, slightly pro-cyclical fiscal policy, faster private consumption growth and strong investments. We are confident in solid (if slowing) export growth in the next years as competitiveness gains, rising technological complexity, contained unit labour cost (despite tighter labour market) and export market share gains defy signals of slowing EU upswing. Record capacity utilization rates and upbeat hiring prospects reveal healthy investment appetite ahead, supported by accelerated EU funding, high retained profits and stronger corporate credit particularly at longer maturities. Despite weaker sentiment of late, we see private consumption growth at 3% clip driven by employment, rising wages and household credit. While trade links with Germany and Italy are very strong, it is conceivable that the disconnection between Slovenian and euro zone growth stays in place over the short term, supported by local demand. Risks to our baseline are a bit more on the downside in case of slower euro zone growth, US-China trade conflicts (limiting Europe's export potential) and Italy's short-lived recession. While disorderly and escalating trade wars may hit 12-15% of the world trade and pose extra uncertainty to domestic real-side prospects, Italy is the biggest risk through both the trade (15% of exports in final Italian demand) and (indirectly) financial market channels. Positive surprises on global growth, fiscal easing, SOEs' privatization and stronger rebound in (public) capex pose the main upside risks.

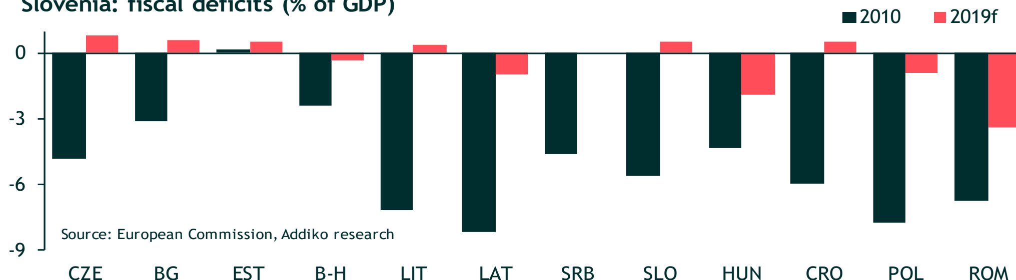
Inflation moderates in 2019, stays below the euro zone average

Most Inflation in both the euro zone and Slovenia was weaker than expected in Q4 and we pared forecasts a little in 2019 to factor in this weaker-than-expected momentum and lower oil price assumption. Prolonged core inflation stickiness at low levels is consistent has reflected weak pass-through of stronger wages into prices and ongoing uncertainty in that respect. This suggests slower-than-expected gradual return of area-wide underlying domestic inflation towards the ECB targets, despite the weaker euro helping energy and import prices to recover faster. Nonetheless, we expect tighter labour markets and strong consumer demand to limit any downside surprises. We expect inflation to fluctuate within 1.6%+/-0.4pp and average 1.6% for 2019 (vs. 1.8% in 2018), just below the euro zone average. With inflation target still tricky, the ECB looks set to be on hold through 2019, with a first (20bp-alike) rate hike in 1H20 in our view. Once the ECB starts to hike, we see an annual pace of hikes of only around 20bp-40bp.

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

The C/A surplus expansion continued in 2018, driven by strong export growth, higher tourism FC receipts and EU funding, with higher primary income owing to lower interest rates bill. In 2019, we see lower C/A surplus courtesy of soaring (import-intensive) domestic demand and partly due slower goods export growth. As long as net external debt declines sharply and banks' are flush with liquidity, we expect a further improvement in the net international investment position on its way to -25% of GDP, outperforming the Baa-rated median substantially in a further evidence of much lower external vulnerabilities relative to pre-2008-crisis period.

With sizeable C/A surplus, hefty 9%/GDP fiscal reserve, funding position stays extremely favourable, allowing further gains through active debt management policy, with e.g further average debt duration extensions. FDI have picked up recently, importantly driven by the sale of 59.1% in the largest NLB bank (market share 23%) for about EUR600m (or PBV just below 0.7x) through an IPO. Financial sector will remain in the spotlight with additional 15% in NLB expected to be sold by end-2019, followed by Abanka sale sometimes this year. Removal of the EC state aid restrictions will allow the banks to deploy excess liquidity at higher yields and pursue more growth opportunities and improve NIM profitability, all of which will enhance competition further banking sector consolidation. Beyond banks' privatization, we think the narrowing of the group of 'strategic' SOEs that are not available for sale is of utmost importance to boost FDI and grow presence in the global value chains, both comparatively weak by euro zone standards.



Fiscal consolidation continues but spending risks have increased

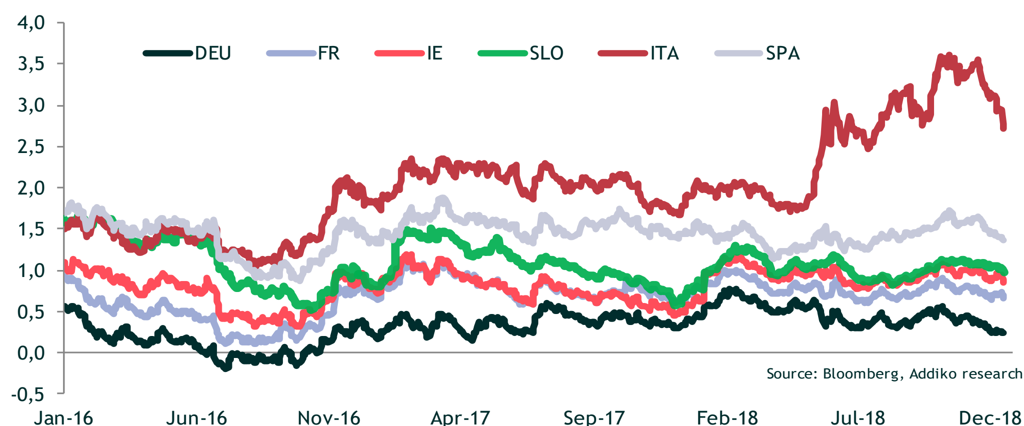
The budget surplus for 2018 likely rose close to 0.7% of GDP on tax revenue (notably CIT and VAT) overshooting, NLB dividend payout, lower interest bill and positive impact from BAMC, in spite of public wage, pension and social transfer hikes. While strong tax-rich domestic demand, further interest rate savings and positive BAMC contribution feature in 2019 budget as well and support 0.5% budget surplus, there are increased risks on the expenditure side of the budget due to last election's entitlement promises. Stronger-than-expected wage and social transfers hikes (EUR230m above plan on our estimates), stronger EU-co-funded public capex and extraordinary pension indexation (to a lesser extent) pose the key performance risks. From what we see, strong cyclical windfall tax revenue has given boost to generous entitlement spending rather than structural fiscal measures, which should on our estimates double structural deficit close to 1% of GDP. Given the starting point of 0.6% GDP structural tightening in the 2019 draft budget (close to the EC target), and the potential hit to growth from external demand, it is conceivable that unless mitigation action is taken in terms of expenditure savings, Slovenia will move further away from its structural MTO of +0.25% of GDP. One of the key risks going forward is that having seen the new cabinet's populism under pressure at the start of its mandate, populist groups only strengthen demands (eg. in healthcare, pension system), hoping to get more while impacting the hard-won competitiveness and endangering the government's already fragmented position.

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

Following a decline below 70% of GDP in 2018 on strong nominal GDP growth and higher budget surplus, we expect public debt to fall again on above-trend GDP growth, similar budget surplus and hitherto interest rate savings, with additional downside potential hidden in the MinFin's hefty cash reserve (around 9% of GDP). This effectively puts public debt net of liquid assets below 60% of GDP and on a declining path through 2020 and beyond. Positive BAMC results together with the NLB secondary public offering and Abanka sale scheduled for 2019 may cut public debt even further. With slightly higher funding needs in 2019 (5.7% of GDP) relative to 2018 followed by a sharp nominal decline in 2020, Slovenia has perhaps the best pre-funding position in CESEE on our estimates. As long as the borrowing terms remain favourable, the MinFin will look to seize cheaper refinancing opportunities to bring the average interest rate towards 2.5% by 2020 from 3.1% in 2018 and 4.4% in the peak year 2014. In the medium term (beyond 2020), when GDP growth converges toward 2.5% on average and borrowing costs will have normalized, government debt reduction essentially depends on stronger reform content in further fiscal consolidation, something where the appetite has recently weakened. Ongoing banking sector consolidation, stronger focus on alternative sources of funding for SMEs and SOEs' restructuring are equally important in mitigating the medium term risks in public finance.

Slovenian bonds underperformed slightly

Slovenian 10Y yield proved stable around 1.10% in Q4 (20bp higher than in Q3), insensitive to the renewed risk aversion from global trade tensions and Italian budget drama. Some 30bp spread widening relative to Bund, however, reflects in our view semi core EUR government bonds underperformance (despite the recent tightening in the periphery) in response to higher supply, Brexit concerns and the semi core class being the instrument of choice to position for the end of the ECB QE. Strong macro/fiscal performance, further sovereign interest bill cuts and the last rating outlook upgrades have acted as the key anchors for Slovenian bonds. The growing chances for the Fed rate pause in March at a time of heightened US-China tariff uncertainty and given the recent substantial US FCI tightening (+80bp since September), together with Italian political volatility and ECB QE reinvestment ahead, all alleviate the risks to long-term Bund and Slovenian yields ahead.

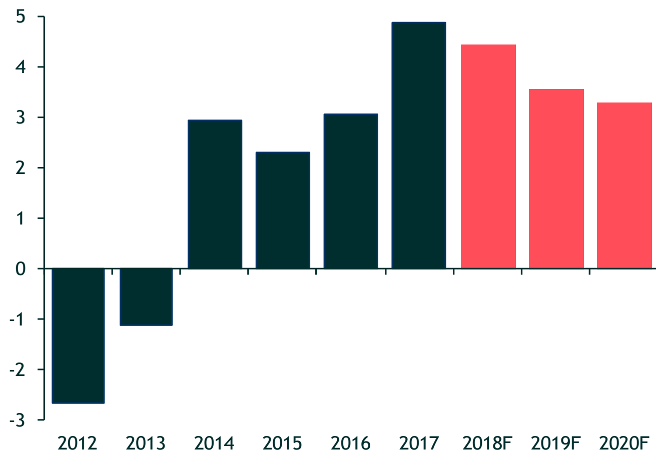


The end of QE does not hurt Slovenian bonds...

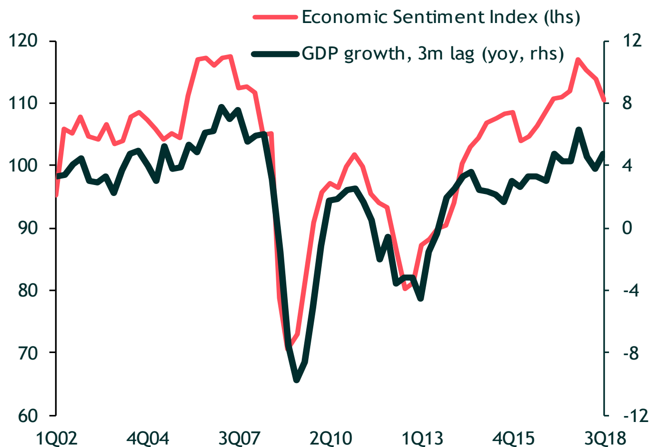
After the formal end to QE, it has become clear more than ever that this does not signal the end of the loose monetary policy. Further tweaks for GDP growth and core inflation forecasts in our view reassure the ECB to stay on very gradual path of monetary policy normalisation by delaying rate hikes into 2020 and generously supporting duration risk via reinvestments of maturing bonds and a new wave of TLTRO at least until end-2020, in our view. While the ECB still had confidence in its medium-term inflation target, the genuine downside risks to ECB policy rate future path have though risen due to weaker-than-expected activity and core inflation, and intolerance for higher funding costs with two large economies (Italy, France) on the verge of EDP. If things get nasty, the ECB could be forced to resume QE, adopt outright intervention in equity markets and/or abandon the capital-key for asset purchases. With Slovenia's extremely good financing position and even lower funding needs in 2019-2020 and no sudden changes in the ECB policy ahead, the Slovenian base case is driven by macro/fiscal over performance, proactive asset/liability management and rating upgrades. That said, with heated euro zone moments well into 1H19 and the market highly directional, Slovenian semi-core-perceived spreads will likely see a modest widening amid higher semi-core supply (inside 70-90bp spread range above Bund) before the next bout of positive discrimination (and return to 40-60bp spread range). While significant deviations from the prescribed fiscal route and reversal of policy efforts invested so far would certainly push Slovenian yields higher, positive risks for bond performance as ever include new ALM transactions, further bank stakes sales, above-trend GDP growth, ensuing rating upgrades and faster public debt reduction closer to sub-50% single-A median.

Slovenia's data trends

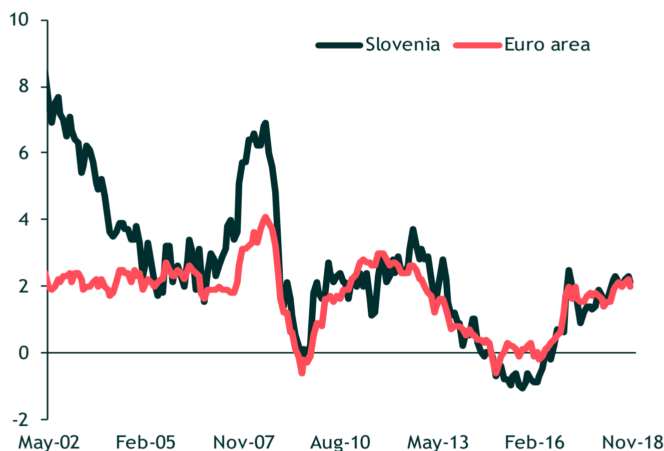
Real GDP growth (yoy, %)



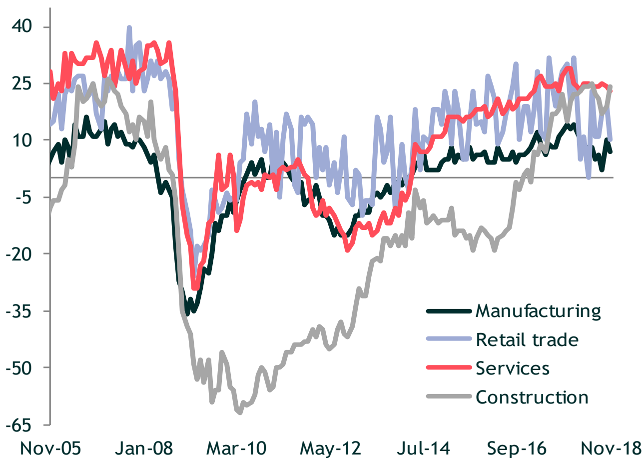
Economic confidence vs. GDP growth



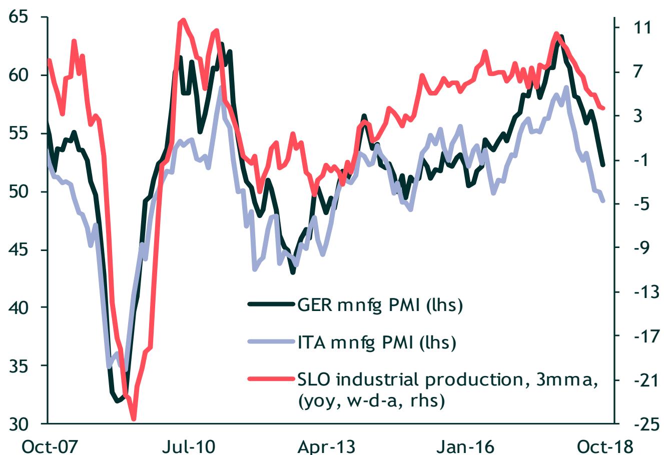
CPI inflation dynamics (% YoY)



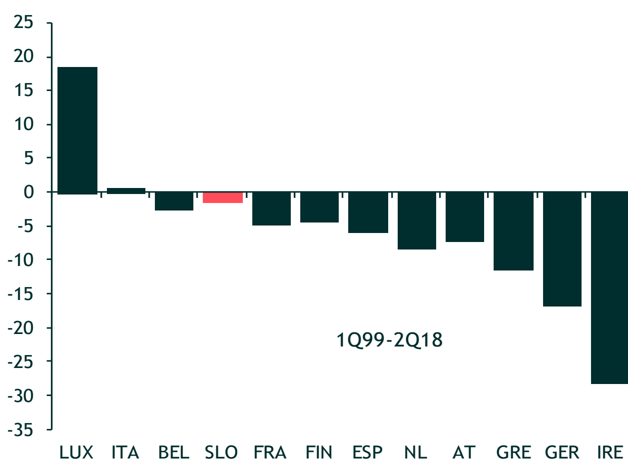
Business sentiment



PMI vs. Industrial production



Unit labour cost for the total economy



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

SELECTED ECONOMIC FORECASTS

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Activity									
Nominal GDP (EURbn, current prices)	36,1	36,2	37,6	38,9	40,4	43,0	45,7	48,0	50,6
Nominal GDP (USDbn)	46,4	48,1	50,0	43,1	44,7	48,6	54,0	55,7	61,4
GDP per capita (EUR)	17.538	17.592	18.244	18.839	19.551	20.814	22.105	23.225	24.444
GDP per capita (USD)	22.554	23.364	24.238	20.895	21.651	23.501	26.123	26.941	29.700
Real GDP (constant prices YoY, %)	-2,7	-1,1	3,0	2,3	3,1	4,9	4,5	3,6	3,3
Private consumption (YoY, %)	-2,4	-4,2	1,9	2,3	4,0	1,9	2,0	2,9	2,7
Fixed investment (YoY, %)	-8,8	3,2	1,0	-1,6	-3,7	10,7	10,8	7,5	5,7
Industrial production (YoY, %)	-0,8	-0,9	1,8	5,1	7,8	8,3	5,6	5,2	5,0
Unemployment rate (ILO, average %)	8,9	10,1	9,7	9,0	8,0	6,6	5,5	5,0	4,8
Prices									
CPI inflation (average % YoY)	2,6	1,8	0,2	-0,5	-0,1	1,4	1,8	1,6	2,0
CPI inflation (end-year % YoY)	2,7	0,7	0,1	-0,5	0,5	1,7	1,7	1,5	2,0
PPI inflation (average % YoY)	0,9	0,3	-0,6	-0,2	-1,4	2,2	2,1	2,4	2,6
Net wage rates (% YoY, nominal)	0,4	0,6	0,8	0,7	1,8	2,7	3,8	3,4	2,3
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-4,0	-14,7	-5,5	-2,9	-1,9	0,1	0,7	0,5	0,4
Public debt	53,8	70,4	80,3	82,6	78,7	74,1	69,3	65,3	61,5
Gross public funding needs	8,2	19,3	14,5	6,4	9,7	6,4	5,0	5,7	3,2
External balance									
Export of goods and services (EURbn)	26,363	27,010	28,520	29,975	31,478	35,737	39,168	42,011	44,091
Import of goods and services (EURbn)	24,934	24,569	25,641	26,569	27,690	31,457	34,666	37,671	39,668
Merchandise trade balance (EURbn)	-0,081	0,708	1,181	1,476	1,537	1,561	1,742	1,580	1,673
Merchandise trade balance (% of GDP)	-0,2	2,0	3,1	3,8	3,8	3,6	3,8	3,3	3,3
Tourism receipts (EURbn)	2,008	2,043	2,060	2,098	2,190	2,434	2,653	2,789	2,903
Current account balance (EURbn)	0,775	1,594	2,179	1,760	2,224	3,077	3,533	3,552	3,539
Current account balance (% of GDP)	2,1	4,4	5,8	4,5	5,5	7,2	7,7	7,4	7,0
Net FDI (EURbn)	0,5	0,0	0,6	1,3	0,9	0,4	1,6	1,5	1,5
FDI (% of GDP)	1,3	0,1	1,6	3,3	2,1	1,0	3,5	3,0	3,0
FDI cover (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0,722	0,669	0,837	0,760	0,700	0,800	0,800	0,800	0,800
Import cover (months of imports)	0,3	0,3	0,4	0,3	0,3	0,3	0,3	0,3	0,2
Debt indicators									
Gross external debt (EURbn)	42,872	41,658	46,314	46,627	44,810	43,813	44,273	44,973	46,223
Government (EURbn)	11,092	15,459	22,416	24,824	22,953	21,769	22,219	22,419	23,669
Private (EURbn)	25,709	23,457	21,815	19,587	18,400	18,224	18,554	19,054	19,254
Gross external debt (% of GDP)	118,8	115,0	123,2	120,0	111,0	101,9	96,9	93,7	91,4
Gross external debt (% of exports)	162,6	154,2	162,4	155,6	142,4	122,6	113,0	107,0	104,8
Exchange rates and money growth									
EUR/USD (end-year)	1,32	1,38	1,21	1,09	1,05	1,19	1,12	1,20	1,25
EUR/USD (average)	1,29	1,33	1,33	1,11	1,11	1,13	1,18	1,16	1,22
Money supply M1 (% YoY)*	4,4	0,1	18,5	24,9	17,1	16,0	10,4	9,7	9,2
Broad money M3 (% YoY)*	-1,4	-1,3	6,1	4,6	7,1	7,8	6,8	5,2	4,9
Domestic credit (% YoY)	-5,8	-21,4	-11,5	-5,9	1,3	4,8	4,2	4,1	4,0
ECB reference rate (end-year %)	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,00	0,25
EURIBOR 3M interest rate (average %)	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,30	0,00
SLO 5Y yield (average %)	4,55	4,35	2,14	1,64	0,70	0,33	0,40	0,70	1,18
SLO 10Y yield (average %)	6,01	5,87	3,28	1,67	0,82	1,12	1,00	1,30	1,60

* Since 2007 ECB data

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

SELECTED BANKING SECTOR DATA

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Balance sheet									
Assets (EURm)	46.125	40.344	38.714	37.383	37.050	37.946	39.004	39.695	40.668
Assets (%, YoY)	-5,4	-12,5	-4,0	-3,4	-0,9	2,4	2,8	1,8	2,5
Assets (% of GDP)	127,9	111,3	103,0	96,2	91,8	88,2	85,4	82,7	80,5
Net loans (EURm)	30.964	24.338	21.540	20.275	20.534	21.523	22.431	23.353	24.294
Net loans (%, YoY)	-5,8	-21,4	-11,5	-5,9	1,3	4,8	4,2	4,1	4,0
Net loans (% of GDP)	85,8	67,2	57,3	52,2	50,9	50,1	49,1	48,6	48,1
Deposits (EURm)	23.856	22.550	24.426	25.140	26.133	27.528	28.956	30.420	32.043
Deposits (%, YoY)	-1,3	-5,5	8,3	2,9	3,9	5,3	5,2	5,1	5,3
Deposits (% of GDP)	66,1	62,2	65,0	64,7	64,8	64,0	63,4	63,4	63,4
Loan-to-deposit ratio (%)	129,8	107,9	88,2	80,6	78,6	78,2	77,5	76,8	75,8
Capital adequacy ratio (%)	11,9	14,0	19,2	20,8	20,8	19,8	20,6	20,8	21,0
Performance									
Net interest income (EURm)	886	708	832	746	670	652	668	693	707
Net interest income (%, YoY)	-12,9	-20,1	17,5	-10,4	-10,2	-2,7	2,4	3,7	2,1
Total operating income (EURm)	1.566	1.091	1.231	1.158	1.127	1.075	1.145	1.165	1.189
Total operating income (%, YoY)	8,2	-30,3	12,8	-6,0	-2,6	-4,6	6,5	1,8	2,1
Pre-provision profit (EURm)	823	370	544	472	460	401	489	499	514
Pre-provision profit (%, YoY)	22,8	-55,0	47,0	-13,3	-2,5	-12,8	21,9	2,1	2,9
Provision charges (EURm)	1.599	3.809	650	313	96	-43	-50	24	45
Profitability and efficiency									
Net interest margin (%)	1,9	1,6	2,1	2,0	1,8	1,7	1,7	1,9	1,9
Pre-tax ROAA (%)	-1,6	-8,0	-0,3	0,4	1,0	1,2	1,4	1,2	1,2
Pre-tax ROAE (%)	-20,3	-92,9	-2,7	3,7	8,1	9,5	11,1	9,4	8,9
Cost-to-income ratio (%)	47,4	66,1	55,8	59,3	59,2	62,7	57,3	57,1	56,8
Operating expense (% of assets)	1,6	1,7	1,7	1,8	1,8	1,8	1,7	1,7	1,7
Credit quality and provisioning									
NPL ratio (excl. foreborne, %)	14,4	13,4	11,9	9,9	5,5	3,7	2,5	2,4	2,2
NPL coverage (%)	42,7	56,8	60,8	54,3	57,3	57,3	55,5	56,2	56,5
Provision charges (% of loans)	3,4	8,8	1,6	0,8	0,3	-0,1	-0,1	0,1	0,1
Provision charges (% of PPP)	194,3	1.029,2	119,5	66,4	20,9	-10,6	-10,2	4,7	8,8

Source: BSI, Addiko research

Credit accelerating on strong economic fundamentals

Credit activity continued its steady upward trend, picking-up 2.7% in the year till September, driven by higher lending in the private sector. Retail loans increased 5.3% ytd driven by higher both consumer and housing credit, supported by current economic upswing, improved labour market conditions and persistently low interest rates. Corporate loans displayed moderate recovery with 3.0% ytd growth, while public sector continued de-leveraging at somewhat faster pace (-11.1% ytd). At the same time, deposit growth accelerated 3.1% ytd in September driven by 4.6% higher collection in the retail segment, reflecting traditionally strong savings propensity of Slovenian household, at odds with low interest rates on savings currently offered on the market. Corporate deposits growth eased, recording 0.9% ytd. Regarding profits, NII increased by 6.3% yoy in September with interest income recovering by 3.8% yoy, followed by 9.7% yoy lower funding costs. Together with higher non-interest income and release of loan loss provisions, the banking sector recorded 16.2% yoy growth in pre-tax profit till September, amounting to EUR422m.

Private sector continues driving credit activity

Looking ahead, we keep our 4.2% credit growth forecast for 2018 supported by ongoing lending activity in the private sector, with similar growth pace expected in 2019 as well. Solid investment outlook and export activity bode well for corporate loan demand, while strong retail loans growth should continue given favourable employment conditions and disposable income growth, all together supported by easier and cheaper financing conditions, and relatively low indebtedness. With NPL ratio already significantly improved (6.3%, -2.1pp ytd in September), we expect limited decline potential going forth, mainly on the account of still relatively high NPL ration in the corporate sector (14.6%), while the new lending cycle could increase pressures on credit quality in the medium term. We see deposit collection moderating towards 5.1% in 2019, owing to high base effects and stronger capex needs, in the environment of persistently low interest rates. On profitability, while 2018 will see strong profit increase amid provisions release, 2019 could bring about profit moderation amid new provisioning costs, despite strong NII and contained opex growth.

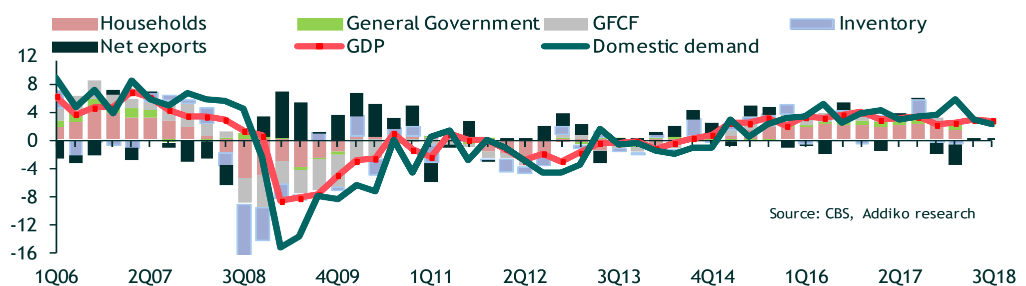
Investment Grade Around the Corner

We keep above-consensus 3.0% GDP growth call for 2019 as private consumption comes to the rescue, investment outlook brightens and fiscal support is building, alleviating external demand drags. The budget remains in balance/small surplus and, importantly, public debt is falling faster than required by the EU rules. We stay positive on Croatian credit on policy coherence and reform appetite under the ERM II 2020 agenda, further debt cuts, lower funding needs, stronger external position and growth potential, lower financial risks upon Agrokor restructure and investment grade prospects.

A steady growth pace has continued

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

Croatia: contributions to GDP (in pp)



We stay above-consensus for 2019, watching downside risks

We keep above-consensus 3.0% GDP growth call for 2019 as private consumption once again comes to the rescue, investment outlook brightens, and fiscal support is building, all of which alleviates potential external demand drags. Fiscal easing importantly involves HRK3bn-alike tax cuts and 6.5% higher public spending, which combined with HRK700m+ parafiscal burden and red tape cuts suggests an 0.5pp attribution to the growth dynamics. Deteriorating economic expectations and further emigration can affect households, but we expect steady disposable income growth, solid job creation, re-leveraging and falling inflation to boost spending. With Agrokor risks fading after the key debt settlement, we see stronger investments on the wings of soaring construction activity, stronger EU funding, corporate re-leveraging and record profits, plus equipment capex in response to competitiveness gains and policy-led optimism. Beyond the record tourist season, diversified goods exports base will partly insulate the economy from external drags. Risks to our baseline are skewed a bit on the downside given the expected euro zone slowdown, financial market volatility, corporate de-leveraging, competition from the Mediterranean tourist destinations, and in the medium term labour shortages given the emigration of the young and population aging. Despite the mainstream HDZ party popularity, the rise of populism in case of the ailing industry rescues, expropriation of banks, etc. makes it difficult to run bolder reforms ahead of elections in 2019-2020. Upside risks involve another tourism overshooting, EU funding, rating upgrades and fiscal easing ahead of 2019-20 elections.

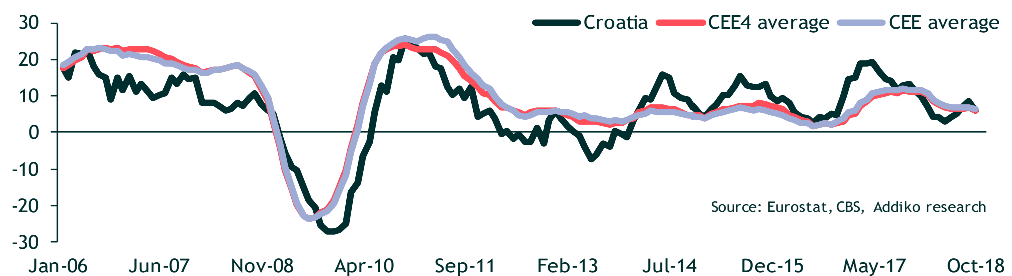
Inflation heading south

While Despite accelerating labour compensation growth, competitive dynamics in retail trade aimed at dethroning Agrokor's retail network, encouraged by VAT cuts on some food prices and other alimentaries, and faltering oil prices will keep headline inflation inside 1-1.5% throughout 2019. Even the revival of underlying imported inflation will be likely more gradual (and drown-out) than previously expected, which may reflect more intense international price competition and some lags in the process of firms responding to higher costs. We also expect higher labour force participation locally and some reform of the labour markets to weigh against the build-up of wage pressures in the medium term. In 2019, we see the average CPI at 1.0% (vs. 1.5% in 2018), with the risks more on the downside from export-related goods prices and lower tourist prices in the event of more severe euro zone slowdown and international competition, respectively.

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

In the light of a decelerating euro zone but still above-trend recovery, and stabilization in domestic industrial output, we still expect solid goods export growth in 2019. The expected rotation from external to domestic demand (incl. investments) across EU, Croatia's export market share gains (resilient to rising labour costs) also provide support to exports. Nevertheless, strong consumer demand as well as private capex, and broader credit recovery lead to stronger imports as well, higher goods trade deficit and C/A surplus moderation. Stably higher services surplus from the tourist industry and stronger EU funding as well as non-resident remittances will on our estimates keep C/A surplus around 2.5% of GDP. External debt slump due to firms' de-leveraging out of record profits and Agrokor-related write-offs, higher banks' net foreign assets and portfolio as well as net FDI and EU capital inflows will likely improve the net international investment position toward -50% of GDP in 2019 vs. -71% in 2016.

Croatia: merchandise exports (s.a. 6mma, %, yoy)



Finding the right pace of monetary accomodation

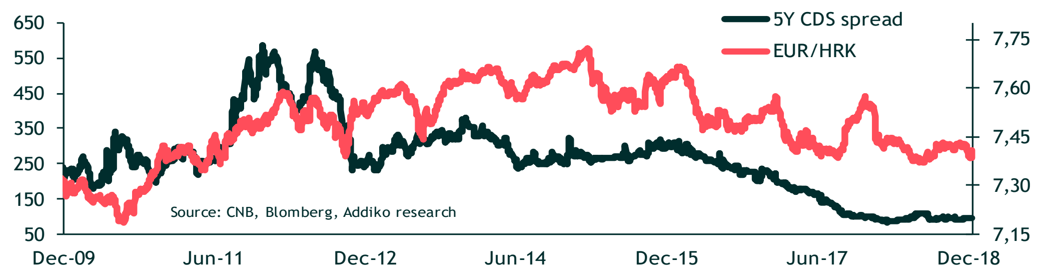
With solid ECB's accommodation even after formal end of QE, we see the CNB in easing mode largely via FX transactions (EUR1.7bn in 2018 vs. EUR0.9bn in 2017), targeting excessive kuna liquidity at 8%+ of GDP. The end of the net-QE buying does not suggest imminent tightening as the ECB delays rate hikes and will reinvest QE holdings at least until end-2020. Ample monetary support via beefed up by the recent HRK1.4bn 5Y REPO close to sovereign debt costs, banks' de-risking and solid macro picture all help stabilize interest rates at new lows and support private-sector re-leveraging. While mandatory reserve cuts fit well into Croatia's ERM II bid, the CNB will in our view add ample liquidity mainly in response to material SME demand as large firms borrow abroad and banks can fund via medium-term MREL-eligible kuna bonds. While citizens' exposure to variable interest rate and FX risks and the systemic vulnerability (solvency, liquidity and snowball effect risks) are reduced visibly, floating loans still dominate and, with the advent of unsecured 10Y retail cash loans, stay under scrutiny. Given the CNB's track record in prudential curbing of excessive credit, stricter standards for debt-to-income and maturity limits are likely in the pipeline but the market impact as ever depends on competition in still high-margin product. Thankfully, there won't be ECB rate hikes until 1H20, and the CNB has ample liquidity arsenal (incl. REPO capacity) to support bank lending even after the ECB starts hiking. Risk-wise, lower external vulnerabilities, fiscal healing and stable kuna allow the CNB's easy stance. As ever, banks need unambiguous rules for NPL resolution, tax incentives, capital hike platforms and firm insolvency mechanism to sustain cost of risk reduction and help monetary transmission.

Appreciation pressures on the kuna halted by CNB

Persistent FX supply overhang on the heels of hefty FC tourist inflows, soaring banks' net foreign assets, stronger EU funding and stable goods import cover triggered the record CNB's EUR495m FX auction in defence of EUR/HRK 7.40 level. Stronger kuna profile is also supported by bank credit de-euroization, fiscal de-risking and significant bank's external debt repayment in the past years. Given the kuna stability, record interbank excess liquidity, short-end rates stayed near record lows. Despite a number of EM challenges driven by tighter US financing conditions and global trade woes, CEE assets have been largely isolated as the region stands out with lower external/fiscal vulnerability and flexible monetary space, which leaves CEE in better shape to withstand material changes in financial conditions. Croatian bonds outperformed as S&P joined Fitch in its rating outlook upgrade to positive (last step before investment grade) on rosier fiscal/external position outlook as well as ERM II bid prospects.

Despite depreciation influences from the worsening goods trade dynamics in the near term, we see the EUR/HRK lower ahead and within 7.25-7.45 in 1H19. For starters, slightly stronger kuna counts in closely-watched year-end public debt metrics as Croatia prepares to launch ERM II bid (2Q19). Appreciation may last on persistent tourist-related and other exporters' FX supply, much lower banks' FX sales in the market, EU funding, steady C/A surplus and foreign inflow upon rating upgrade(s) and almost simultaneous ERM II application. New Eurobond prospects (1Q19) may though revive institutional bid as local pension funds traditionally participate in foreign issuances. Ahead of ERM II entry, appreciation pressures may more often run into bids from the CNB due to its competitiveness considerations given that exports of goods and services (49% of GDP in 2018) surpass corporate FC and FX-linked debt, and improving goods import cover serves to justify the CNB's FX stance.

Croatia: 5Y CDS spreads and EUR/HRK



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

With the CNB's ultra-easy stance in place, still gradual bank lending recovery and steady kuna, we see short-end rates close to record low. Despite higher kuna disbursements, new volumes overall still won't likely have a material impact on MM rates. In a challenging EM environment, i.e. tighter US funding conditions (incl. corporate spreads) and EM outflows, investors may close some CESEE bond positions into year-end and also take profit in Croatian bonds. While in 1Q19 Croatia will see a temporary spike in supply (~EUR2.7bn), the country's funding needs are lower in 2019 (net of a huge FC T-bill redemption in February) and fall sharply thereafter. With also Italy-EU fiscal issues on more constructive footing, China stimulus offsetting the drag from US tariffs, and investors scaling back expectations for Fed hikes, we think the major risks can be avoided. Once the USD and US yields ease in the eve of the Fed's tightening cycle (2H19) alongside dovish ECB in support of risk assets, we'd return to Croatian debt again. Namely, we like policy coherence and reform appetite under the ERM II 2020 agenda, further debt cuts, lower funding needs, stronger external position and growth potential, lower financial risks upon Agrokor restructure and investment grade prospects. In our baseline CEE spreads continue to decouple from EMBI. The major risks to our constructive baseline include the global financial markets volatility, renewed Italian fiscal jitters and liquidity events (e.g. VIX spike).

Positive fiscal news flow continues...

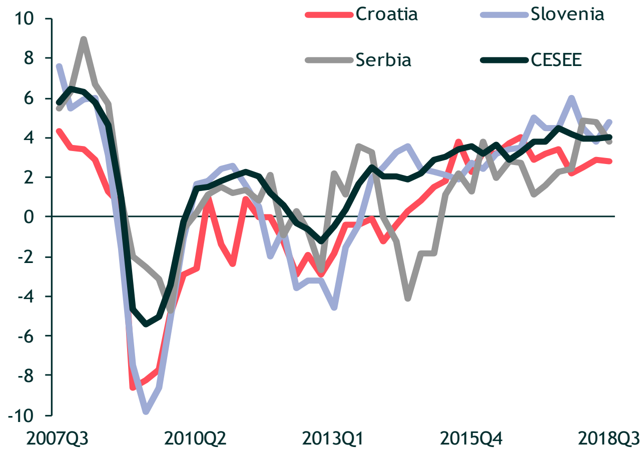
After the first-ever fiscal surplus in 2017, we expected the MinFin will see even higher surplus in 2018 driven by VAT, social contributions and spending restraint. However, what seemed a tail risk earlier this year, materialized with the activation of guarantees for Uljanik shipyard (HRK4.2bn/1.1% of GDP, o/w HRK2.5bn paid in 2018), leaving the general budget 'only' close to balance in ESA 2010 terms. This is better than -0.5% deficit target and marks the third year of strong fiscal over performance. While current spending accelerates at 5.5% yoy in 2019, another round of ~HRK3bn tax cuts attempts to cap tax growth at 1.5% yoy, and contributions are seen lower, we expect net EU inflow (~3% of GDP) and 'policy' of tax revenue underestimation to do the magic. While the election cycle 2019-2020, stronger demographic spending and the lack of material reforms pose the main risks on the expenditure side, these are offset by stronger tax-rich local demand growth and firmer commitment to spending rules (ahead of ERM II) under a new Fiscal Responsibility Act. That said, Croatia has already had more success in public wages and pension containment in contrast to many CESEE peers. We are, hence, comfortable with the small budget surplus in 2019, alongside small widening of the structural deficit around 0.5% of GDP. Since the MinFin eyes a 1pp cut in general VAT rate in 2020, it would be prudent to peg new tax cuts to non-discretionary spending cuts. With healthy 4.5%-alike nominal GDP growth, stable primary surplus (2% of GDP) and lower risk premium, we see public debt below 70% of GDP in 2019 and 67% in 2020, falling 2-3x stronger than asked by the Maastricht 1/20th rule.

... stronger expectations management needed

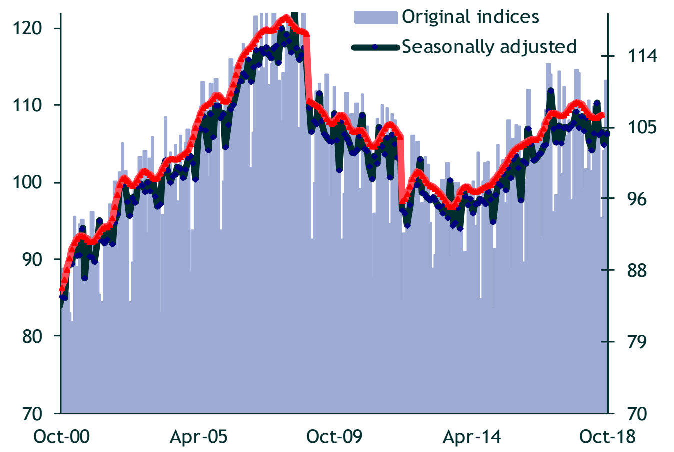
Given the growing pressure on non-discretionary spending (wages, transfers), imperatives to cut above-EU-average tax burden further and interest rate normalization in the medium term, we deem fiscal sustainability dependent on public administration and entitlement reforms. The last proposal to align the wage system with job complexity and performance in our view boosts the cabinet's leverage in future collective bargaining, durable public wage containment and holistic public sector reforms. Stricter penalization of early retirement, pension age hike to 67, abolition of accelerated plans and inflation-based pension indexation are steps in the right direction, but the actual reforms do little to strengthen private pension plans. By allowing pension transfers from the second pillar (capitalized savings) to the first pay-as-you-go pillar, the cabinet revives fanciful expectations from the first pillar and raise political and intra-generational conflicts (the latter encouraging emigration). That said, spending containment has to be accompanied by convincing growth-enhancing reforms: flexible labour, product and service markets, parafiscal fees' and red tape cuts, partial substitution of labour duties with real estate taxes, and strengthening the funding channel with incentives for NPL workouts, equity capital raising and faster insolvency models. Lastly, better sovereign asset-liability management does not only pertain to financial restructuring and privatization, but also SOEs' operating restructuring on industry standards, with stronger profits and cost flexibility crucial in the state guarantee-free capex financing. The final aim should be a 3-4%/GDP primary surplus as Croatia pays ~1pp/GDP for interest costs above CEE average, wants to anchor risk premium lower and ensure durable public debt reduction to 60% of GDP by 2023, i.e. targeted euro zone entry.

Croatia's data trends

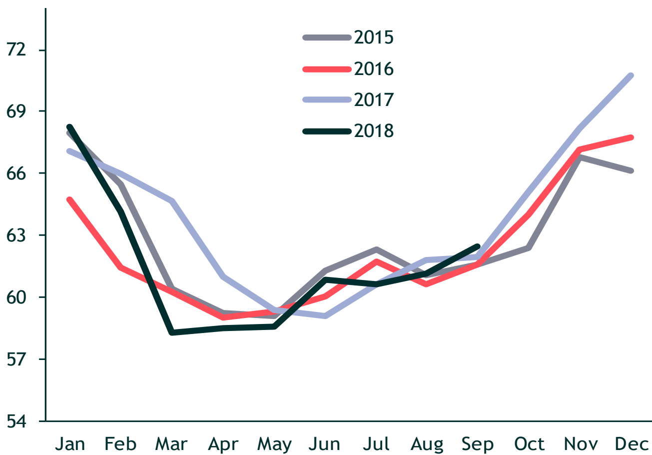
CRO growth in line with CESEE



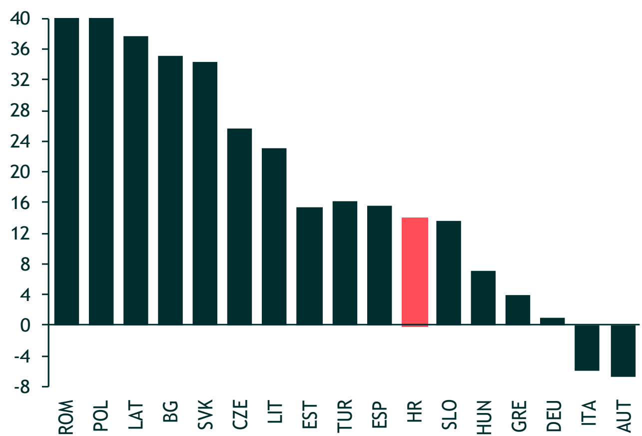
Industrial production, 2015=100



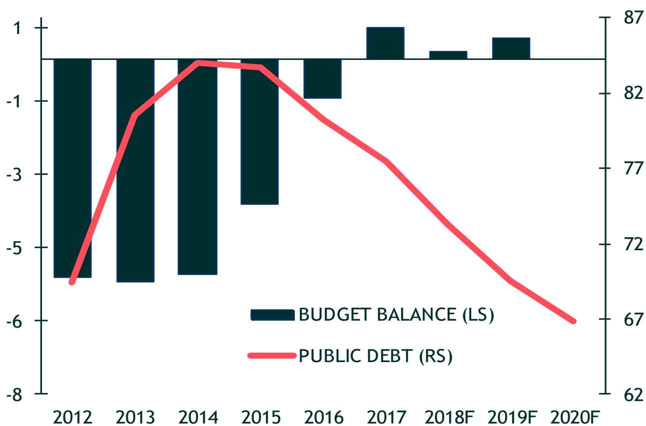
Merchandise trade import cover on 3mma basis



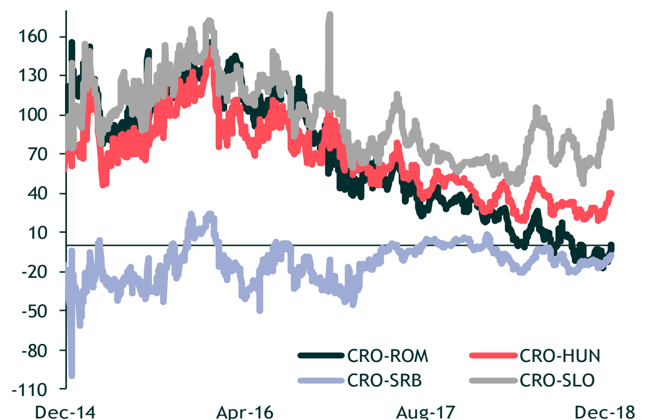
Change in export shares vs. EU countries, 2018-2008,(%)



Budget balance and public debt (%/GDP)



Spread on CRO USDs vs. peers (bp)



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

SELECTED ECONOMIC FORECASTS

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Activity									
Nominal GDP (HRKbn, current prices)	330,8	331,8	331,6	339,6	351,3	365,6	383,3	399,7	418,8
Nominal GDP (EURbn)	44,0	43,8	43,5	44,6	46,7	49,0	51,7	54,3	57,0
Nominal GDP (USDbn)	56,5	58,1	57,7	49,5	51,6	55,2	61,1	63,0	69,2
GDP per capita (EUR)	10.311	10.293	10.254	10.616	11.180	11.882	12.640	13.335	14.068
GDP per capita (USD)	13.233	13.663	13.617	11.772	12.372	13.385	14.938	15.469	17.092
Real GDP (constant prices YoY, %)	-2,3	-0,1	-0,1	2,3	3,5	2,9	3,0	3,0	2,8
Private consumption (YoY, %)	-3,0	-1,9	-1,6	1,0	3,4	3,6	3,4	3,0	2,8
Fixed investment (YoY, %)	-3,3	1,4	-2,8	3,8	6,5	3,8	4,3	6,5	6,0
Industrial production (YoY, %)	-5,5	-1,7	1,4	2,5	5,1	1,9	-0,4	2,2	2,6
Unemployment rate (ILO, average %)	15,9	17,3	17,3	16,3	13,1	11,2	9,0	8,0	7,5
Prices									
CPI inflation (average % YoY)	3,4	2,2	-0,2	-0,5	-1,1	1,1	1,5	1,0	1,6
CPI inflation (end-year % YoY)	4,7	0,3	-0,5	-0,6	0,2	1,2	1,2	1,1	1,7
PPI inflation (average % YoY)	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,2	2,1	2,3
Net wage rates (% YoY, nom., €)	-0,4	-0,1	-0,4	1,5	2,9	5,0	5,5	4,1	2,8
Fiscal balance (% of GDP)									
State budget balance	-5,2	-5,3	-5,1	-3,4	-0,9	0,8	0,2	0,5	0,0
Public debt	69,4	80,5	84,0	83,7	80,2	77,5	73,3	69,5	66,9
Gross public funding needs	17,8	24,8	18,2	19,9	16,3	20,1	14,2	15,0	14,5
External balance									
Export of goods and services (EURbn)	18,319	18,768	19,677	21,473	22,784	25,124	27,018	28,508	29,628
Import of goods and services (EURbn)	18,125	18,599	18,852	20,442	21,457	24,059	26,090	27,936	29,292
Merchandise trade balance (EURbn)	-6,296	-6,587	-6,512	-6,974	-7,385	-8,254	-9,087	-10,017	-10,812
Merchandise trade balance (% of GDP)	-14,3	-15,0	-15,0	-15,6	-15,8	-16,8	-17,6	-18,5	-19,0
Tourism receipts (EURbn)	6,859	7,203	7,402	7,962	8,635	9,493	10,273	10,842	11,222
Current account balance (EURbn)	-0,050	0,414	0,858	2,018	1,206	1,963	1,525	1,298	1,153
Current account balance (% of GDP)	-0,1	0,9	2,0	4,5	2,6	4,0	2,9	2,4	2,0
Net FDI (EURbn)	1,2	0,8	0,7	0,2	1,9	1,2	1,8	1,9	2,0
FDI (% of GDP)	2,8	1,9	1,6	0,5	4,1	2,4	3,4	3,5	3,4
FDI cover (%)	2.469,6	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	11,236	12,908	12,688	13,707	13,514	15,706	17,156	18,689	19,248
Import cover (months of imports)	7,4	8,3	8,1	8,0	7,6	7,8	7,9	8,0	7,9
Debt indicators									
Gross external debt (EURbn)	45,297	45,803	46,416	45,384	41,668	40,069	38,306	38,625	39,853
Government (EURbn)	12,705	14,647	15,841	18,049	16,253	16,327	15,489	15,261	15,500
Private (EURbn)	32,592	31,157	30,575	27,335	25,415	23,742	22,817	23,364	24,353
Gross external debt (% of GDP)	102,9	104,6	106,8	101,7	89,3	81,8	74,1	71,2	69,9
Gross external debt (% of exports)	247,3	244,1	235,9	211,4	182,9	159,5	141,8	135,5	134,5
Exchange rates and money growth									
USD/HRK (end-year)	5,47	5,55	6,30	6,99	7,17	6,27	6,65	6,17	5,90
USD/HRK (average)	5,85	5,71	5,75	6,86	6,80	6,62	6,27	6,35	6,05
EUR/HRK (end-year)	7,55	7,64	7,66	7,64	7,56	7,51	7,45	7,40	7,38
EUR/HRK (average)	7,52	7,57	7,63	7,61	7,53	7,46	7,41	7,36	7,35
Money supply M1 (% YoY)	0,9	11,5	9,6	11,4	18,2	19,1	20,4	15,3	11,6
Broad money M4 (% YoY)	3,6	4,0	3,2	5,2	4,7	2,1	4,8	3,9	3,7
Domestic credit (% YoY, euros)	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	2,5	3,3	4,1
ZIBOR 3M interest rate (average %)	3,55	1,54	0,99	1,27	0,90	0,65	0,44	0,30	0,40
HRK 1Y yield (average %)	3,93	2,54	1,86	1,50	0,96	0,43	0,12	0,05	0,40
HRK 10Y yield (average %)	6,26	4,30	4,00	4,09	3,60	2,75	2,15	2,09	2,39

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

SELECTED BANKING SECTOR DATA

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Balance sheet									
Assets (EURm)	54.395	54.338	54.719	54.536	54.689	54.416	55.372	56.764	58.921
Assets (%, YoY)	-1,7	-0,1	0,7	-0,3	0,3	-0,5	1,8	2,5	3,8
Assets (% of GDP)	123,6	124,0	125,9	122,2	117,2	111,0	107,1	104,6	103,4
Gross loans (EURm)	37.678	37.543	36.561	35.941	34.125	32.706	33.536	34.638	36.073
Gross loans (%, YoY)	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	2,5	3,3	4,1
Gross loans (% of GDP)	85,6	85,7	84,1	80,5	73,1	66,7	64,8	63,8	63,3
Deposits (EURm)	30.087	30.959	31.874	33.660	35.237	36.355	38.186	40.211	42.145
Deposits (%, YoY)	2,7	2,9	3,0	5,6	4,7	3,2	5,0	5,3	4,8
Deposits (% of GDP)	68,4	70,7	73,3	75,4	75,5	74,2	73,8	74,1	74,0
Loan-to-deposit ratio (%)	125,2	121,3	114,7	106,8	96,8	90,0	87,8	86,1	85,6
Capital adequacy ratio (%)	20,9	21,0	21,8	20,9	23,0	23,8	22,4	22,4	21,3
Performance									
Net interest income (EURm)	1.449	1.360	1.366	1.401	1.457	1.477	1.440	1.521	1.502
Net interest income (%, YoY)	-5,9	-6,2	0,5	2,5	4,0	1,4	-2,5	5,7	-1,2
Total operating income (EURm)	2.015	1.923	1.922	1.904	2.150	2.134	2.109	2.211	2.214
Total operating income (%, YoY)	-10,4	-4,5	0,0	-1,0	12,9	-0,7	-1,2	4,8	0,1
Pre-provision profit (EURm)	972	920	934	915	1.178	1.134	1.095	1.169	1.137
Pre-provision profit (%, YoY)	-13,7	-5,4	1,6	-2,0	28,7	-3,8	-3,4	6,8	-2,8
Provision charges (EURm)	501	780	645	1.529	380	574	298	273	354
Profitability and efficiency									
Net interest margin (%)	2,6	2,5	2,5	2,6	2,7	2,7	2,7	2,6	2,6
Pre-tax ROAA (%)	0,9	0,3	0,5	-1,1	1,5	1,0	1,5	1,6	1,4
Pre-tax ROAE (%)	6,2	1,9	3,9	-8,7	11,4	7,3	10,0	11,0	9,6
Cost-to-income ratio (%)	51,7	52,2	51,4	51,9	45,2	46,9	48,1	47,1	48,7
Operating expense (% of assets)	1,9	1,8	1,8	1,8	1,8	1,8	1,8	1,9	1,9
Credit quality and provisioning									
NPL ratio (%)	13,9	15,7	17,1	16,7	13,8	11,4	10,1	9,4	8,9
NPL coverage (%)	42,6	46,2	51,3	56,9	63,7	61,5	60,3	61,1	62,3
Provision charges (% of loans)	1,3	2,1	1,7	4,2	1,1	1,7	0,9	0,8	1,0
Provision charges (% of PPP)	51,5	84,8	69,0	167,0	32,2	50,6	27,2	23,3	31,1

Source: CNB, Addiko research

End of de-leveraging

Credit activity remained in recovery mode with 2.8% ytd growth in October driven by increased borrowing of the private sector, while public sector continued de-leveraging, albeit at a much slower pace compared to previous years. The strongest positive contribution to credit growth came from 5.0% ytd higher retail lending, predominantly driven by increased demand for cash non-purpose loans in the context of positive labour market developments and strong consumer sentiment, additionally supported by low interest rates and strong bank competition. Corporate credit displayed 1.9% ytd growth, leveraging on higher firms' profits and easier credit standards, particularly in the SME segment. At the same time deposits recorded 6.5% ytd growth owing to strong collection in the retail segment (4.9% ytd), followed by increased contribution from corporate clients (6.2% ytd). Regarding profits, NII decreased 4.1% yoy in 9M18, since lower funding costs (-28.7% yoy) proved insufficient to compensate for interest income fall (-10.4% yoy). Nonetheless, pre-tax profit recorded 96.5% yoy growth, boosted by release of loan loss provisions.

Private sector driving credit activity acceleration

Looking ahead we keep our 2018 credit growth forecast at 2.5%, while in 2019 we see credit activity accelerating towards 3.3%. Our viewpoint remains supported by solid economic prospects and investment growth, alongside stronger labour market and private consumption outlook. Meantime, prolonged loose monetary conditions and high competition among banks will keep interest rates at low level. We expect further cleaning of bank portfolios to bring NPL ratio below the 10% mark in 2019 (vs. 10.3% in 9M18), with potentially negative impact on overall credit stock, but more importantly creating space for new lending activity. Notwithstanding low interest rate environment, we see deposit growth around 5.0% in 2018 with slight acceleration towards 5.3% in 2019, on the back of ongoing economic recovery, improved labour market outlook and strong wage growth, additionally supported by high tourism and remittances inflows. While 2018 profits were influenced by lower impairment costs, next year we expect more moderate profit increase supported by new lending cycle, though strong bank competition will keep margins under pressure.

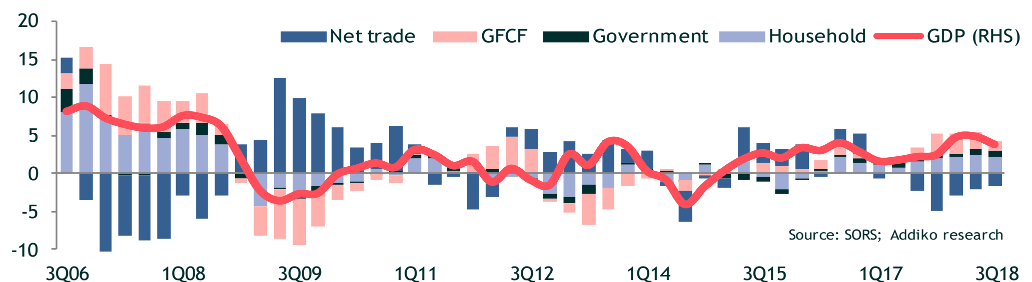
Goldilocks Economy, with no Hikes Ahead

We expect Serbian economy to manifest the strongest GDP growth in 2019, supported by robust domestic demand, further export market share gains, fiscal easing and favourable financing conditions. While 2019 will see a balanced budget on public capex growth and entitlement spending, we expect public debt contraction towards 50% of GDP due to strong nominal growth, primary surplus, cheaper debt service and strong dinar. We expect NBS to stay on hold for a longer in the absence of recovery in core inflation, despite robust GDP growth and tighter labour market. Long-term dinar yields have a little downside potential thanks to stronger growth prospects, fiscal discipline and lower funding needs, new IMF policy anchor and improved sovereign rating-relevant metrics.

Domestic demand set the tune

The Q3 GDP growth (3.7% yoy) came in a bit slower than expected, but still driven by domestic demand, i.e. accelerating private consumption and somewhat stronger investment growth. The main driver of the slowdown was the weaker performance of industrial output (-1.2% yoy) due to renewed energy output outages and operating problems in mining. As before, household consumption is driven by accelerating wage, remittances and re-leveraging dynamics on top of steady private job creation (4%+ yoy). Investments gathered pace on the back of resurgent FDIs, soaring public capex, hefty firms' profits and re-leveraging. Despite accelerating 8%-alike (yoy) export growth, net trade contributed negatively amid mounting import pressures (a flip side of soaring demand). While foreign demand poses downside risks, we expect strong investment, steady consumption and new export capacity to keep GDP growth around 4% yoy in Q4 and likely thereafter. On the back of stronger-than-expected 1H18, stronger investments and agriculture output, we keep 2018 GDP forecast at 4.5%, just above the CESEE average.

Serbia: contributions to GDP (pp, %)



Growth remains in high gear in 2019

We maintain 2019 growth forecast at 4.0% on vibrant domestic demand, export market share gains, fiscal easing and ample funding conditions. Despite external concerns, investment is one of the key drivers on manufacturing FDI, state-sponsored EUR2.5bn railway/road construction and energy infrastructure projects, real estate development, high firms' profits, cheap funding and corporate tax cuts in 2019. The business climate perception is also flashing green in the WEF's competitiveness survey for 2018 as Serbia improved the most of all SEE countries (from 70th to 65th place) due to strong FDI, strong bad loan resolution and more accessible SME funding. Its doing business gauges are well above 'BB' peers' median and slightly above 'BBB' median. Stronger private consumption growth has legs on faster disposable income gains on higher wages and pensions, soaring remittances, employment gains and re-leveraging. Strong export growth is set to continue, helped by hefty capacity expansion in tradable sectors and agriculture, which despite strong import demand will see less negative net trade contribution compared to 2018. More meaningful fiscal stimulus, tax cuts, ever stronger FDIs, SOE restructuring and privatization projects, alongside progress on the EU 2025 entry agenda and infrastructure capex pose upside risks. Downside risks stem from the EU demand, public capex under-execution, negative EM sentiment and harsher-than-expected NBS' monetary tightening.

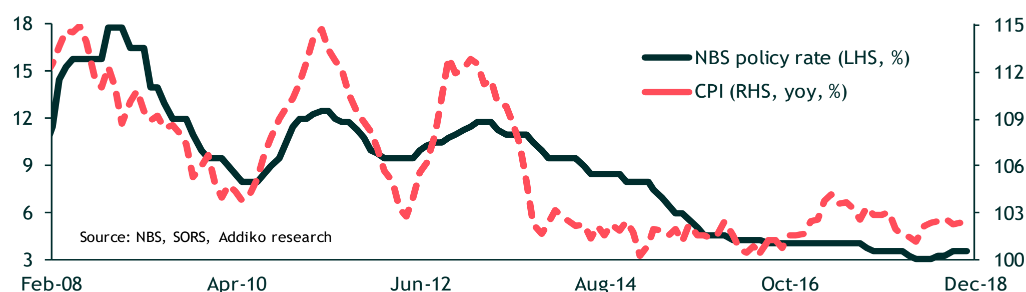
Inflation stays subdued

Headline inflation remained low and stable due to subdued import prices (partly due to oil price slump) and lower cost of food processing. Despite strengthening demand-pull factors, inflation pressures appear low, with core inflation a way below the 3.5%+/-1.5pp NBS' target band, and inflation expectations well anchored over the next two years. Sharply lower oil prices, subdued food prices and substantial base effects alongside stable dinar will keep inflation below 2% by the next spring, while stronger domestic demand supported by expansionary fiscal backdrop will help CPI approach 2.5% yoy by year-end. Upside risks to inflation mainly arise from stronger-than-expected administered price hikes and ongoing tightness of the labour markets (including strong disposable income growth), while the steady dinar development and a regular agricultural season act on the downside. We again expect the average CPI around 2% in the absence of significant food prices supply-side shocks.

External position continues to improve

With the ongoing if slowing upswing in the euro zone, Serbian competitiveness and export market share gains, hefty export capacity build-up, and in particular robust agriculture and IT exports, we see exports growth in high single-digits in 2019-2020. Despite simultaneously stronger capex-related and consumer goods imports, we expect stronger export momentum, record remittances and other (EU) transfers to lower C/A deficit toward 4% of GDP by end-2020. Meanwhile, strong industrial capacity additions, privatizations projects (copper smelter RTB Bor, few state banks), foreign retailers' expansion, other real estate projects and higher non-resident banks' profit are driving FDI close to 6.5% of GDP. FDI over financing and the state external de-leveraging (above private sector re-leveraging) support improvement in the net international investment position. Higher FDI in tradable sectors will help boost exports (to CEE-alike 75-80% of GDP in five years, in our view) and lower C/A deficit toward 1-2% of GDP in the medium term.

Serbia: CPI inflation and NBS policy rate



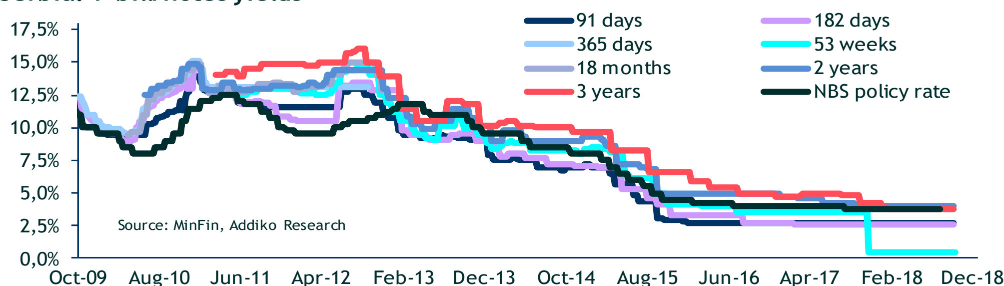
NBS: auto pilot with a slight dovish bias

Soft and stable inflation outlook, uncertain global backdrop (Fed/ECB policies, global trade and oil outlook, EM risks) and fading RSD appreciation pressures left the NBS on hold. While gradual reflation story stays intact, the NBS maintains its dovish communication, highlighting that core inflation remains weak and has again lowered 2019 inflation forecast due to the cheaper oil assumption and lower food price outlook. While expectations are well -anchored, the NBS in our view looks inclined to stay on hold for a long time as long as there is no significant recovery in core inflation despite robust GDP growth and tightening labour markets. Given also intensified ECB's forward guidance (pushing out expectations of the first rate hike further ahead again), cautious Fed tightening, we expect the ECB policy will be a more important driver for the NBS to start hiking only in 1H20 in sync or slightly later than the ECB. Risk-wise, fiscal de-risking, lower public/private external imbalances and stable inflation/FX outlook allow the NBS take time in their easy stance. As the current economic expansion is not much credit-driven, we expect the NBS to delay rate hikes as much as they can into 2020 and shy away from any hasty tightening once they kick-off. Our baseline won't work if the Fed/ECB hike faster/sooner to curb inflation, and EM spreads need to widen from almost historical lows to halt capital outflows. Conversely, protracted ECB dovishness (due to deteriorating growth and inflation outlook) with a later and slower pace of rate hikes may allow the NBS cut(s).

Dinar stays stable ahead

A temporary bout of EUR/RSD upward volatility owed to non-resident financial agents' dividend payments, lower capital inflows in local T-bills amid non-existent debt supply and EM wobbles. The dinar weakness was partly idiosyncratic and related to the market talk of the NBS' (capital-intensive) measures designed to arrest interest rate and FX risks longer maturity loans. At the time the market positioned for much lower FX-linked lending ahead that would effectively remove one of the sources of the RSD strength, only to backtrack recently after rumours that the NBS won't play that much retroactive. Despite broader EM risk-off, Serbian risk has remained stably lower, as S&P lifted 'BB' rating outlook to positive, and investors honour improving macro/fiscal story and narrowing external imbalances. While EM local rates are most directly affected by global financial market volatility, long-term dinar yields fell in the absence of local debt supply, as investors also appreciate prospects for EM indices' inclusion.

While C/A gap is still widening in the near term, we expect FDI over financing (including hefty privatization receipts), improving goods import cover and soaring remittances to stabilize the dinar the current non-friendly global environment for EM FX vanishes in early 2019 and RSD re-connects with capital inflows. We have though difficulty seeing any stronger pace of the RSD appreciation because: (i) market participants are unwilling to commit to high conviction RSD longs as FX-linked loan disbursement will decline, (ii) ongoing real appreciation stemming from wages growth and reflation, and (iii) tricky EM environment even in 1H19 due to persistent trade war overhang in markets and stronger USD. As more efficient two-way FX management has reduced RSD sensitivity to regional FX risk-off episodes, this suggests range-bound trading inside 117-119 interval through 1H19. Our constructive RSD outlook in the medium term is driven by GDP growth re-pricing, fiscal de-risking, strong FDI and export growth in support of C/A rebalancing, appetite for Serbian assets upon rating upgrades and EM indices' inclusion.



Serbian rates face further downside potential on macro over performance and fiscal de-risking

Given the NBS' accommodativeness and low inflation, we see short-end rates close to record lows, despite accelerated banks' RSD lending. Following RSD20bn T-bill buy-backs and USD1bn bond redemption in Q4 out of persistent budget surplus and strong cash reserve, we expect the MinFin to opportunistically issue mainly 5Y/10Y RSD bonds in 2019 as the budget situation ahead does not require immediate issuance. In 2018, Serbia predominantly sold long-term bonds in excess of 4% of GDP (vs. just 0.7% in 2017) as part of efforts to boost the RSD share in public debt, which increased to about 30% after USD bond redemption. Given the ongoing fiscal discipline and lower debt amortization/debt supply next year, improved sovereign rating-relevant metrics, long-term dinar yields have a little further downside potential later in the year. Namely, in EM credit, we expect a Janus-faced environment in that EM turmoil continues in 1H19 without meaningful policy response to global risk deterioration, followed by some relief in 2H19 as the USD weakens and US yields come off cyclical highs towards the end of the Fed’s tightening cycle. That said, Serbian yields may first suffer against still-very-high public debt FX exposure (USD!) and net external debt as well as low FX reserves compared to 'BB' peers. Thereafter, once EM spillover and volatility end, and the weaker USD revives carry in Serbian bonds, we see stronger interest for Serbian assets set against stronger growth/trade potential, fiscal de-risking, new IMF policy anchor, stronger sovereign rating outlook and the prospects of EM indices’’ inclusion in 2019.

Fiscal healing continues...

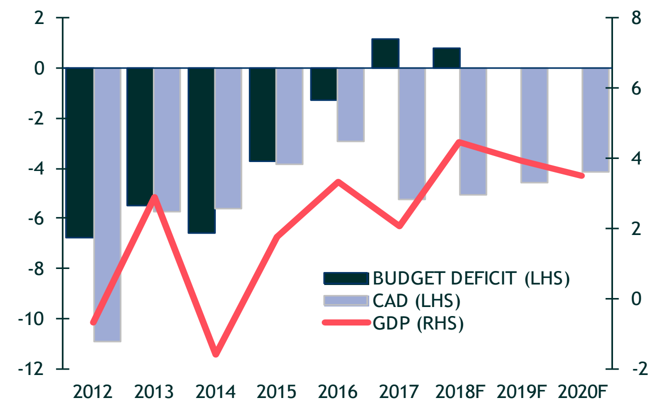
In 2018, Serbia likely eked another budgetary surplus around 0.8% of GDP (vs the planned -0.5% FY18 deficit) thanks to strong broad-based tax revenue growth (~5.5% yoy) driven by tax-rich domestic demand, stronger tax compliance and one-off non-tax revenues. Expenditures rose 9% yoy on soaring infrastructure capex, and public wage and pension hikes, partly offset by interest bill and guarantee cuts. While similarly stronger domestic demand in 2019 will likely ensure another 6%-alike tax growth (and 7% higher VAT intake), and interest rate bill drops -12.5% yoy, we still expect the budget to return to a balance in 2019 on steady public capex growth, steep wages (+9% yoy) and pension hikes, 13% higher guarantees and 1pp employers' unemployment contributions cut. From a competitiveness point of view, it would have been smarter if labour tax cuts were stronger and public wage hikes milder. Also, better-than-targeted fiscal result is not accompanied by bolder reforms (notably when it concerns SOEs, despite intensified privatization deals) and instead encouraged entitlement spending. This may ultimately affect GDP growth and reduce fiscal space in the medium term as the cycle slows. In our view, the 2019 budget plan looks reasonable given strong GDP growth, accommodative funding and the pro-growth effects of the overall economic policy. All said, public debt stays on a declining path toward 50% of GDP by end-2019 thanks to strong nominal growth, solid primary surplus (~2.5% of GDP), cheaper debt service and firmer dinar. With the state debt toward 'BB' median in the medium term alongside contained external imbalances, we expect rating firms to upgrade Serbia ahead of more synchronized global/domestic policy normalization.

... as improved reform outlook supports structural adjustment

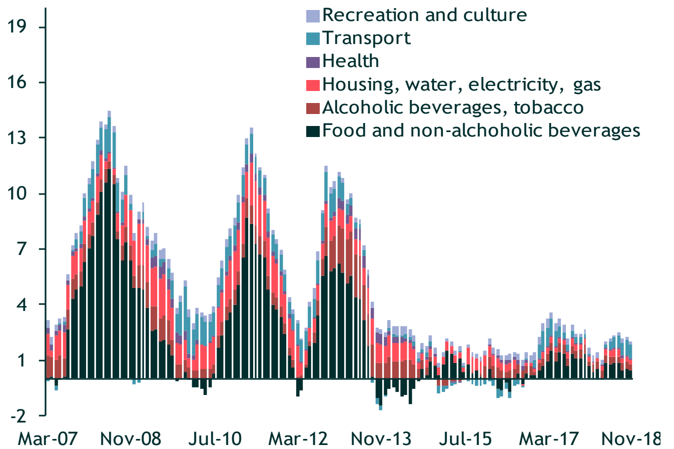
The key signposts to watch ahead involve implementation of long-overdue reforms of the tax and public administration, SOE restructuring and containment of spending which becomes unsustainable in case of the global monetary tightening and/or cyclical slowdown. The key fiscal risks are contingent liabilities from SOEs (~4% of GDP), whereby privatization projects pave the way for durable risk reduction. These and other structural reforms, including public wage setting models, better-targeted entitlement outlays, labour market and a competitiveness package (tax and parafiscal fee cuts, more-productive capex) are in the focus of the IMF program, albeit for most reforms the time horizon is vague. The main goal in any case is more efficient deployment of ~1pp/GDP fiscal space on way to a medium-term balanced budget after frontloaded fiscal consolidation in the past years. Much-debated utility (electricity, gas) price hikes to prop up funding of badly-needed energy infrastructure modernization will initially lift energy prices, but energy capacity expansion is a must for sustained FDI inflow. After the current GDP growth and entitlement spending hump, Serbia needs to stick to the pro-reformist agenda, smart industrialization (FDI) strategy and complementarities of competitiveness reforms. Alongside red tape and non-wage cost cuts, and higher non-taxable income thresholds for private sector jobs, Serbia needs to follow with corporate income tax credit for innovative capex and pro-digitalization policies in order to move up the value chain and accelerate productivity gains.

Serbia's data trends

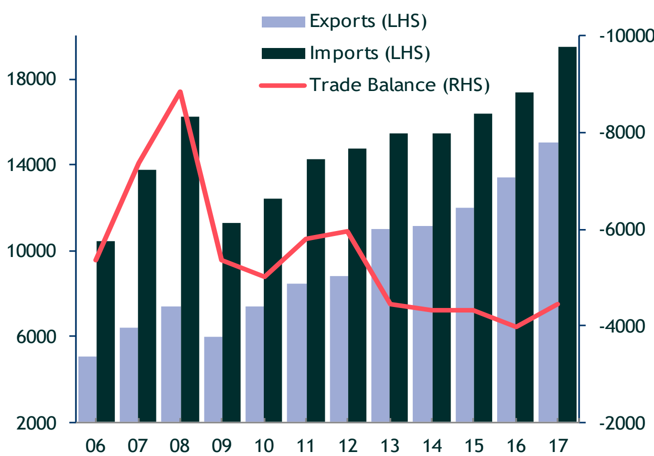
Budget and C/A gaps (% of GDP) vs. GDP growth (%)



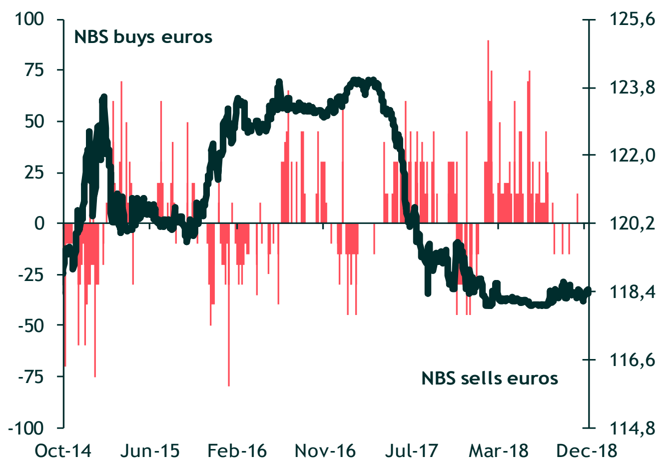
CPI contribution - key categories (pp)



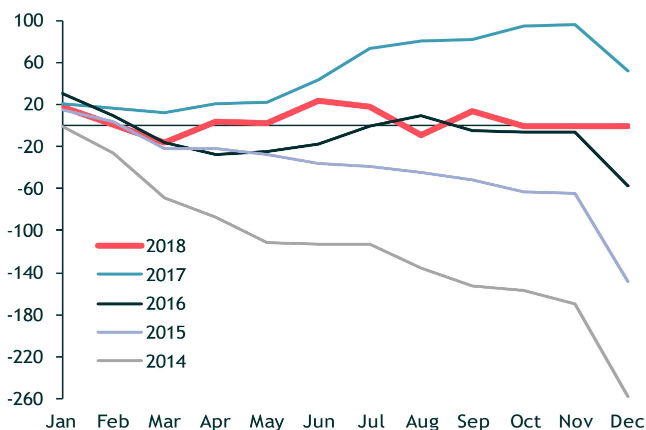
Trade balance (EURbn)



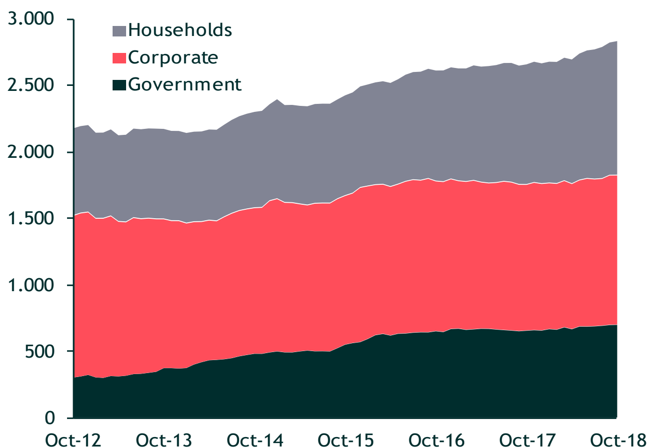
NBS activity on the market



Consolidated government budget balance (RSDbn)



Credit distribution by sector (RSDbn)



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

SELECTED ECONOMIC FORECASTS

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Activity									
Nominal GDP (RSDbn,current prices)	3.810	4.121	4.161	4.312	4.521	4.754	5.067	5.382	5.722
Nominal GDP (EURbn)	33,7	36,4	35,5	35,7	36,7	39,2	42,8	45,7	48,8
Nominal GDP (USDbn)	43,2	48,4	47,0	39,6	40,7	44,2	50,6	53,0	59,3
GDP per capita (EUR)	4.401	4.783	4.963	5.034	5.187	5.566	6.085	6.489	6.935
GDP per capita (USD)	5.650	6.353	6.575	5.582	5.744	6.284	7.192	7.442	8.331
Real GDP (constant prices YoY, %)	-0,7	2,9	-1,6	1,8	3,3	2,0	4,5	4,0	3,5
Private consumption (YoY, %)	-2,1	-0,4	1,7	-2,6	1,3	2,0	3,3	3,6	3,5
Fixed investment (YoY, %)	13,9	-12,0	-3,4	4,9	5,4	7,3	11,6	12,4	7,2
Industrial production (YoY, %)	-2,2	5,4	-6,4	8,4	4,7	3,5	5,3	5,5	5,3
Unemployment rate (ILO, average %)	23,9	22,1	19,2	17,7	15,3	13,5	12,5	11,5	10,6
Prices									
CPI inflation (average % YoY)	7,8	7,8	2,1	1,4	1,1	3,1	2,0	2,0	2,7
CPI inflation (end-year % YoY)	12,2	2,2	1,7	1,5	1,6	3,0	1,8	2,5	2,6
PPI inflation (average % YoY)	5,6	3,6	0,7	0,2	-0,4	3,0	2,3	3,0	2,9
Net wage rates (% YoY, nominal, euros)	-1,8	-1,8	-4,3	-3,3	1,8	3,5	7,9	6,0	4,0
Fiscal balance (% of GDP)									
State budget balance	-6,8	-5,5	-6,6	-3,7	-1,3	1,2	0,8	0,0	0,0
Public debt	56,2	59,6	70,4	74,7	71,9	61,6	54,7	50,7	48,2
Gross public funding needs	14,9	15,5	16,9	15,9	13,2	8,2	11,5	9,1	9,2
External balance									
Export of goods and services (EURbn)	11,469	13,937	14,451	17,467	17,385	19,312	21,505	23,419	24,871
Import of goods and services (EURbn)	16,992	17,782	18,096	20,704	19,597	22,343	25,374	27,515	29,165
Merchandise trade balance (EURbn)	-5,634	-4,159	-4,111	-4,052	-3,119	-3,997	-4,975	-5,543	-6,008
Merchandise trade balance (% of GDP)	-16,7	-11,4	-11,6	-11,3	-8,5	-10,2	-11,6	-12,1	-12,3
Remittances, net (EURbn)	1,989	2,217	1,931	2,390	1,953	2,151	2,689	2,904	3,049
Current account balance (EURbn)	-3,671	-2,098	-1,985	-1,369	-1,075	-2,051	-2,167	-2,102	-2,016
Current account balance (% of GDP)	-10,9	-5,8	-5,6	-3,8	-2,9	-5,2	-5,1	-4,6	-4,1
Net FDI (EURbn)	0,8	1,3	1,2	2,0	1,9	2,4	2,7	2,9	3,2
FDI (% of GDP)	2,2	3,6	3,5	5,6	5,2	6,2	6,3	6,4	6,5
FDI cover (%)	20,5	61,9	62,3	145,8	176,7	117,9	124,1	139,9	156,2
Gross international reserves (EURbn)	10,915	11,189	9,907	10,378	10,205	9,962	11,139	11,695	12,353
Import cover (months of imports)	7,7	7,6	6,6	6,0	6,2	5,4	5,3	5,1	5,1
Debt indicators									
Gross external debt (EURbn)	25,645	25,644	25,679	26,234	26,494	25,630	25,730	26,071	26,260
Government (EURbn)	12,185	13,120	14,145	15,295	15,680	13,911	12,971	12,121	11,757
Private (EURbn)	13,460	12,525	11,534	10,939	10,815	11,719	12,759	13,950	14,503
Gross external debt (% of GDP)	76,1	70,4	72,4	73,5	72,1	65,4	60,1	57,1	53,8
Gross external debt (% of exports)	223,6	184,0	177,7	150,2	152,4	132,7	119,6	111,3	105,6
Exchange rates and money									
USD/RSD (end-year)	86,18	83,13	99,46	111,64	117,93	99,30	105,54	97,88	93,60
USD/RSD (average)	88,12	85,17	88,54	108,88	111,17	107,47	100,07	101,56	96,46
EUR/RSD (end-year)	113,7	114,6	121,5	121,8	123,5	118,5	118,2	117,5	117,0
EUR/RSD (average)	113,1	113,1	117,3	120,7	123,1	121,3	118,3	117,8	117,2
Money supply M1 (% YoY)	-3,3	24,8	5,2	16,4	18,7	14,8	9,0	8,7	9,7
Broad money M3 (% YoY)	0,7	3,7	3,0	5,0	9,9	7,9	7,5	4,8	3,6
Domestic credit (% YoY, euros)	0,8	-5,2	-2,3	2,4	1,0	6,2	7,9	6,9	6,3
NBS policy rate (average %)	10,10	10,90	8,75	5,63	4,13	3,81	3,06	3,00	3,20
NBS policy rate (end-year %)	11,25	9,50	8,00	4,50	4,00	3,50	3,00	3,00	3,50
6M BELIBOR interest rate (average %)	12,00	10,40	8,53	6,43	3,65	3,60	3,12	3,10	3,25

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

SELECTED BANKING SECTOR DATA

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Balance sheet									
Assets (EURm)	25.326	24.825	24.546	25.060	26.257	28.440	30.033	31.234	32.327
Assets (%, YoY)	0,0	-2,0	-1,1	2,1	4,8	8,3	5,6	4,0	3,5
Assets (% of GDP)	75,2	68,2	69,2	70,2	71,5	72,6	70,1	68,4	66,2
Gross loans (EURm)	17.148	16.255	15.879	16.253	16.412	17.431	18.817	20.115	21.379
Gross loans (%, YoY)	0,8	-5,2	-2,3	2,4	1,0	6,2	7,9	6,9	6,3
Gross loans (% of GDP)	50,9	44,6	44,8	45,5	44,7	44,5	43,9	44,0	43,8
Deposits (EURm)	13.310	13.634	13.967	14.728	16.159	17.404	18.500	19.453	20.374
Deposits (%, YoY)	1,6	2,4	2,4	5,4	9,7	7,7	6,3	5,2	4,7
Deposits (% of GDP)	39,5	37,4	39,4	41,2	44,0	44,4	43,2	42,6	41,7
Loan-to-deposit ratio (%)	128,8	119,2	113,7	110,4	101,6	100,2	101,7	103,4	104,9
Capital adequacy ratio (%)	19,9	20,9	20,0	20,9	21,8	22,6	22,5	22,1	21,8
Performance									
Net interest income (EURm)	1.025	1.044	1.063	1.075	973	996	1.105	1.124	1.148
Net interest income (%, YoY)	-9,4	1,9	1,8	1,1	-9,5	2,4	11,0	1,7	2,1
Total operating income (EURm)	1.484	1.435	1.489	1.520	1.387	1.563	1.544	1.599	1.656
Total operating income (%, YoY)	-6,7	-3,3	3,8	2,1	-8,8	12,7	-1,2	3,6	3,6
Pre-provision profit (EURm)	571	504	529	574	501	627	629	658	677
Pre-provision profit (%, YoY)	-7,5	-11,6	4,8	8,6	-12,8	25,2	0,4	4,5	2,9
Provision charges (EURm)	339	510	490	494	333	61	20	52	60
Profitability and efficiency									
Net interest margin (%)	4,0	4,2	4,3	4,3	3,8	3,6	3,7	3,6	3,6
Pre-tax ROAA (%)	0,9	-0,1	0,1	0,3	0,7	2,1	2,1	2,0	1,9
Pre-tax ROAE (%)	4,3	-0,3	0,6	1,6	3,3	10,7	10,4	9,4	8,8
Cost-to-income ratio (%)	66,1	65,3	64,7	62,2	63,9	59,9	59,2	58,9	59,1
Operating expense (% of assets)	3,6	3,7	3,9	3,8	3,5	3,4	3,1	3,1	3,1
Credit quality and provisioning									
NPL ratio (%)	18,6	21,4	21,5	21,6	17,0	9,8	6,2	6,0	5,8
NPL coverage (%)	50,0	50,9	54,9	62,3	67,8	58,1	69,5	69,7	70,3
Provision charges (% of loans)	2,0	3,1	3,1	3,1	2,0	0,4	0,1	0,3	0,3
Provision charges (% of PPP)	59,4	101,1	92,8	86,0	66,6	9,8	3,2	7,9	8,9

Source: NBS, Addiko research

Credit growth driven by retail segment

Lending activity increased by 6.0% ytd in October thanks to strong positive contribution from the private sector, as public sector loans continued de-leveraging. Retail loans surged 11.7% ytd driven by strong demand for cash non-purpose loans, supported by positive labour market developments and wage gains, alongside record low interest rates offered on both RSD and FX-linked loans. Corporate lending resumed its recovery displaying 3.0% ytd growth despite significant write-offs of non-performing loans, which contributed to further decline of NPL ratio in 3Q18 to 6.4% (from 9.8% 2017YE). Meanwhile, deposit growth picked-up 7.4% ytd in October owing to faster deposit collection on the corporate side (11.8% ytd), with continuously strong households' deposit growth (6.5% ytd). While 3Q18 P&L results still haven't been published, we expect increased lending activity to boost NII growth, which combined with decreasing provision charges will lead to higher yoy profit level in 2018.

Economic prospects keep supporting credit activity

Going forward, we expect strong credit activity to continue till the end of the year, resulting with 8%-alike yoy growth and then decelerating towards 7% in 2019. Credit growth remains supported by robust private consumption and investment outlook, with the latter particularly important for a more stable corporate lending recovery going forth. Besides economic growth and labour market recovery, financial conditions on the market remain favourable as intensified competition among banks and continued NPL reductions keep raising banks' risk appetite and contributing to easier credit standards. Regarding deposits, we expect somewhat slower deposit collection in the forthcoming period leading to 5.2% yoy growth in 2019, mostly owing to high base effects but also due to increased consumption and investment propensity in the environment of continuously low interest rates. We see somewhat higher pre-tax income level going forth owing to solid growth of NII, courtesy of increasing credit portfolio and lower funding costs, along with stable provisioning and opex.

Solid Growth Outlook amid Political Risks

We keep 2018 GDP growth forecast at 3.0% on stronger private consumption, exports and commercial construction. In 2019, we see growth accelerating a bit to 3.5%, as the current political stalemate ends, paving the way for hefty infrastructure investments, and exports growth potential has strengthened. National budget stays in small surplus, while C/A gap continues to widen slightly on stronger both consumer and investment import demand.

GDP growth remains steady around 3%

After acceleration to 3.4% yoy in Q2, high frequency data suggest somewhat slower GDP growth in Q3 but still close to 3% yoy, driven by private consumption and service sectors. Namely, retail sales jumped 9.2% yoy in Q3 on the heels on further employment (+2.5% yoy) and accelerating wage growth (almost 4% yoy) as well as 14% higher foreign tourist nights. At the same time, slower industrial dynamics (0.8% yoy vs. 1.7% in Q2) and goods export growth (4% yoy vs. 12% in Q2) set against weaker EU demand and temporary Turkish demand shock has been more than offset by steady imports (+6% yoy), lowering goods import cover to 60.4% (on a 3-month basis). Industry slowed mainly in durable goods, energy generation and consumer durables. With the economic activity in Q4 on stronger note via private consumption, stabilizing (net) exports and private construction, we keep 2018 growth forecast at 3.0% after upwardly revised 3.4% in 2017.

We expect GDP to accelerate as political uncertainty ends

We see stronger GDP growth in 2019 at 3.5% as the current political stalemate ends, paving the way for hefty infrastructure investments, and exports growth potential has strengthened. The main driver still being private consumption has staying power on steady wage and employment growth, higher remittances, re-leveraging and stably higher tourism inflows. Solid EU demand, removal of (processed) food export bans for EU markets and higher energy capacity will boost exports, but given strong domestic demand, we see net trade contribution in 2019 negative. Faster investments will boost growth largely via EUR700m EBRD funding commitment until 2020, stronger budget support upon fuel excise duty and road toll hikes and stronger FDIs in energy capacity (Tuzla TPP EUR900m, TPP Ugljevik and a few HPPs). Competitiveness has though not improved really as B-H remains the region's lowest-ranked economy in the WEF's Global Competitiveness Survey for 2018, falling another three places in the World Bank's Doing Business 2018 Survey. Despite small improvement in resolving insolvency, B-H still underperformed strongly in categories such as starting a business, getting electricity, etc. compared to peers. The risks to 2019 growth are a bit on the downside, stemming from political/policy uncertainty and stalling or even reversal of reforms, plus protracted external demand weakness.

After elections and new cabinet in place, time for reforms?

October elections outcome is another politically fragmented parliament, potentially incapable to find common grounds on the main reforms. While the national parties got most votes in both the state- and canton-level polls, they lack coalition-forming potential on the national level, hence the process of government formation may take some months. Apart from delays in public capex, we expect business climate, institutional, labour as well as SOE reforms to be on hold as the authorities shy away from the IMF-enshrined agenda given strong budget liquidity for now. Reform priority after the elections should be given to red tape and administrative burden cuts after the recent social contribution cuts (to 33% from 41.4%) and public administration reforms on the heels of the recent Strategic framework for public administration reforms. All above-mentioned is crucial for credibility on B-H's EU path and comforting rating agencies. Should political tensions lead to lengthy government deadlock, and reverse the progress under the reform agenda so far, B-H’s rating may be under pressure (not likely in our view).

Healthy fiscal developments continues

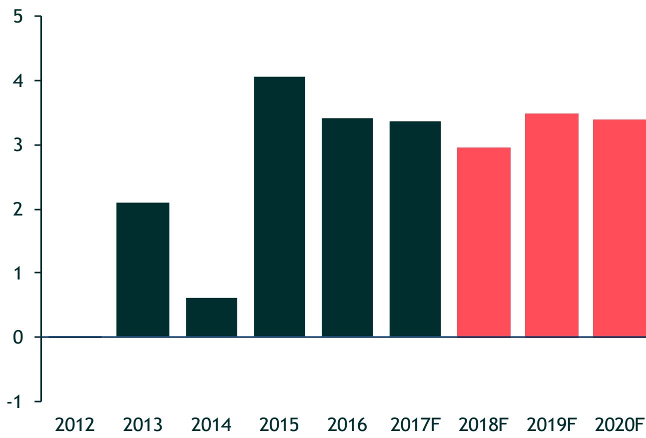
Given the prolonged national government formation, temporary financing regime at least in 1Q19 and slower public capex, B-H is heading for another budget surplus in 2019 close to 1% of GDP, and public debt below 40% of GDP. A 'policy' of tax revenue underestimation, better tax compliance and broader tax base may even contribute to higher surplus. According to the RS budget and news flow in Federation B-H, the risks on the expenditure side are also on the upside - from public wage bill, war veteran and childcare spending to agriculture subsidies - none of which has ever been envisaged in the last IMF program. We expect spending appetite to wane as soon as B-H approaches the IMF for a new stand-by (2Q19?), which given its past non-compliance will likely be subject to prior policy actions. Among those, we see quick enablers in implementing the Law on deposit insurance and political commitment to privatization (incl. two state-run telecoms) and restructuring of SOEs and development banks. Looking ahead, policy focus will be on fiscal space for capex via spending containment and SOE restructuring, parallel with labour tax/red tape cuts harmonized between the entities.

External position worsens slightly, but quality of funding improving

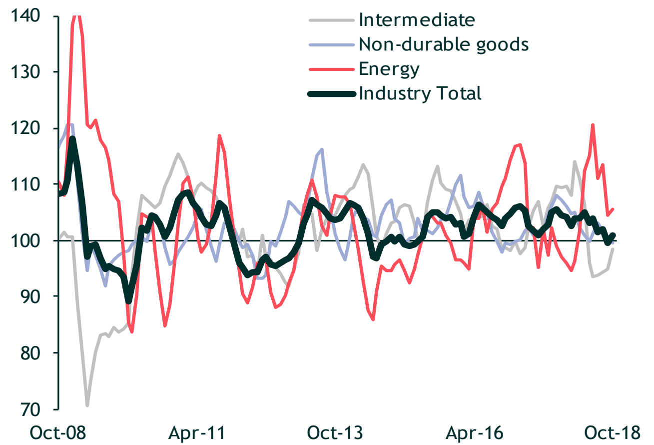
Despite wider C/A gap at 5.5% of GDP in 2018 on stronger import demand, external risks seem contained by higher FX reserves (7+ months of import cover) and FDI cover (after political stabilization, restarting reforms) toward 60% in 2020, and still ample IFI financing. In 2019, we see modest C/A widening close to 6% of GDP on stronger both consumer and investment-related import demand. Inflation has stabilized just below 2% as slowing food inflation annulled higher contribution from fuel prices, which paves the way for 2018 CPI average at 1.4%. In 2019, we see inflation somewhat higher at 1.8% on stronger domestic demand and higher wages.

Bosnia and Herzegovina's data trends

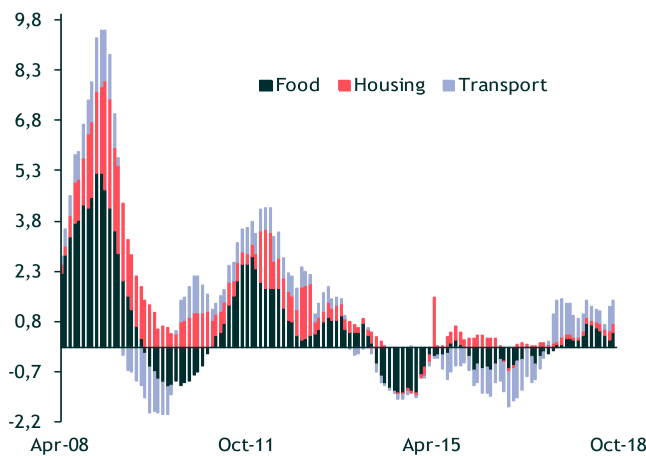
Real GDP growth (% YoY)



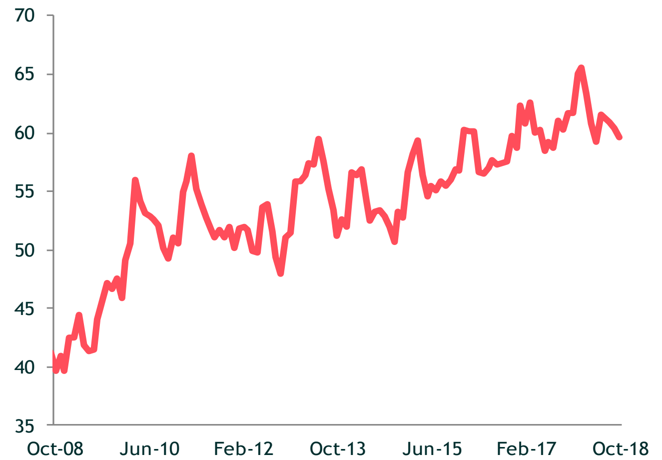
Industrial production (%, yoy, s-a, 3mma)



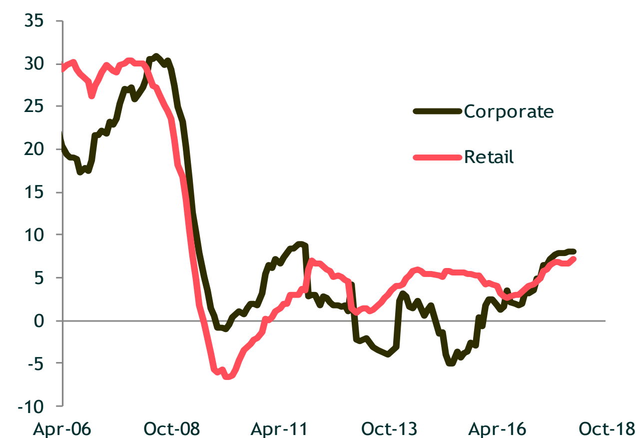
Key CPI contributions (pp)



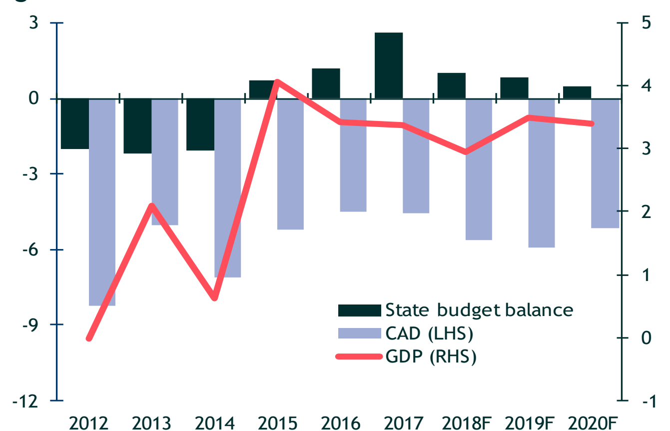
Merchandise import cover (%, 3mma)



Private credit dynamics (%, YoY)



Budget and C/A gaps (% of GDP) vs. GDP growth



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

SELECTED ECONOMIC FORECASTS

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Activity									
Nominal GDP (BAMbn, current prices)	27,5	28,2	28,3	29,7	31,0	32,3	33,7	35,5	37,5
Nominal GDP (EURbn)	14,1	14,4	14,5	15,2	15,9	16,5	17,2	18,2	19,2
Nominal GDP (USDbn)	18,1	19,2	19,2	16,8	17,6	18,6	20,4	21,1	23,3
GDP per capita (EUR)	3.856	4.005	4.063	4.294	4.512	4.696	4.902	5.165	5.447
GDP per capita (USD)	4.958	5.320	5.397	4.762	4.996	5.302	5.793	5.991	6.618
Real GDP (constant prices YoY, %)	0,0	2,1	0,6	4,1	3,4	3,4	3,0	3,5	3,4
Private consumption (YoY, %)	-0,7	0,0	1,9	1,8	2,2	1,2	3,2	3,1	3,3
Fixed investment (YoY, %)	2,1	-1,2	11,5	-3,5	2,5	5,8	3,2	4,6	4,4
Industrial production (YoY, %)	-5,2	6,6	1,8	3,5	4,4	3,1	3,3	4,6	4,4
Unemployment rate (ILO, average, %)	28,0	27,4	27,5	27,7	25,4	20,6	18,5	16,5	15,7
Prices									
CPI inflation (average % YoY)	2,1	-0,1	-0,9	-1,0	-1,1	1,2	1,4	1,8	2,0
CPI inflation (end-year % YoY)	1,8	-1,2	-0,4	-1,3	-0,3	1,3	1,7	2,1	2,2
PPI inflation (average % YoY)	1,3	-2,2	-0,2	0,6	-2,1	2,9	2,4	2,4	2,6
Net wage rates (% YoY, nominal)	1,2	0,1	0,4	0,0	0,9	1,8	3,2	3,2	2,8
Fiscal balance (% of GDP)									
State budget balance	-2,0	-2,2	-2,1	0,7	1,2	2,6	1,0	0,8	0,5
Public debt	43,4	44,5	45,0	45,5	43,7	40,6	38,3	35,6	33,0
External balance									
Export of goods and services (EURbn)	4,337	4,620	4,754	5,080	5,450	6,429	7,223	7,612	7,955
Import of goods and services (EURbn)	-7,481	-7,419	-7,927	-7,794	-8,345	-9,542	-10,188	-10,735	-11,317
Merchandise trade balance (EURbn)	-3,977	-3,630	-4,026	-3,677	-3,958	-4,267	-4,217	-4,422	-4,636
Merchandise trade balance (% of GDP)	-28,3	-25,1	-27,8	-24,2	-24,9	-25,8	-24,5	-24,3	-24,2
Remittances (EURbn)	1,070	1,111	1,181	1,216	1,247	1,353	1,415	1,463	1,507
Current account balance (EURbn)	-1,159	-0,728	-1,033	-0,796	-0,711	-0,754	-0,967	-1,072	-0,984
Current account balance (% of GDP)	-8,2	-5,0	-7,1	-5,2	-4,5	-4,6	-5,6	-5,9	-5,1
Net FDI (EURbn)	0,3	0,3	0,2	0,4	0,2	0,3	0,4	0,5	0,6
FDI (% of GDP)	2,4	1,8	1,2	2,6	1,6	1,6	2,5	2,9	3,1
FDI cover (%)	29,7	35,5	16,9	50,4	35,0	34,0	44,5	49,0	61,0
Gross international reserves (EURbn)	3,328	3,614	4,001	4,400	4,873	5,398	6,231	7,034	7,438
Import cover (months of imports)	5,3	5,8	6,1	6,8	7,0	6,8	7,3	7,9	7,9
Debt indicators									
Gross external debt (EURbn)	10,980	11,064	10,289	12,416	12,847	12,838	13,348	14,238	14,566
Government (EURbn)	3,780	4,013	3,951	4,378	4,318	4,424	4,590	4,840	4,940
Private (EURbn)	7,200	7,051	6,339	8,038	8,529	8,414	8,758	9,398	9,626
Gross external debt (% of GDP)	78,1	76,6	71,0	81,8	81,0	77,7	77,4	78,4	76,0
Gross external debt (% of exports)	253,2	239,5	216,4	244,4	235,7	199,7	184,8	187,0	183,1
Exchange rates and money growth									
USD/BAM (end-year)	1,48	1,42	1,61	1,79	1,87	1,64	1,75	1,63	1,56
USD/BAM (average)	1,52	1,47	1,47	1,76	1,77	1,73	1,65	1,69	1,61
EUR/BAM (end-year)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
EUR/BAM (average)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
Money supply M1 (% YoY)	-0,7	9,0	9,2	11,9	13,7	13,7	16,1	9,2	9,9
Broad money M2 (% YoY)	3,4	7,9	7,3	8,0	8,3	9,5	8,4	7,4	7,6
Domestic credit (% YoY)	4,1	0,5	2,8	2,4	2,0	7,1	6,4	5,0	8,7
EURIBOR 3M interest rate (average %)	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,30	0,00

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

SELECTED BANKING SECTOR DATA

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Balance sheet									
Assets (EURm)	11.414	11.794	12.299	12.756	13.344	14.440	15.058	15.720	16.645
Assets (%, YoY)	1,9	3,3	4,3	3,7	4,6	8,2	4,3	4,4	5,9
Assets (% of GDP)	81,2	81,7	84,9	84,0	84,1	87,4	87,3	86,5	86,9
Gross loans (EURm)	8.151	8.194	8.423	8.624	8.795	9.419	10.019	10.516	11.431
Gross loans (%, YoY)	4,1	0,5	2,8	2,4	2,0	7,1	6,4	5,0	8,7
Gross loans (% of GDP)	57,9	56,7	58,1	56,8	55,4	57,0	58,1	57,9	59,7
Deposits (EURm)	6.814	7.285	7.861	8.452	9.077	10.057	10.878	11.561	12.337
Deposits (%, YoY)	2,6	6,9	7,9	7,5	7,4	10,8	8,2	6,3	6,7
Deposits (% of GDP)	48,4	50,5	54,3	55,7	57,2	60,9	63,1	63,6	64,4
Loan-to-deposit ratio (%)	119,6	112,5	107,1	102,0	96,9	93,7	92,1	91,0	92,7
Capital adequacy ratio (%)	17,0	17,8	16,3	14,9	15,8	15,7	15,7	16,0	16,2
Performance									
Net interest income (EURm)	389	385	383	398	411	424	442	472	508
Net interest income (%, YoY)	-1,8	-1,0	-0,5	3,9	3,3	3,3	4,2	6,8	7,6
Total operating income (EURm)	610	618	623	642	680	728	738	781	833
Total operating income (%, YoY)	-1,5	1,2	0,8	3,1	6,0	7,0	1,4	5,8	6,6
Pre-provision profit (EURm)	207	184	213	206	222	288	285	312	351
Pre-provision profit (%, YoY)	-0,8	-11,1	15,8	-3,6	8,1	29,4	-1,0	9,4	12,6
Provision charges (EURm)	130	192	117	171	91	94	95	92	90
Profitability and efficiency									
Net interest margin (%)	3,4	3,3	3,2	3,2	3,1	3,1	3,0	3,1	3,1
Pre-tax ROAA (%)	0,7	-0,1	0,8	0,3	1,0	1,4	1,3	1,4	1,6
Pre-tax ROAE (%)	4,8	-0,5	5,6	1,9	7,0	9,8	9,1	9,8	10,6
Cost-to-income ratio (%)	66,0	70,2	65,7	67,9	67,3	60,5	61,4	60,1	57,8
Operating expense (% of assets)	3,6	3,7	3,4	3,5	3,5	3,2	3,1	3,0	3,0
Credit quality and provisioning									
NPL ratio (%)	13,5	15,1	14,2	13,7	11,8	10,0	9,0	8,6	7,9
NPL coverage (%)	65,9	66,7	69,7	71,2	74,4	76,7	77,0	77,1	77,3
Provision charges (% of loans)	1,6	2,3	1,4	2,0	1,0	1,0	1,0	0,9	0,8
Provision charges (% of PPP)	62,8	104,1	55,1	83,1	41,1	32,6	33,4	29,6	25,6

Source: CBBH, banking agencies, Addiko research

Retail sector as key growth driver

Total loans increased by 5.8% in the year till October with the strongest positive contribution coming from the retail segment (+6.9% ytd), driven by increased demand for consumer credit amid employment and wage growth, along more favourable financing conditions. Corporate lending followed with 4.0% ytd, while public sector decelerated slightly though still displaying strong growth pace (10.9% ytd). Although loan book quality improved since beginning of the year, 3Q18 NPL ratio stagnated at 9.4% level (vs. 10.0% at YE17). At the same time, deposit collection increased by 9.2% ytd, driven by strong growth from both corporate (11.3% ytd) and retail (5.3% ytd) side, on improving labour market and increased remittances, while public sector deposits accelerated even further (24.9% ytd) carried by favourable fiscal trends. Although 3Q18 P&L results are yet to be published, we expect weak NII growth to result in slightly lower yoy profit level in 2018, with possible positive surprises coming from lower provisioning costs.

2019 brings credit and deposit deceleration

Looking ahead, we keep our 2018 credit growth forecast at 6.5%, while in 2019 we see credit activity slowing down towards 5% level. Besides positive labour market developments and private consumption outlook, credit growth remains supported by increased business optimism and investment recovery, alongside further decline in interest rates. At the same time we expect further improvement in credit quality with NPL ratio falling below 9% mark in 2019 as banks continue cleaning their balance sheets through NPL sales, write-offs and recovery practices. On funding, we expect slower deposit collection going forth, decelerating to 6.5% in 2019 due to high base effects, as well as improved consumption and investment outlook. Ongoing credit cycle should bring about NII recovery, resulting in somewhat higher profit level next year, assuming contained opex and lower provision charges.

Rebalancing amid Balance Sheet Healing

We lift 2018 GDP forecast to 4.3% mainly on account of strong investment dynamics, record tourist season and stabilizing private consumption trends. In 2019, we expect GDP growth to decelerate towards more healthy 3%. With highway works smartly extended in 2019 and early 2020, we again cut 2018 budget gap forecast to 2.5% of GDP, and expect public debt to peak just below 70% of GDP. We expect average CPI inflation to slow to 2.3% in 2019 as administrative hikes fade away and oil prices recovery slowly.

Growth expectations revised higher

GDP growth continued at a robust pace in Q3 (~4.5% yoy) on soaring investments (highways, energy, tourism), manufacturing and private consumption in response to stellar tourist season, accelerating employment and remittances. Sentiment gauges suggest the strong 4%-alike growth continued in Q4, driven by private consumption, construction and services sectors, and spill-over from EUR1bn tourism industry (foreign tourist nights +8% in 2018). A rebound in goods exports though is nowhere close to offset accelerating import growth and stop a further trade deficit widening to EUR2.1bn in 2018 (46% of GDP). Based on stronger-than expected growth dynamics throughout the year, we lift 2018 GDP forecast to 4.3% powered by strong investment dynamics, record tourist season and stabilizing private consumption trends.

Slower but still strong growth in 2019

We keep GDP growth forecast of 3.0% for 2019, with the gradual slowdown due to milder private consumption and public capex growth as highway projects are prolonged into 2020. The growth will be likely driven by tourism and highway building, electricity exports through the key energy grid linking SEE region with Italy, and FDIs in tourism, energy generation and aluminium sectors. Strong bank lending has staying power from very low LDRs and de-risking. Despite another record tourist season and narrower goods trade gap, net trade will contribute negatively given strong imports of investment-related equipment. The key risks on the upside include stronger tourist season and/or hefty electricity exports to Italy, construction activity and one-notch rating upgrades on sharply reduced fiscal and (re)financing risks, progress in EU talks and competitiveness gains, GDP growth potential and external position on hefty FDIs. Downside risks stem from unstable external backdrop and higher local contingent liabilities.

Fiscal consolidation slashes deficit below 3% of GDP

In the year to October, budget deficit sank to just EUR8m thanks to 14.3% higher tax intake on cyclically strong VAT intake (+14.2% yoy) partly due to 2pp VAT hike and strict tax compliance. Meanwhile, expenditure is driven by soaring capex, as current outlays (+4.3% yoy) essentially grow slower than nominal GDP growth. With highway works smartly extended in 2019 and early 2020, we again cut 2018 budget gap forecast to 2.5% of GDP once the annual highway costs and severance payments (for ~3,000 layoffs by 2020) are fully booked at year-end. Further deficit reduction to about 1.5% of GDP in 2019 rests on the first full-year interest bill savings upon short-term debt restructuring (incl. much cheaper Eurobond and bank club loan) and moderating highway project dynamics. While 2020 may see substantial surplus once highway works draw to a close, possible delays in highway completion and cost overruns ahead of 2020 elections. That said, public debt probably peaked around 70% of GDP in 2018 and should fall sharply toward 62% in 2020 when the highway project is complete.

2019 average CPI inflation seen at 2.3%

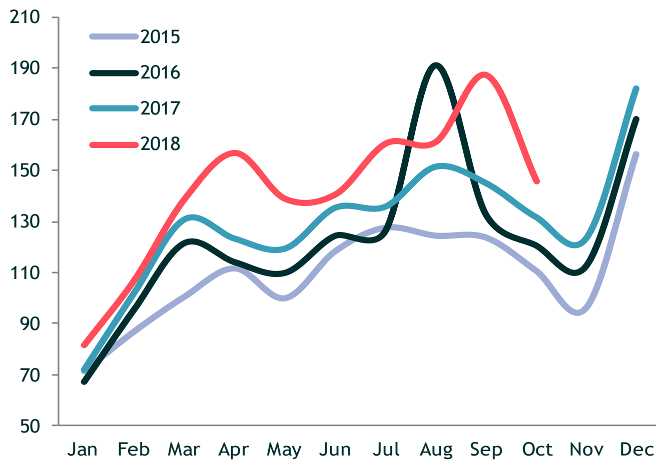
The level of CPI inflation was halved to 1.7% yoy in October from a 3.4% yoy peak in the summer (driven by VAT/excise duty hikes) despite strong seasonal demand during the tourist season. With the recent oil price slump and wage growth contained, we expect 2018 inflation to average at 2.7%. Next year, we see CPI inflation slowing to 2.3% as administrative hikes fade away and oil prices recovery slowly. Upside risks mainly stem from a renewed pick-up in oil prices and stronger foreign tourist demand-pull pressures.

Lower C/A gap normalization ahead

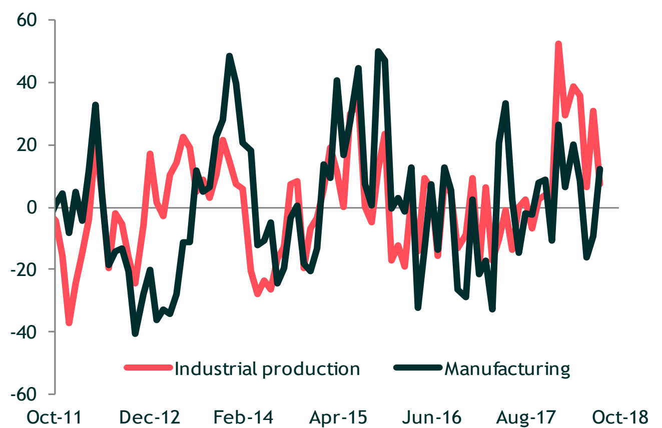
C/A deficit rose 36.3% yoy to EUR793.1m (18.5% of GDP) on 4-quarter moving average, largely owing to soaring goods trade deficit (+12.6% yoy) on the back of resurgent capex-related imports. The latter is only partly offset by record FC tourist receipts (+8.3% yoy) as well as higher remittances (+13.1% yoy). Net FDI fell 30% yoy to EUR391.1m (FDI cover just 25.1%), albeit largely due to EPCG re-privatization, as FDI share of ~9% of GDP still places Montenegro among top CESEE FDI destinations. We see C/A gap wrapping up 2018 around 17.5% of GDP, about 1.25pp higher on 2017, followed by a gradual drop in 2019-2020 toward 16% as tourism- and energy-driven export growth exceeds that of imports amid slower dynamics of expensive capital goods imports (related to energy projects) and slower highway project dynamics. With attractive taxes and concessions for investors, hefty hotel development pipeline, reconstruction of key airports and renewable energy projects, we see FDI in low-teens (as % of GDP) in the medium term as sustainable. This not only ensures solid FDI cover above 80% in 2020, but also helps stronger export growth with C/A deficit toward 13% of GDP in the medium term.

Montenegrin data trends

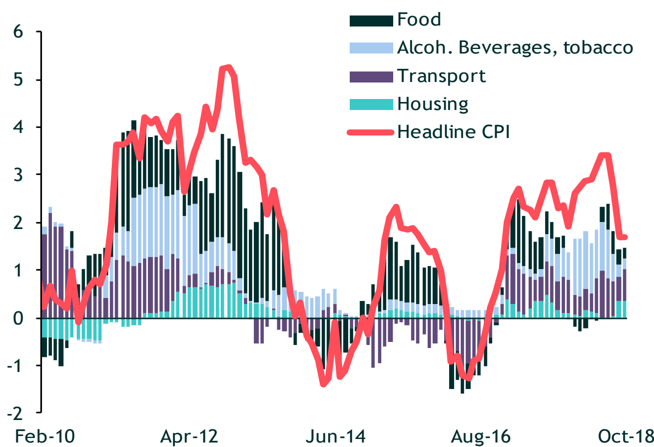
Budget revenue movements (EURm)



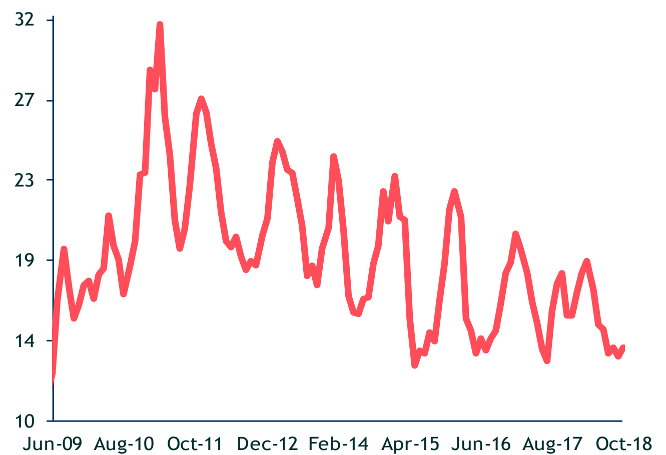
Industrial production (%, yoy)



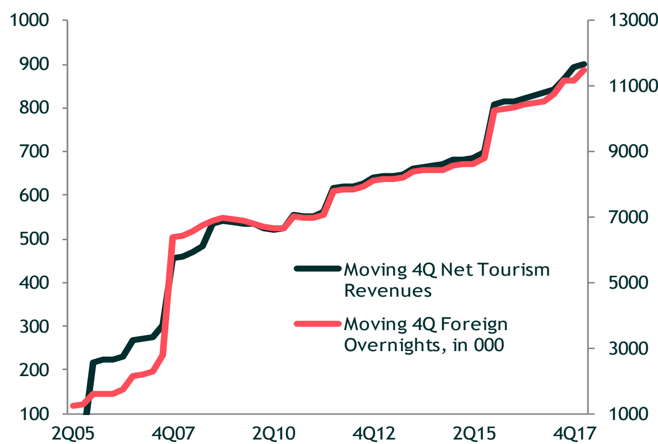
CPI by key contributions (pps)



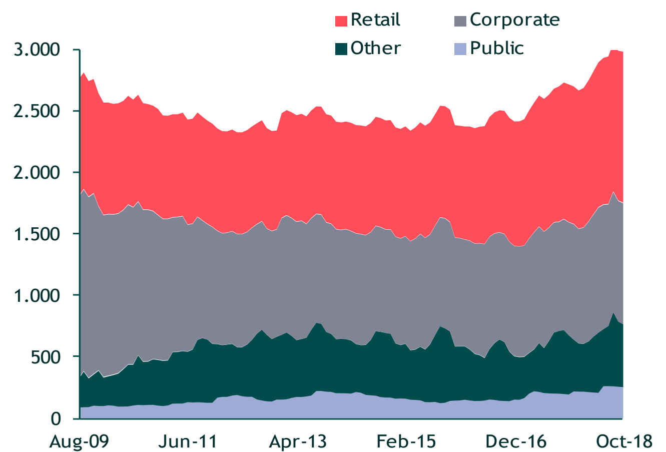
Merchandise import cover (%, 3mma)



Tourism



Gross loans by sector (EURm)



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

SELECTED ECONOMIC FORECASTS

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Activity									
Nominal GDP (EURbn,current prices)	3,2	3,4	3,5	3,7	4,0	4,2	4,5	4,8	5,0
Nominal GDP (USDbn)	4,1	4,5	4,6	4,1	4,4	4,8	5,4	5,5	6,1
GDP per capita (EUR)	5.114	5.415	5.564	5.875	6.355	6.807	7.291	7.683	8.103
GDP per capita (USD)	6.577	7.191	7.391	6.516	7.037	7.686	8.617	8.912	9.845
Real GDP (constant prices YoY, %)	-2,7	3,5	1,8	3,4	2,9	4,7	4,3	3,0	3,0
Private consumption (YoY, %)	-3,9	1,6	2,9	2,2	5,4	3,9	3,3	2,7	2,9
Fixed investment (YoY, %)	-2,4	10,7	-2,6	12,0	38,4	18,7	19,0	11,5	3,5
Industrial production (YoY, %)	-6,2	10,7	-10,5	9,2	-3,6	-4,3	15,0	5,0	4,5
Unemployment rate (ILO, average %)	19,9	19,5	18,0	17,6	17,7	16,1	15,4	14,8	14,4
Prices									
CPI inflation (average % YoY)	4,1	2,2	-0,7	1,5	-0,3	2,4	2,7	2,3	2,4
CPI inflation (end-year % YoY)	5,1	0,3	-0,3	1,4	1,0	1,9	2,2	2,8	2,5
PPI inflation (average % YoY)	1,8	1,7	0,2	0,3	-0,1	0,4	1,3	1,7	2,7
Net wage rates (% YoY, nominal)	0,7	-1,7	-0,5	0,7	3,8	2,5	0,3	2,4	2,4
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,5	-6,0	-2,9	-8,3	-3,6	-5,5	-2,5	-1,5	2,0
Public debt	53,4	57,6	58,6	62,3	64,4	63,7	69,7	67,3	61,8
Gross public funding needs	n/a	9,5	5,1	14,0	16,8	9,3	11,6	12,7	11,8
External balance									
Export of goods and services (EURbn)	1,338	1,390	1,388	1,539	1,605	1,765	1,951	2,101	2,238
Import of goods and services (EURbn)	-2,109	-2,066	-2,074	-2,214	-2,494	-2,773	-3,093	-3,306	-3,445
Merchandise trade balance (EURbn)	-1,384	-1,329	-1,376	-1,464	-1,658	-1,860	-2,099	-2,243	-1,745
Merchandise trade balance (% of GDP)	-43,5	-39,5	-39,8	-40,0	-41,9	-43,9	-46,2	-46,9	-34,6
Tourism receipts (EURbn)	0,643	0,666	0,682	0,813	0,836	0,922	0,995	1,057	1,142
Current account balance (EURbn)	-0,486	-0,383	-0,429	-0,401	-0,642	-0,692	-0,794	-0,828	-0,816
Current account balance (% of GDP)	-15,3	-11,4	-12,4	-11,0	-16,2	-16,3	-17,5	-17,3	-16,2
Net FDI (EURbn)	0,5	0,3	0,4	0,6	0,4	0,5	0,5	0,6	0,7
FDI (% of GDP)	14,5	9,6	10,2	16,9	9,4	11,4	10,6	12,5	13,5
FDI cover (%)	95,0	84,6	82,5	154,4	57,9	70,0	60,4	72,5	83,3
Gross international reserves (EURbn)	0,318	0,395	0,514	0,641	0,780	0,877	1,133	1,244	1,527
Import cover (months of imports)	1,8	2,3	3,0	3,5	3,8	3,8	4,4	4,5	5,3
Debt indicators									
Gross external debt (EURbn)	4,959	5,093	5,353	5,559	6,121	6,617	7,288	7,727	8,246
Government (EURbn)	1,295	1,352	1,646	2,061	2,187	2,361	2,446	2,500	2,349
Private (EURbn)	3,665	3,742	3,707	3,498	3,934	4,256	4,842	5,227	5,897
Gross external debt (% of GDP)	155,9	151,5	154,8	152,1	154,8	156,2	160,6	161,6	163,5
Gross external debt (% of exports)	370,6	366,4	385,6	361,2	381,3	374,9	373,5	367,8	368,5
Exchange rates and money growth									
EUR/USD (end-year)	1,32	1,38	1,21	1,09	1,05	1,19	1,12	1,20	1,21
EUR/USD (average)	1,29	1,33	1,33	1,11	1,11	1,13	1,18	1,16	1,22
Money supply M1 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Broad money M3 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (% YoY)	-0,7	3,1	-1,9	0,8	1,3	11,8	10,0	7,8	5,8
ECB reference rate (end-year %)	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,00	0,25
EURIBOR 3M interest rate (average, %)	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,30	0,00

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

SELECTED BANKING SECTOR DATA

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Balance sheet									
Assets (EURm)	2.808	2.959	3.136	3.472	3.790	4.182	4.585	4.906	5.224
Assets (%, YoY)	-0,1	5,4	6,0	10,7	9,2	10,3	9,6	7,0	6,5
Assets (% of GDP)	88,3	88,0	90,7	95,0	95,9	98,7	101,0	102,6	103,6
Gross loans (EURm)	2.342	2.414	2.367	2.386	2.416	2.701	2.970	3.202	3.388
Gross loans (%, YoY)	-0,7	3,1	-1,9	0,8	1,3	11,8	10,0	7,8	5,8
Gross loans (% of GDP)	73,6	71,8	68,5	65,3	61,1	63,7	65,4	67,0	67,2
Deposits (EURm)	1.981	2.098	2.308	2.625	2.872	3.267	3.602	3.893	4.133
Deposits (%, YoY)	9,0	5,9	10,0	13,7	9,4	13,8	10,2	8,1	6,2
Deposits (% of GDP)	62,3	62,4	66,7	71,8	72,6	77,1	79,4	81,4	81,9
Loan-to-deposit ratio (%)	118,2	115,1	102,6	90,9	84,1	82,7	82,5	82,2	82,0
Capital adequacy ratio (%)	14,7	14,4	16,2	15,5	16,1	17,6	18,2	18,1	17,8
Performance									
Net interest income (EURm)	106	104	111	117	122	125	136	142	149
Net interest income (%, YoY)	-0,1	-1,6	6,6	5,3	4,2	2,4	8,8	4,8	4,9
Total operating income (EURm)	178	156	158	171	175	189	184	192	200
Total operating income (%, YoY)	-19,5	-12,0	1,2	8,3	1,9	8,2	-2,4	4,4	4,1
Pre-provision profit (EURm)	65	48	46	52	53	59	49	52	54
Pre-provision profit (%, YoY)	-43,2	-26,7	-2,6	11,5	2,6	11,3	-16,9	6,0	4,4
Provision charges (EURm)	121	44	21	53	44	22	10	14	15
Profitability and efficiency									
Net interest margin (%)	3,8	3,6	3,6	3,5	3,4	3,1	3,1	3,0	3,0
Pre-tax ROAA (%)	-2,0	0,1	0,8	-0,1	0,3	0,9	0,9	0,8	0,8
Pre-tax ROAE (%)	-18,7	1,0	6,0	-0,4	2,0	7,4	7,5	7,2	7,4
Cost-to-income ratio (%)	63,5	69,6	70,7	69,8	69,6	68,7	73,4	73,0	72,9
Operating expense (% of assets)	4,0	3,8	3,7	3,6	3,3	3,3	3,1	3,0	2,9
Credit quality and provisioning									
NPL ratio (%)	17,6	18,4	16,8	12,6	10,3	7,3	6,2	5,7	5,4
NPL coverage (%)	40,0	39,1	39,5	39,5	41,3	42,9	45,0	46,1	51,0
Provision charges (% of loans)	5,1	1,9	0,9	2,2	1,8	0,9	0,4	0,5	0,5
Provision charges (% of PPP)	185,7	92,5	45,6	103,2	82,2	37,2	20,8	26,7	27,3

Source: CBCG, Addiko research

All segments contributing to credit growth

Total loans increased by 10.4% ytd in the year to October, with all sectors contributing positively. Retail lending picked-up to 9.8% ytd driven by cash loans growth, amid increased employment and improved consumer sentiment. Corporate credit accelerated to 5.1% ytd on strong construction activity, followed by strong contributions from the public sector (15.7% ytd) and volatile ‘other’ segment (21.3% ytd). Increased credit activity resulted in improvement of loan portfolio quality as NPL ratio fell to 6.7% in 3Q18 (vs. 7.3% 2017YE). Meanwhile, deposit collection increased by 5.9% ytd owing to strong growth from both retail (6.5% ytd) and corporate segment (11.4% ytd), leveraging on strong tourism inflows and improving labour market conditions, while public sector deposits surprised with 12.3% ytd fall. Regarding profitability, pre-tax profit increased 3.4% yoy to EUR33m in 3Q18 as strong NII growth (10.4% yoy) and lower provisioning costs (-68.4% yoy) were partially offset by sharp decline in other operating income.

Credit activity remains strong

Looking ahead, we keep our 10.0% yoy credit growth forecast for 2018, while in 2019 we see somewhat slower lending dynamics at 7.8% yoy. Credit growth remains supported by yet another record tourist season, alongside rising employment, soaring construction activity, falling interest rates and high bank liquidity. Credit activity will also result in improved quality of the loan portfolio, leading to further decline of NPL ratio below the 6% mark. Regarding deposit growth, we expect slower collection in the forthcoming period with 8%-alike growth in 2019, mostly due to high base effects and strong investment outlook. Strong NII growth and substantially lower impairments bode well for 2018 profits of Montenegrin banks, while next year we expect pre-tax profit stabilising around similar levels.

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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