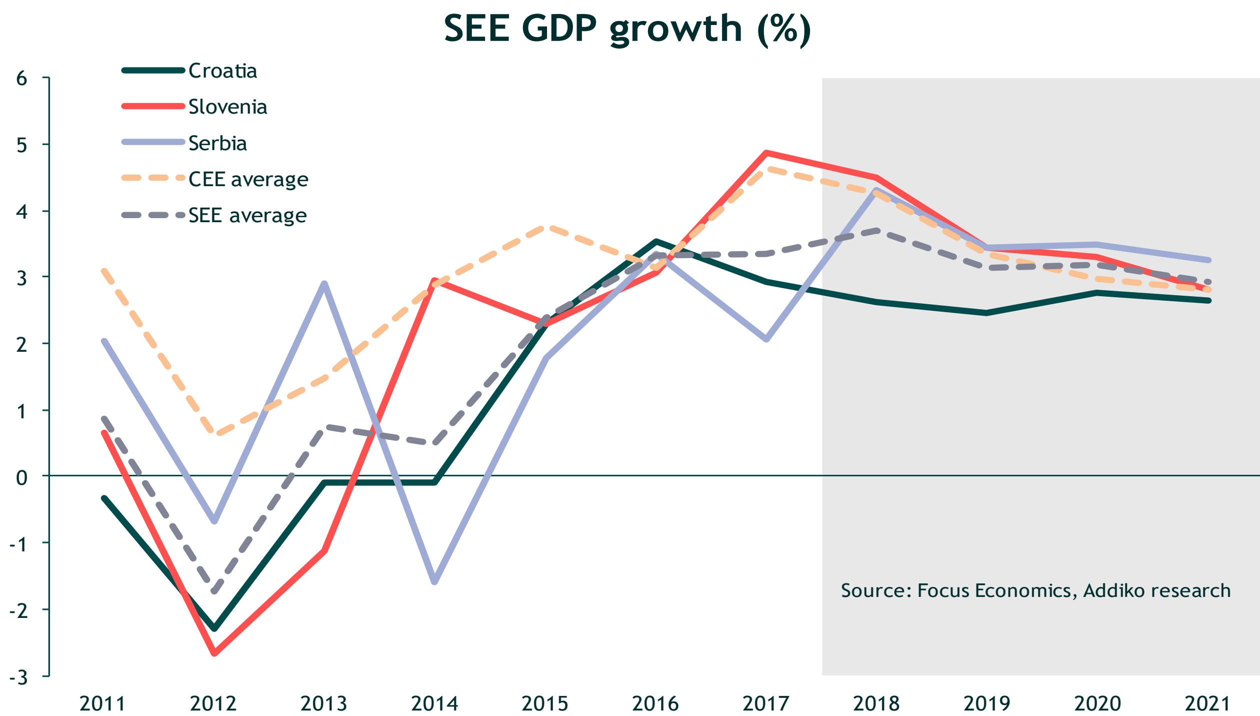
SEE Quarterly

Addiko Bank

03 May 2019

MILD WEAKENING IN GROWTH OUTLOOK



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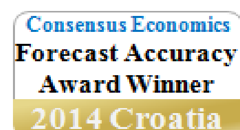
#1 BEST OVERALL FORECASTER - SLOVENIA

#1 BEST OVERALL FORECASTER - SERBIA



EXECUTIVE SUMMARY

BOTTOM LINE: With the exception of Montenegro, we downgraded 2019 GDP forecasts for SEE markets to 3.1% on average from 3.5% in the eve of 2018. Serbia and Slovenia should see the strongest growth of about 3.5%, driven by strong domestic demand and investment trends. In Croatia, we expect investment rebound and strong private consumption to help offset the weakening external momentum. Monetary conditions will remain loose, while inflation continues moderating mostly due to strong retailers' competition and lower oil and import prices, despite higher wage costs. We expect positive fiscal developments to continue with cyclical budget surpluses in most of the markets, while Croatia and Serbia return to balance and Montenegro narrows its budget deficit as highway construction project approaches its end.

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

*vs USD

KEY POINTS:

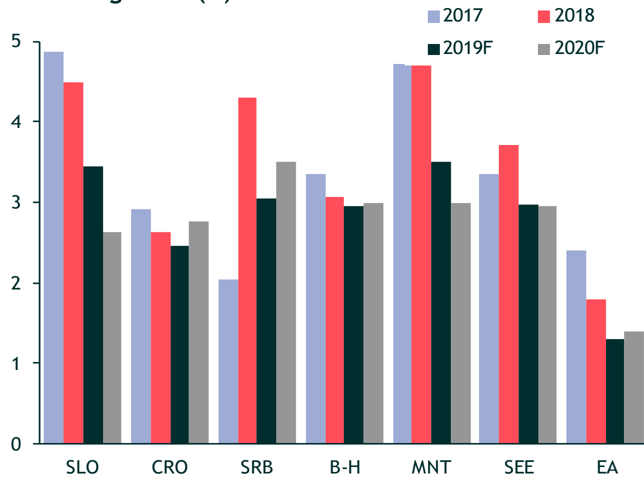
1. In Slovenia, we reiterate 3.5% GDP growth call in 2019 on stronger private consumption dynamics and strong investment growth, supported by slightly pro-cyclical fiscal policy and ultra-easy financial conditions. In Croatia, we cut our 2019 GDP forecast to 2.5% (-0.5pp) based on deteriorating external demand and lower carry-over from 4Q18, partially offset by encouraging investment outlook and strong private consumption trend. We also lowered our GDP growth expectations in Serbia to 3.5% in 2019, owing to external demand concerns and negative net trade contribution, though growth remains supported by strong domestic demand, steady investments trend and fiscal stimulus. In Bosnia and Herzegovina, we cut 2019 GDP growth forecast to 3.0% on weaker external demand and more negative net trade contribution, counterbalanced by accelerating investment and solid private consumption. In Montenegro, we lift our 2019 GDP growth expectations to 3.5% on the account of higher carry-over effects, with strong investment dynamics continued, another record tourism result and stabilising private consumption trends.

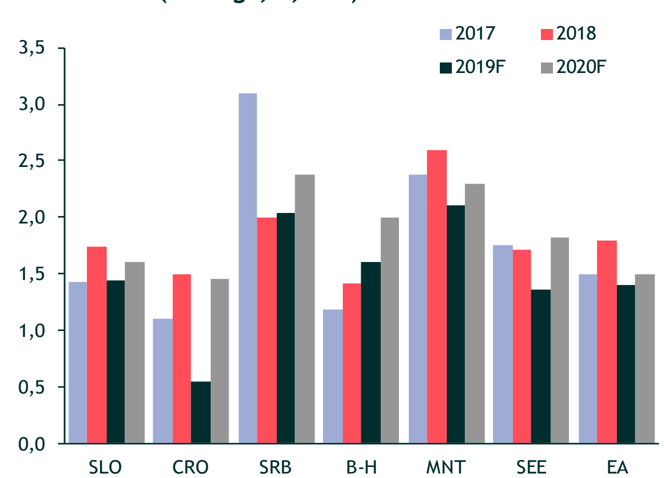
2. We expect Slovenia's budget surplus moderating toward 0.5% of GDP in 2019 as strong tax-rich domestic demand, positive BAMC impact and further interest rate savings meet stronger spending pressures. In Croatia, despite stronger spending pressures ahead of 2020 election cycle, we see balanced budget owing to stricter fiscal compliance under ERM II agenda and possible tax revenues undershooting on moderating GDP growth. Following two years of consecutive budget surpluses, we see Serbia's 2019 budget returning to balance on steady public capex outlays, steep wages (+9% yoy) and pension hikes, and 1pp employers' unemployment contribution cut.

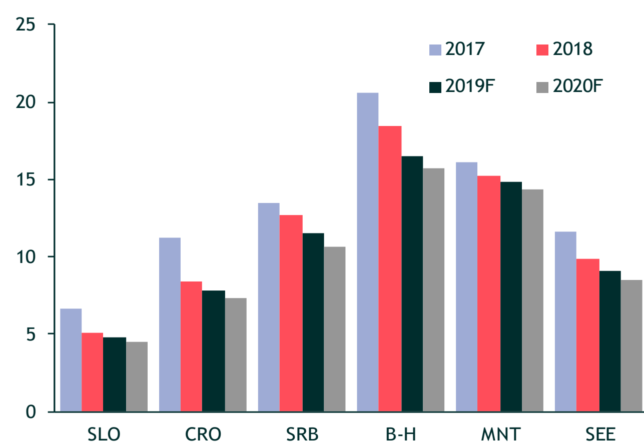
3. We see Slovenian CPI 2019 average of 1.4%, just slightly above the euro zone average, while tighter labour markets and strong consumer demand limit downside surprises. In Croatia, we see average inflation at 0.5% in 2019 on the account of strong price competition in the retail trade segment, alongside weaker import price pressures due to intensified international competition and economic slowdown. In the absence of food prices supply-side shocks, we expect average Serbian CPI around 2% in 2019, with the risks slightly skewed on the downside owing to persistent trend of subdued import prices, strong retailers' rivalry and stable dinar.

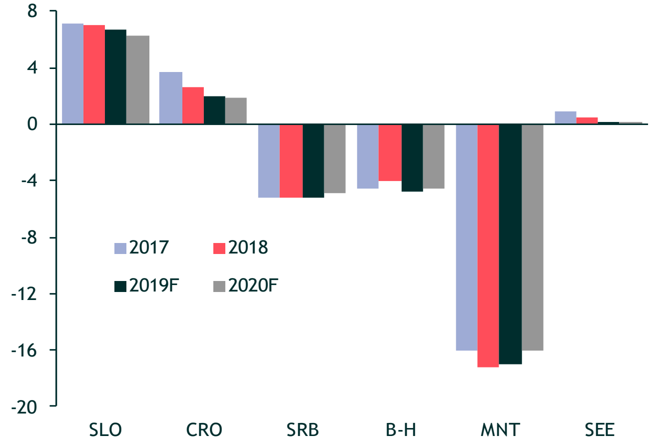
4. Recent downgrades in GDP growth and core inflation forecasts have seemingly locked the ECB's position, by prolonging the accommodative policy stance and possibly delaying rate hikes beyond 2020. Although the QE programme formally ended, the ECB will continue its generous support through reinvestments of maturing bonds and new wave of TLTRO starting from September. The euro zone momentum weakness in the next quarters might see modest (20bp) shrinking of Slovenian semi-core perceived spreads to 40-60bp range above the Bund. Croatian spreads may still tighten, with domestic bond sales for 2019 completed, further rating upgrade(s) and sound prefunding options on the Eurobond markets. Our bullish near-term outlook assumes sound fiscal performance including faster debt cuts, economic restructuring under Agrokor operating reshuffle, increased policy coherence and structural reform orientation under the ERM II mechanism, with further improvement in external position. Given the ECB rates forward guidance extension (well) into 2020, re-pricing out of most Fed hikes, renewed appreciation pressures on the RSD and domestic inflation undershooting, we see room for the NBS' rate cut in Q3 and/or long-awaited reduction of the RSD part of mandatory reserves, though the NBS may first want to see some 'EM risk positive' news. As the current economic expansion is not much credit-driven, we see NBS rates unchanged throughout 2020 or at least some quarter(s) after the start of the ECB's own normalization process.

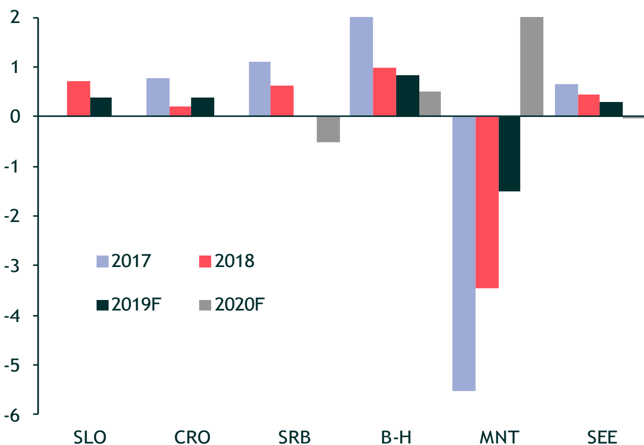
SEE data trends

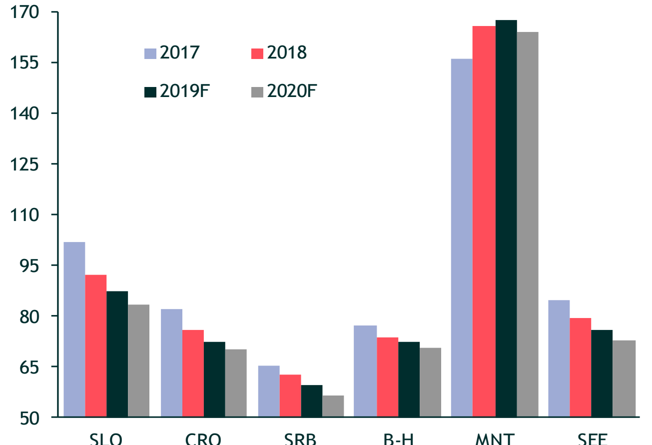








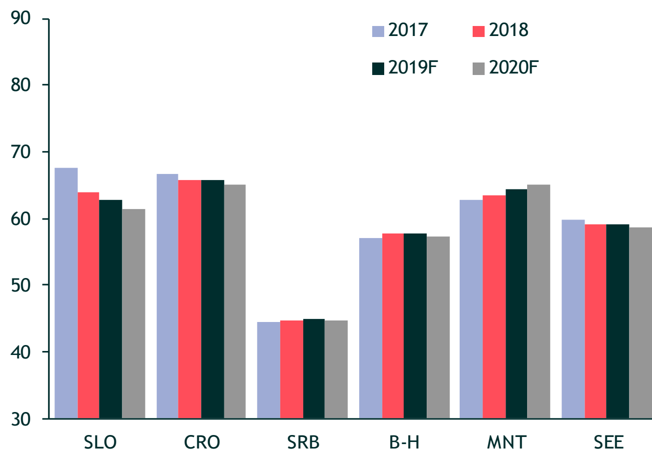




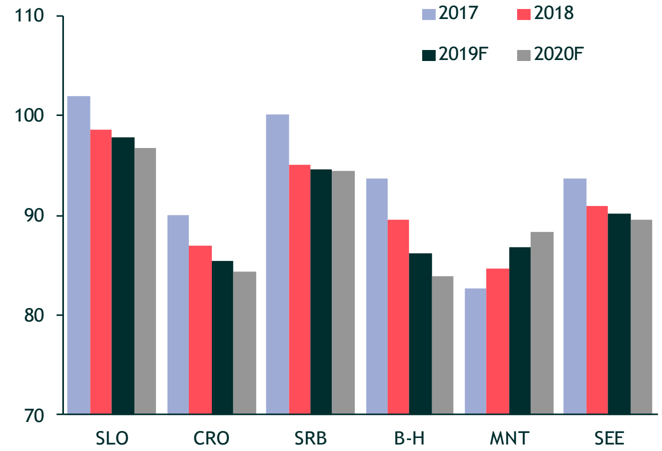
Source: National sources, Focus Economics, Addiko research

SEE banking sector trends

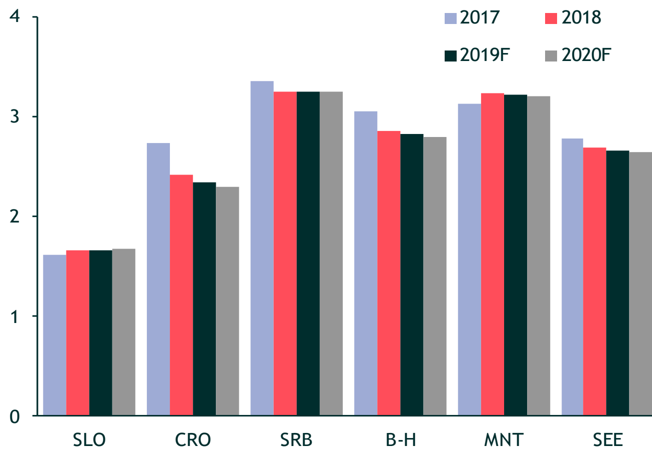
Gross loans (% of GDP)



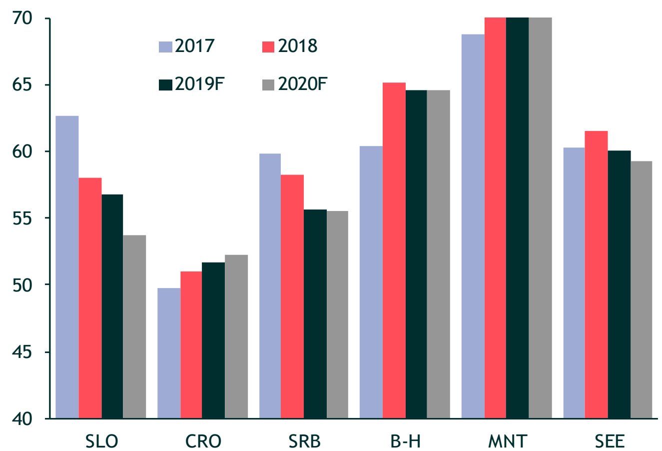
Loan-to-deposit ratio (%)



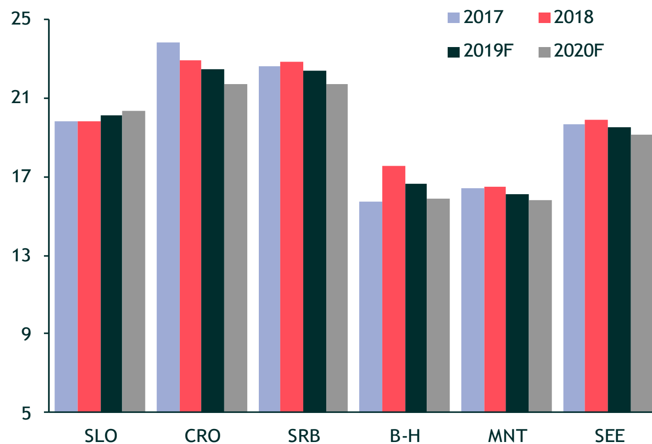
Net interest margin (%)



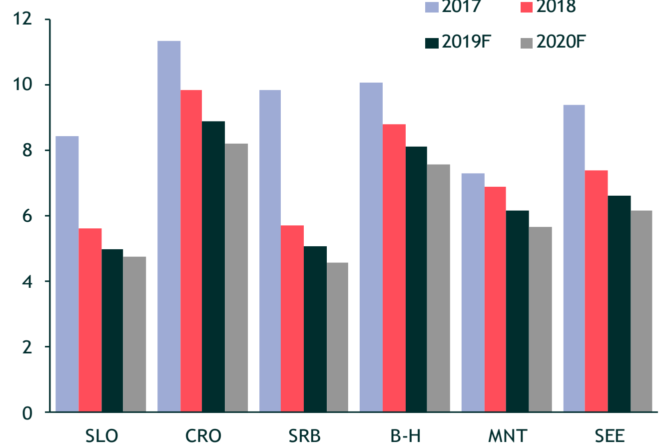
Cost-to-income ratio (%)



Capital adequacy ratio (%)



NPL ratio (%)



Source: central banks, Addiko research

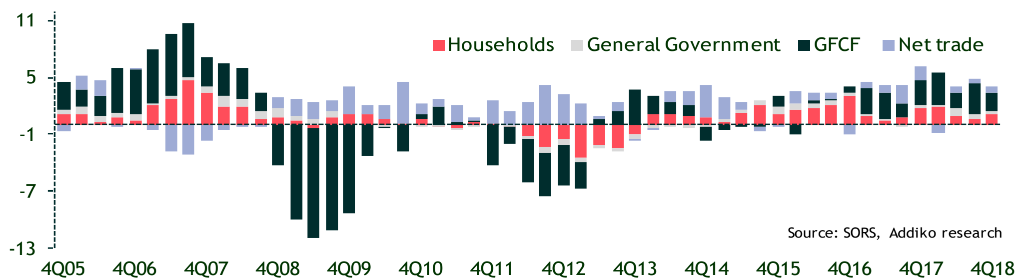
Slower Growth in Healthy Economy

We have above-consensus 2019 GDP growth call at 3.5% on accelerated private consumption dynamics and still strong investment on slightly pro-cyclical fiscal policy and ultra-easy funding conditions. We expect the budget to stay in surplus, contributing to further decline of public debt reduction, though downside risks to growth from external demand and entitlement spending pressures threaten to widen the structural deficit. Continued macro/fiscal over performance, further interest bill cuts and stronger rating prospects suggest stable bond performance in the context of prolonged ECB accommodation.

Growth passed its peak

The 4Q18 GDP (+0.8% qoq, +3.6% yoy seasonally adjusted) met our above-consensus growth expectations. Despite demand-driven imports acceleration combined with weaker external demand momentum, exports displayed solid growth (+6.8% yoy) with net trade contributing positively to the overall growth (adding +0.7pp). Private consumption picked up (+2.1% yoy) albeit dynamics appear understated considering the strong consumer sentiment, positive job market developments and rising disposable income, as well as retail re-leveraging and soaring tourist consumption. While machinery and equipment capex lost momentum amid foreign demand uncertainty, investment growth nonetheless remained strong (+10.0% yoy) driven by real estate markets as Slovenia manifested the strongest growth in home prices in 2019 among all EU countries (~15%). That said, the FY18 GDP met our long-held growth 4.6% target, slowing slightly from 4.9% in 2017. Our model suggests the growth is likely to continue at 0.7%-alike (qoq) pace in (1H19) helped by even stronger consumer demand, for now offsetting softer EU demand.

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



External weakness and growth moderation

We keep above-consensus 2019 GDP growth forecast at 3.5% on accelerated private consumption dynamics and still strong investment on slightly pro-cyclical fiscal policy and ultra-easy funding conditions. Exports growth will lose allure and inventories contribute negatively amid manufacturing recession in major trading partners, as stronger labour cost pressures and lower volumes bring disappointment on operating margins. Meanwhile, faster 5%-alike wage growth beefed up by end-2018 public wake hikes and employment gains will boost disposable incomes and private consumption growth at 3%-alike clip, additionally supported by households' re-leveraging, increased tourist spending and solid sentiment. Investment growth will remain driven by private construction, increased EU funding and infrastructure upgrades, while high capacity utilization supports private machinery capex. The main change though is the 0.7pp downgrade to 2020 GDP forecast to 2.6% when domestic demand cools off in response to protracted external weakness. Risks to our scenario are mostly on the downside in the case of even more pronounced euro zone downturn, particularly in the case of prolonged German manufacturing weakness, ongoing US-China-EU trade uncertainty, longer Italian recession and hard Brexit. Upside risks include positive surprises in the global growth developments (global monetary intervention, stable Chinese economy) and domestic fiscal easing, including wage tax cuts and stronger public capex.

Inflation moderating slightly above euro zone average

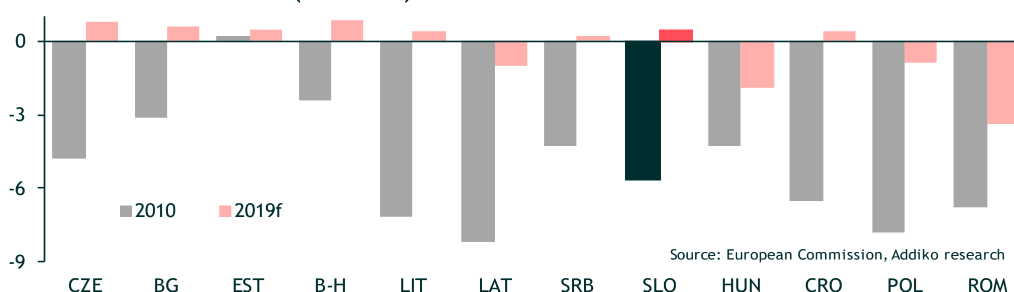
Besides slight March uptick attributable to higher energy prices, inflation has moved downwards since end-2018 on subdued commodity prices, while service prices continued gradual ascent. Core inflation though remains at low levels as companies seem unable to pass higher wage costs to end-consumers. This largely corresponds to inflation developments in the euro zone where the ECB expectations of rising wages translating into higher prices repeatedly fail to materialise, and core inflation moving even further away from the desired target. We expect inflation fluctuating within 1.3%-1.6% with the average 2019 CPI of 1.4%, just slightly above the euro zone average, while tighter labour markets and strong consumer demand limit downside surprises. Meanwhile, the elusive inflation target will keep ECB on hold, avoiding rate hikes throughout 2020 at least.

C/A surplus moderating, but international position improves further

After a steady C/A surplus at 7.0% of GDP in 2018 thanks to 12% higher tourism receipts, we expect it to moderate in 2019-2020 towards 6.3% of GDP on strong import-intensive domestic demand and slower export growth. Strong decline in net external debt below 14% of GDP in 2018 (down from 22% in 2017) and ample bank liquidity support the improvement in the net international investment position towards -25% of GDP, with its current level already displaying considerable outperformance of similar A-rated countries in the region.

Given sizeable C/A surplus, hefty fiscal reserve and active sovereign debt management, including new EUR1.5bn issuance, funding position remains strong with the average debt duration comfortably extended. While the recent pick-up in FDI activity is largely due to the sale of 51.9% stake in the largest NLB bank, the second tranche of 15% NLB stake should follow this year, together with the sale of Abanka. While average FDI flows stay well below the euro zone average, we expect private FDI activity to pick up thanks to a clear emergence of high-tech SMEs and new sources of private capital fuelling competition, hopefully followed by a more substantial reduction of the strategic SOEs list - required to sustain privatization process.

Slovenia: fiscal balance (% of GDP)



More fiscal consolidation required ahead

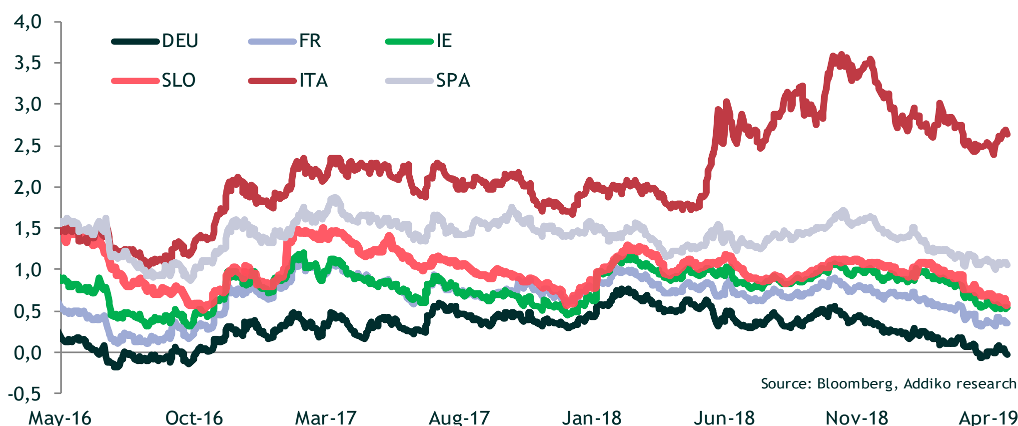
2018 saw the record budget surplus (0.7% of GDP) driven by soaring taxes (+7% yoy on income/profit tax and VAT), EU funding, NLB dividend and BAMC contribution. Strong revenue stream and further interest bill reduction have comfortably offset a plethora of public wage, pensions and social transfer hikes. In 2019, we expect budget surplus moderating below 0.5% of GDP as continued strong tax-rich domestic demand, positive BAMC impact and further interest rate savings meet stronger spending pressures (extraordinary pension hikes, expiry of previous spending freeze, stronger EU-co-funded capex). Strong cyclical windfall tax revenue has encouraged entitlement spending rather than structural fiscal measures, which puts the structural balance to about -0.5pp of GDP deficit (vs. 0.1% of GDP in 2018). Given the EC-advocated 0.6pp GDP structural tightening in the 2019 budget, downside risks to growth from external demand and populist spending pressures, Slovenia is just moving further away from its structural MTO of +0.25% of GDP. We also sense a desire to change the original MTO to -0.25% of GDP on hopes the EC may be more lenient given the past years' stronger-than-expected public debt cuts and in exchange for some progress in structural reforms (healthcare, pension system).

Public debt and interest costs downward trend continues

With last year's public debt dropping below 70% of GDP on strong nominal GDP growth and higher budget surplus, in 2019 we expect further reduction of public debt supported by above-trend economic growth, budget surplus level and additional interest rate savings. Continued positive BAMC impact and privatisation proceedings (second part of NLB public offering and Abanka sale) will also help cut debt further, which combined with the MinFin's hefty cash reserve (~9% of GDP) brings the net public debt below 60% of GDP. While 2019 envisages somewhat higher funding needs (5.7% of GDP) relative to 2018, Slovenia's funding position remains favourable with the large part of funding requirements already covered in January via a new EUR1.5bn 10Y bond issue. We expect the MinFin's to continue its pro-active approach, making full use of current favourable market terms and lowering the average interest rate paid further towards 2.5% by 2020 (from 4.4% in the peak year 2014). In the medium term, once the GDP growth converges towards 2.5% average, let alone downside risks to that, debt reduction will essentially depend on broader structural reforms and further fiscal consolidation. That said, Slovenia is not using the current good economic situation to carry out the necessary structural adjustments and ensure sustainable debt reduction in the long run. 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.

Stable bond performance

Slovenian 10Y yields dropped to 0.60% and spread narrowed below 60bp over Bund in the aftermath of prolonged ECB accommodation prospects and the Fed's decision to stop hiking rates this year, raising the likelihood for 2020 rate cuts. Combined with latest downgrades in GDP growth and alleviated recession fears, markets saw increased investor appetite towards safer long-term options, pushing the 10Y Bunds into negative territory. Slovenian bonds performed relatively well with spreads against the Bund practically unchanged, moving inside narrow range around 70bp, anchored by increased semi-core perception on strong macro/fiscal performance and proactive debt management policy. Risks are still pending, given US-China trade deal uncertainty, Italian political volatility and Brexit outcomes.

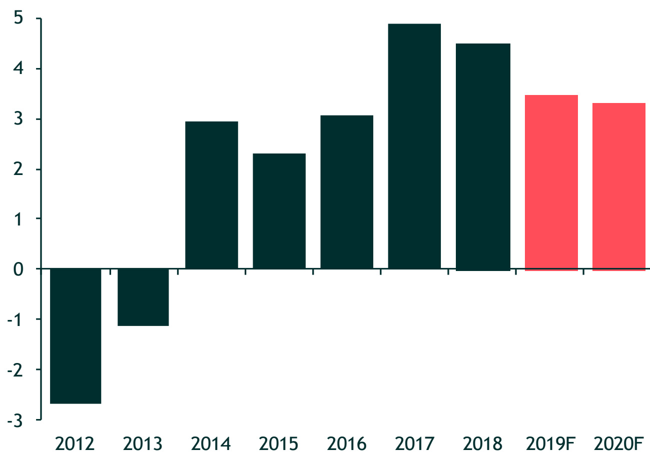


The end of QE does not hurt Slovenian bonds...

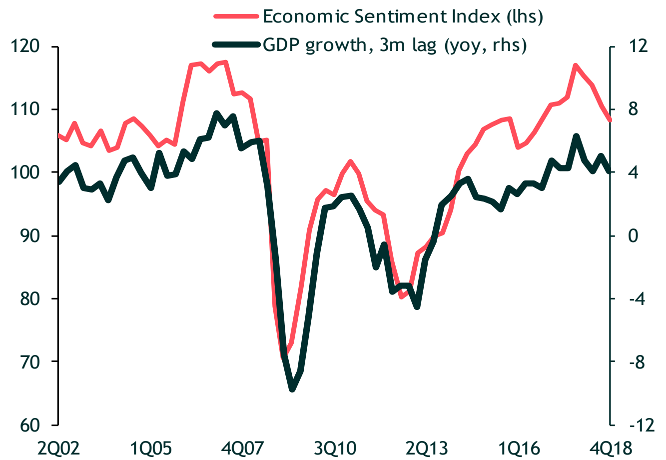
The recent downgrades in GDP growth and core inflation forecasts have seemingly locked the ECB's position by prolonging the accommodative policy stance and possibly delaying rate hikes beyond 2020. Although the QE programme formally ended, the ECB will continue its generous support through reinvestments of maturing bonds and new wave of TLTRO starting from September. While the terms for TLTRO III are yet to be defined, the most likely option assumes somewhat stricter conditions, possibly in the form of shorter maturity (2Y) combined with variable interest rates. Weaker than expected economic activity and constant setbacks in core inflation developments remain the main obstacle in the ECB policy normalisation path, with Italian fiscal risk also simmering in the background. In the worst case scenario the ECB can again turn to QE, adopt outright intervention in equity markets and/or abandon the capital-key for asset purchases. Otherwise, it should perhaps look beyond price stabilisation agenda and consider the side effects of lower-for-longer interest rates policy i.e. potential real-estate/debt bubble. Nevertheless, Slovenia's base case remains strong, leveraging on solid macro/fiscal performance and favourable financing position amid lower funding needs in 2019-2020 and proactive asset/liability management. That said, euro zone momentum weakness in the next quarters might see modest (20bp) shrinking of Slovenian semi-core perceived spreads to 40-60bp range above the Bund. Beyond safe haven flows, positive risks for bond performance involve still much-above-EMU GDP growth, further privatisation proceedings, new ALM transactions, ensuing rating upgrades and faster public debt cut prospects. On the other hand, any significant deterioration in hitherto conservative fiscal agenda would have the reverse effect on policy efforts invested so far, and hence push the yields higher.

Slovenia's data trends

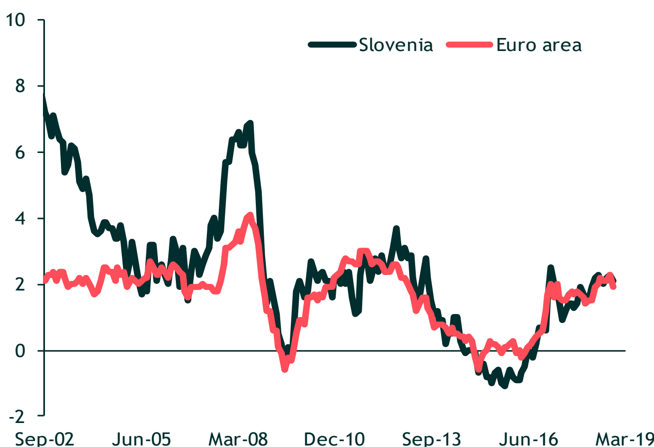
Real GDP growth (%, YoY)



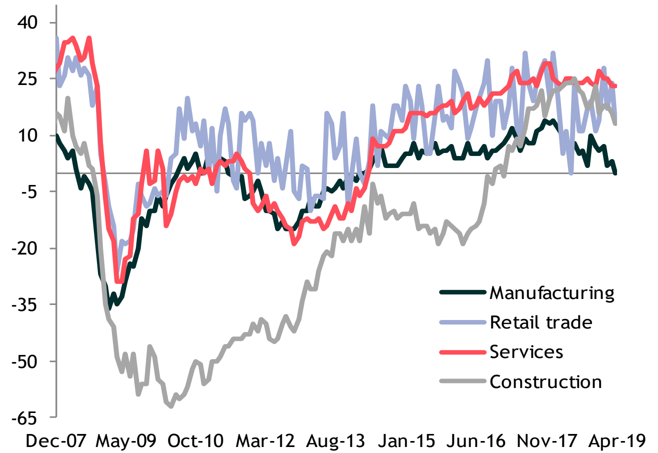
Economic confidence vs. GDP growth



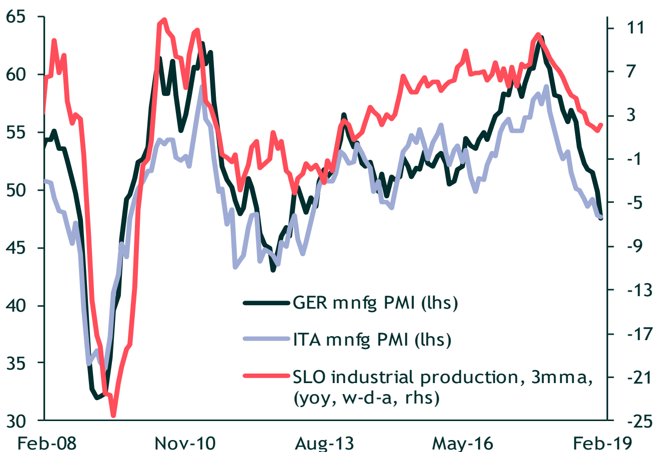
CPI inflation dynamics (% YoY)



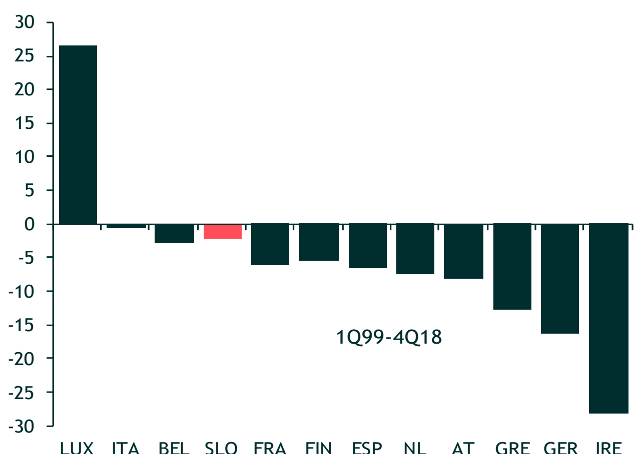
Business sentiment



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	2018	2019F	2020F
Activity									
Nominal GDP (EURbn, current prices)	36,1	36,2	37,6	38,9	40,4	43,0	45,9	48,2	50,2
Nominal GDP (USDbn)	46,4	48,1	50,0	43,1	44,7	48,6	54,3	55,4	60,3
GDP per capita (EUR)	17.538	17.592	18.244	18.839	19.551	20.814	22.240	23.318	24.295
GDP per capita (USD)	22.554	23.364	24.238	20.895	21.651	23.501	26.299	26.817	29.154
Real GDP (constant prices YoY, %)	-2,7	-1,1	3,0	2,3	3,1	4,9	4,5	3,5	2,6
Private consumption (YoY, %)	-2,4	-4,2	1,9	2,3	4,0	1,9	2,2	3,1	2,3
Fixed investment (YoY, %)	-8,8	3,2	1,0	-1,6	-3,7	10,7	10,6	6,8	5,0
Industrial production (YoY, %)	-0,8	-0,9	1,8	5,1	7,8	8,2	4,7	4,5	4,2
Unemployment rate (ILO, average %)	8,9	10,1	9,7	9,0	8,0	6,6	5,1	4,6	4,4
Prices									
CPI inflation (average % YoY)	2,6	1,8	0,2	-0,5	-0,1	1,4	1,7	1,4	1,6
CPI inflation (end-year % YoY)	2,7	0,7	0,1	-0,5	0,5	1,7	1,4	1,6	1,7
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)	0,1	-0,2	1,1	1,0	1,8	2,7	3,4	5,0	4,8
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-4,0	-14,7	-5,5	-2,8	-1,9	0,0	0,7	0,4	0,0
Public debt	53,8	70,4	80,4	82,6	78,7	74,1	70,1	66,4	63,3
Gross public funding needs	8,2	19,3	14,5	6,4	9,7	6,4	5,0	5,7	3,4
External balance									
Export of goods and services (EURbn)	26,363	27,010	28,520	29,975	31,478	35,737	39,171	40,839	42,779
Import of goods and services (EURbn)	24,934	24,569	25,641	26,569	27,690	31,457	34,874	36,886	38,855
Merchandise trade balance (EURbn)	-0,081	0,708	1,181	1,476	1,537	1,561	1,149	0,914	0,804
Merchandise trade balance (% of GDP)	-0,2	2,0	3,1	3,8	3,8	3,6	2,5	1,9	1,6
Tourism receipts (EURbn)	2,008	2,043	2,060	2,098	2,190	2,434	2,716	2,863	2,980
Current account balance (EURbn)	0,775	1,594	2,179	1,760	2,224	3,077	3,203	3,229	3,165
Current account balance (% of GDP)	2,1	4,4	5,8	4,5	5,5	7,2	7,0	6,7	6,3
Net FDI (EURbn)	0,5	0,0	0,6	1,3	0,9	0,4	1,1	1,4	1,5
FDI (% of GDP)	1,3	0,1	1,6	3,3	2,1	1,0	2,5	2,8	2,9
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	0,787	0,705	0,743	0,816	0,844	0,892
Import cover (months of imports)	0,3	0,3	0,4	0,4	0,3	0,3	0,3	0,3	0,3
Debt indicators									
Gross external debt (EURbn)	42,872	41,658	46,314	46,627	44,810	43,813	42,483	42,083	41,883
Government (EURbn)	11,092	15,459	22,416	24,824	22,953	21,769	20,726	20,523	20,423
Private (EURbn)	25,709	23,457	21,815	19,587	18,400	18,224	18,196	18,061	18,161
Gross external debt (% of GDP)	118,8	115,0	123,2	120,0	111,0	101,9	92,5	87,3	83,4
Gross external debt (% of exports)	162,6	154,2	162,4	155,6	142,4	122,6	108,5	103,0	97,9
Exchange rates and money growth									
EUR/USD (end-year)	1,32	1,38	1,21	1,09	1,05	1,19	1,15	1,20	1,24
EUR/USD (average)	1,29	1,33	1,33	1,11	1,11	1,13	1,18	1,15	1,20
Money supply M1 (% YoY)	4,4	0,1	18,5	24,9	18,7	14,4	12,3	10,8	9,7
Broad money M3 (% YoY)	-1,4	-1,3	6,1	4,6	8,3	6,6	8,0	6,2	5,5
Domestic credit (% YoY)	-3,9	-12,4	-11,0	-6,8	-1,6	2,0	0,9	3,3	2,9
ECB reference rate (end-year %)	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,00	0,00
EURIBOR 3M interest rate (average %)	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,32	-0,29
SLO 5Y yield (average %)	4,55	4,96	2,07	1,64	0,68	0,36	0,38	0,20	0,50
SLO 10Y yield (average %)	6,01	6,09	3,21	1,67	0,82	1,12	0,96	0,76	1,10

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	2018	2019F	2020F
Balance sheet									
Assets (EURm)	50.787	46.315	43.575	41.603	40.191	40.447	40.630	41.163	41.582
Assets (%, YoY)	-3,1	-8,8	-5,9	-4,5	-3,4	0,6	0,5	1,3	1,0
Assets (% of GDP)	140,8	127,8	115,9	107,0	99,6	94,1	88,4	85,4	82,8
Gross loans (EURm)	39.869	34.944	31.101	28.976	28.507	29.080	29.331	30.304	31.183
Gross loans (%, YoY)	-3,9	-12,4	-11,0	-6,8	-1,6	2,0	0,9	3,3	2,9
Gross loans (% of GDP)	110,5	96,4	82,7	74,6	70,6	67,6	63,8	62,9	62,1
Deposits (EURm)	24.729	23.469	25.573	26.292	27.098	28.527	29.750	30.985	32.229
Deposits (%, YoY)	-2,6	-5,1	9,0	2,8	3,1	5,3	4,3	4,1	4,0
Deposits (% of GDP)	68,5	64,8	68,0	67,7	67,1	66,3	64,7	64,3	64,1
Loan-to-deposit ratio (%)	161,2	148,9	121,6	110,2	105,2	101,9	98,6	97,8	96,8
Capital adequacy ratio (%)	11,9	14,0	19,3	20,8	20,8	19,8	19,8	20,1	20,3
Performance									
Net interest income (EURm)	886	708	832	746	670	652	672	683	694
Net interest income (%, YoY)	-12,9	-20,1	17,5	-10,4	-10,1	-2,7	3,0	1,7	1,6
Total operating income (EURm)	1.566	1.091	1.231	1.158	1.127	1.074	1.154	1.174	1.232
Total operating income (%, YoY)	8,2	-30,3	12,8	-6,0	-2,6	-4,7	7,4	1,8	5,0
Pre-provision profit (EURm)	823	370	544	472	460	401	488	507	570
Pre-provision profit (%, YoY)	22,8	-55,0	47,0	-13,3	-2,5	-12,9	21,9	3,9	12,4
Provision charges (EURm)	1.599	3.809	650	313	96	-43	-48	-30	15
Profitability and efficiency									
Net interest margin (%)	1,7	1,5	1,9	1,8	1,6	1,6	1,7	1,7	1,7
Pre-tax ROAA (%)	-1,5	-7,1	-0,2	0,4	0,9	1,1	1,3	1,3	1,3
Pre-tax ROAE (%)	-19,3	-88,2	-2,5	3,4	7,6	9,1	10,9	11,0	11,3
Cost-to-income ratio (%)	47,4	66,1	55,8	59,3	59,2	62,7	58,0	56,8	53,7
Operating expense (% of assets)	1,4	1,5	1,5	1,6	1,6	1,7	1,7	1,6	1,6
Credit quality and provisioning									
NPL ratio (%)	n/a	n/a	n/a	16,3	11,6	8,4	5,6	5,0	4,7
NPL coverage (%)	n/a	n/a	n/a	54,3	57,3	57,3	54,4	53,9	53,8
Provision charges (% of loans)	3,9	10,2	2,0	1,0	0,3	-0,1	-0,2	-0,1	0,1
Provision charges (% of PPP)	194,3	1.029,2	119,5	66,4	20,9	-10,7	-9,8	-5,9	2,7

Source: BSI, Addiko research

Credit activity driven by retail sector

Credit activity displayed 0.9% yoy growth in 2018 with private sector resuming its steady upward trend, largely offset by substantially lower public sector loans (-12.2% yoy). Retail loans increased 6.5% yoy driven by higher both consumer and housing credit, on the wings of strong economic growth, improved labour market conditions and persistently low interest rates. Corporate loans remained in the negative territory, though the pace of deceleration seems to be fading (-0.4% yoy), suggesting the long awaited recovery going forth. At the same time, deposit growth decelerated to 4.3% yoy as corporate deposits growth almost halved (6.0% yoy), while retail deposits gained more pace with 6.6% yoy growth, reflecting traditionally strong savings propensity of Slovenian households, at odds with the current low interest rates environment. Regarding profits, NII increased by 3.0% yoy as interest income recovered by modest 1.1%, followed by 10.1% yoy lower funding costs. Together with higher non-interest income and release of loan loss provisions, the banking sector recorded strong 20.0% yoy growth in pre-tax profit, amounting to EUR532m.

Economic prospects remain supportive of credit activity

Looking ahead, in 2019 we expect credit growth accelerating towards 3.3% driven stronger lending activity in the private sector. Our viewpoint remains supported by solid investment outlook which should reflect in modest corporate loans recovery, 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 (5.6%, -2.8pp yoy), we expect limited decline potential going forth, mainly on the account of still relatively high NPL ration in the corporate sector (13.1%), while the new lending cycle could increase pressures on credit quality in the medium term. We see deposit collection moderating towards 4.1% in 2019, owing to high base effects and stronger capex needs, in the environment of persistently low interest rates. On profitability, in 2019 we expect similar profit levels, with contained opex and provisioning costs.

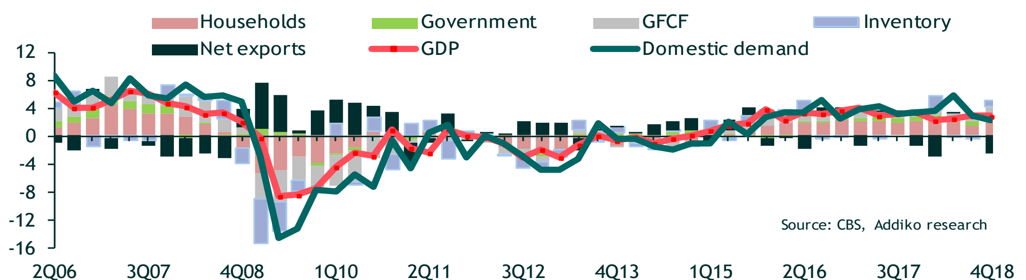
Investment Grade Again

We lowered 2019 GDP growth forecast to 2.5% mainly due to deteriorating external demand, partially offset by solid tourism and private consumption trend, with stronger investments dynamics. The budget remains in small surplus, with public debt on steady downward trajectory, falling faster than required by the EU rules. We remain constructive on Croatian credit given sound fiscal performance, increased policy coherence and structural reform orientation under the ERM II mechanism, economic restructuring under Agrokor operating reshuffle and further improvement in external position.

Stronger domestic demand against external demand woes

The growth slowed in 4Q18 (2.3% yoy) amid foreign demand woes, industry slump (exacerbated by shipyards and energy generation amid warm weather and Sisak refinery maintenance) plus soaring consumer goods imports. Thankfully, temporary and 'welcome' shocks (troubled firms' downsizing, maintenances) improve resources allocation in the future. Moreover, productivity rose 1% yoy in Q4 as manufacturing jobs fell 2.5% yoy. Consumer spending (+3.9% yoy) exceeded expectations, driven by employment growth, tourist-related consumption, re-leveraging and stronger sentiment in response to tax cuts for 2019. Also positively, investments picked up 6.1% yoy on soaring EU funding (doubling in 2018 vs. 2017) as well as construction output. For the FY18, GDP expanded by 2.6% after 2.9% in 2017. After a poor Q4, sentiment gauges point to 2.5%+ GDP growth in 1Q19 as stronger private consumption, capex and industrial output offset weaker external demand and later Easter impact on tourist season.

Croatia: contributions to GDP (pps)



Source: CBS, Addiko research

We downgrade 2019 outlook, watching downside risks

We cut 2019 GDP forecast by 0.5pp to 2.5% on deteriorating external (EU) demand, slightly negative inventory contribution and lower 4Q18 carry-over. While tourism (export) growth continues on investment in hotels and infrastructure, we expect the growing Mediterranean competition will limit dynamics. Encouragingly, domestic demand will again smooth the slowdown as resilient 3%-alike private consumption growth is sustained by improving labour markets (both hiring and wages), stronger retail credit, VAT cuts, low inflation and rising remittances. We see stronger investment on soaring (public) construction activity and EU funding, firms' record profits and re-leveraging in response to cheaper funding, red tape cuts (HRK2.5bn), accelerated Agrokor's operating restructuring, and upgrades to investment grade (starting with S&P) now that Croatia no longer faces EC-monitored excessive imbalances. The key signposts for business climate and durable 2.5%+ GDP growth involve further tax and red tape cuts, labour, entitlement and education reforms, and accelerated intangible investment (e.g. digital economy), particularly important for productivity. Risks to our baseline are skewed on the downside given the euro zone downturn, market volatility, corporate de-leveraging, tourism undershooting, bank unfriendly policy-making, and in the medium term labour shortages given the emigration of the young and population aging. Upside risks involve EU funding, fiscal easing ahead of 2019-20 elections, and rating upgrades as the economy proves resilient in deteriorating external environment and presses on with the ERM II agenda.

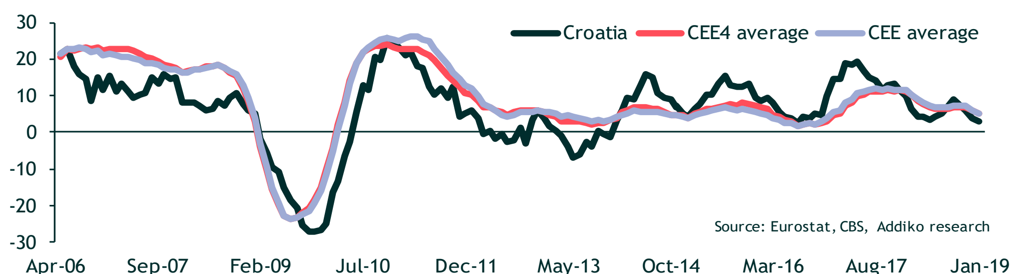
Inflation even lower

Inflation has surprised on the downside on much weaker-than-expected seasonal food inflation, in the afterglow of VAT cuts on some food prices and other alimentaries, lower oil prices and longer clothes sales. In our view, food price cuts have only brought grist to the mill when it comes to fierce rivalry in retail trade in non-food categories as well via growing power of hard-discounters, in-fighting for Agrokor's (once high-margin) retail space and the growing online retailers' price signals to brick-and-mortar stores. On top of aforementioned, anaemic imported inflation has and will reflect more intense international price competition and concerns over economic downturn. We expect higher labour force participation and some pension/labour market reform to weigh against the build-up of wage pressures going forth. Barring a sharp recovery in oil, we see average inflation for 2019 around 2019 after 1.5% in 2018.

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

Following a sharp downturn in the euro zone's PMI indices, we reduce our goods export forecast for 2019 to similar low-single-digit pace as in 2018. But even then we expect further integration into EU supply chains, decent domestic demand across the EU markets and low exposure to trade outside EU will partly insulate Croatia from external drags. Nevertheless, strong consumer demand, firmer capex and healthy credit recovery lead to stronger imports as well, higher goods trade deficit (~19.5% of GDP) and alongside soaring dividend outflows C/A surplus moderation. Despite apparent erosion, C/A surplus around 2% of GDP in 2019-2020 stays supported by EU funding, large services surplus and non-resident remittances. 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 inflows will continue to strengthen the country’s net international investment position toward -50% of GDP in 2019 from -71% in 2016.

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



CNB easing for longer as ECB turns more dovish

With additional ECB easing looming in the face of downside risks to growth/inflation, we see the CNB in easing mode largely via FX transactions (EUR1.4bn in four months), targeting excessive kuna liquidity at 8%+ of GDP. Having ended its QE program the ECB came up with another forward guidance extension into 2020 and new TLTROs. Ample monetary support is combined with 5Y+ REPO auctions close to sovereign debt costs, medium-term MREL-eligible kuna bonds in pipeline and banks' de-risking, which alongside solid macro picture and bank competition drives interest rates to new lows and supports private-sector re-leveraging. Mandatory reserve cuts would also fit well into Croatia's ERM II bid, for which (including less stringent views in other regulations) the likelihood is rising as Croatia improves its sovereign rating to investment grade territory. While citizens' exposure to variable interest rate and FX risks and the systemic vulnerability (solvency, liquidity, snowball effect risks) is reduced, the CNB still launched stricter rules for unsecured cash loans with ≥5Y maturity by simply aligning criteria with long-term housing loan approvals. Given the CNB's track record in prudential curbing of excessive credit, stricter standards for debt-to-income and maturity limits hardly come as a surprise as banks intensified competition in high-margin 10Y+ unsecured segment where risk assessment appears vague. Thankfully, the ECB may rather lean towards dovishness, and the CNB has ample liquidity arsenal (incl. REPO capacity) to support bank lending for many years to come. Risk-wise, lower external vulnerabilities, fiscal healing and stable kuna allow the CNB easing. As ever, banks need clear rules for NPL resolution, capital hike platforms and faster firm insolvency mechanism to anchor risk costs and help monetary transmission.

Stable EUR/HRK despite appreciation pressures

Despite appreciation pressures driven by ample FC liquidity from the past record tourist season and MinFin's sizeable (re)financing operations, Croatian kuna missed a typical early-year rally as the EUR/HRK stayed above 7.40. This largely reflects soaring non-resident dividend outflow (~2.5x higher yoy, driven by banks), banks' nervousness ahead of the Supreme Court's ruling in variable interest rate cases, deteriorating goods import cover and late Easter (i.e. tourist pre-season). Short-end kuna rates stay close to record lows amid record interbank excessive liquidity at HRK34bn (~HRK10bn over 2018 average), monetary easing and steady kuna outlook. Fairly dovish Fed/ECB rhetoric with growing expectations of the next Fed's move being a cut, combined with low EM net issuance, has encouraged strong bond funds inflows as well as EM spreads compression. Croatian bonds outperformed as S&P lifted Croatian rating to 'BBB-' on better fiscal/external metrics alongside stable growth outlook and ERM II bid prospects.

After non-resident dividend payout, we see stronger kuna with composite investment grade rating around the corner (Fitch 7/6), timely ERM II June application, prospects of IG bond indices’’ inclusion and in turn stronger demand for Croatian assets. Real flows i.e. record tourist FC inflows, soaring EU funding and remittances to underpin the kuna as well. Meanwhile, lower goods import cover and banks’ guessing potentially multi-billion-kuna provisioning needs for CHF variable interest rate cases cap the cross’ downside. We'd also watch the new euro benchmark prospects after re-rating actions in that the new Eurobond may revive institutional bid as local pension funds always buy into foreign issuances. That said, we see the EUR/HRK inside 7.25-7.40 in the next quarters before stabilizing above 7.40 thereafter. Ahead of ERM II entry in mid-2020 (in our view), appreciation pressures may more often run into bids from the CNB due to its competitiveness considerations.

Croatia: 5Y CDS spread and EUR/HRK

Croatian bond performance supported by re-rating prospects

Notwithstanding accelerated banks' new disbursements, we expect the CNB's ultra-easy stance and stable/stronger kuna to keep short-end rates close to record lows. With many banks' LDR below 100%, new loan (kuna) disbursements are still too low to push MM rates materially higher. Moreover, cash-based budget surplus suggests weak MinFin bid at T-bill auctions. With domestic bond sales for 2019 completed, further rating upgrade(s) and sound prefunding options on the Eurobond markets, Croatian spreads may still tighten a bit. Our bullish near-term outlook assumes sound fiscal performance, including faster debt cuts than required by the Maastricht 1/20th rule, economic restructure under Agrokor operating reshuffle, increased policy coherence and structural reform orientation under the ERM II mechanism, and further improvement in external position. Despite poor Italian fiscal matrix and rating uncertainty, we expect the growing skewness of consensus (main) central bank forecasts towards easing and constructive US-China trade deal to ensure benign financial conditions. The main risks for Croatian bonds stem from a global downturn and/or financial markets volatility during the local 2019-2020 election cycle when strong spending hikes (and reversal of some reforms) would result in higher borrowing costs and in turn partly crowd out the positive impact of fiscal stimulus on aggregate demand.

Fiscal consolidation continues faster-than-expected...

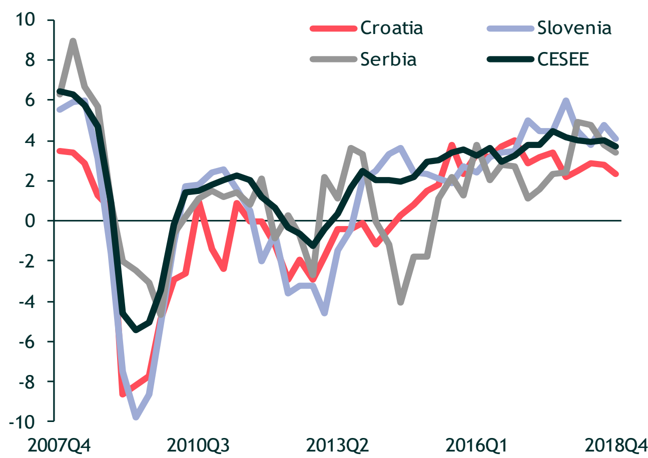
Fiscal situation stays favourable with another consolidated budget surplus (~0.2% of GDP) thanks to cyclically higher tax revenues, interest bill savings and positive impact from tax reforms on growth. There could have been much better result (surplus of 1%+ of GDP) had the MinFin did not book guarantees for Uljanik shipyard (HRK4.5bn/1.2% of GDP, o/w HRK3.1bn actually paid) according to ESA 2010 rules. While current spending picks up at 5.5% yoy this year, some HRK3bn tax cuts provisionally cap tax growth at 1.5% and public capex accelerates, we see net EU inflows (~3% of GDP) and hitherto 'policy' of tax growth underestimation to help the budget stay close to balance. While ample fiscal space makes election-driven spending in demographic and investment areas tempting, and GDP growth moderation may lead to tax revenue undershooting, we still expect stricter compliance to legal spending rules under ERM II agenda. The Fiscal Responsibility Act importantly targets a structural budget balance. That said, Croatia is more successful than many CESEE peers in public wage containment, and we understand the cabinet wants to avoid contingent liabilities after troubled state-aided firms' restructuring. Since Croatia is contemplating new VAT cuts on a broader set of food products, etc. and the cycle is slowing, it would be smart to combine any fiscal easing with at least some entitlement reforms (e.g. new public wage system). With stable primary surplus (2.5% of GDP), 3.5% average nominal growth and lower interest bill amid rating upgrades and SOEs' debt restructuring, we see public debt down to 67% of GDP in 2020, still falling faster than required by the Maastricht 1/20th rule.

... stronger expectations management needed ahead of elections

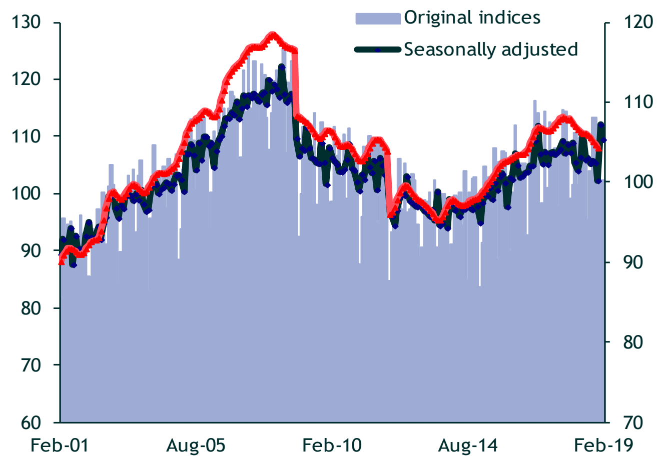
While Croatia no longer has excessive macroeconomic imbalances due to fiscal healing, pension reforms, tax/red tape cuts and services sector liberalization, the focus of the last EC's report is on low productivity and growth potential. In that vein, policy priorities include public sector and entitlement reforms and stronger alignment of higher education with the labour market's needs. Performance and job complexity criteria in public wages are steps in the right direction, but the actual reform proposal fails to quantify savings (public wage bill 11% of GDP) and does not tackle fragmentation as the key obstacle to public sector's efficiency and transparent processes. Initial efforts in hospital network rationalization and procurement are also good news but the key issue of old healthcare debt (2% of GDP) resolution remains open. While HRK2.5bn worth parafiscal fees cuts are due this year, the big-ticket issue of legal tariffs remains untouchable. High fragmentation across the local government and poor co-ordination in social security in fact raise issues of rent-seeking and poorly-targeted social assistance, respectively. Outside the EC report, political volatility hampers structural reforms as evidenced by referendum initiative against pension reforms. All said, spending containment has to be aligned by convincing growth enablers: flexible labour, product and service markets, ongoing tax and red tape cuts (partly funded by asset/sales taxes), and empowering the credit channel with incentives for NPL workouts, equity raising and faster insolvency process. Lastly, sovereign asset-liability operations do not assume only cheaper funds and privatization, but also SOEs operational benchmarking and profits crucial in state guarantee-free capex financing. The main aim is 3-3.5% primary surplus as Croatia pays 0.7pp above CEE average and wants to ensure durable risk premium and public debt reduction to 60% of GDP in 2023, i.e. targeted euro zone entry.

Croatia's data trends

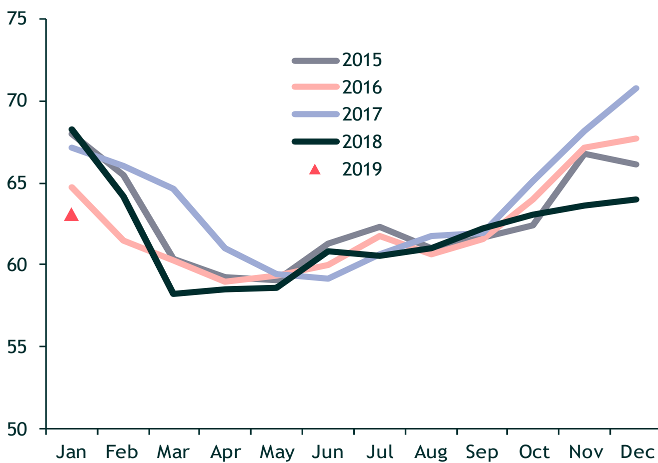
CRO growth in line with CESEE



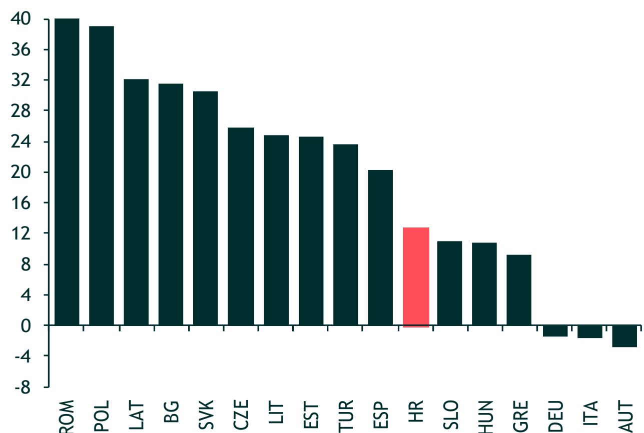
Industrial production (2015=100)



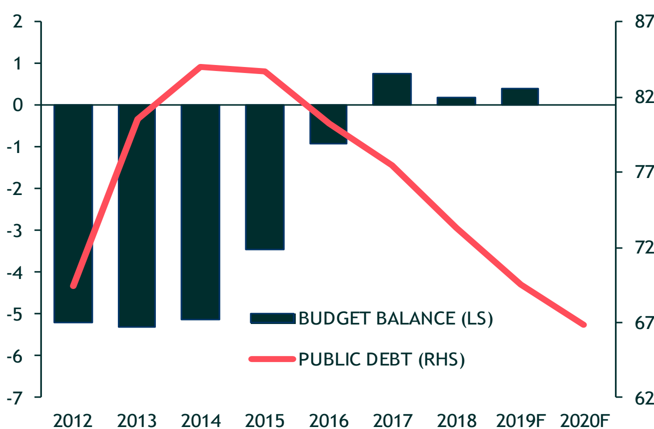
Merchandise trade import cover on 3mma basis



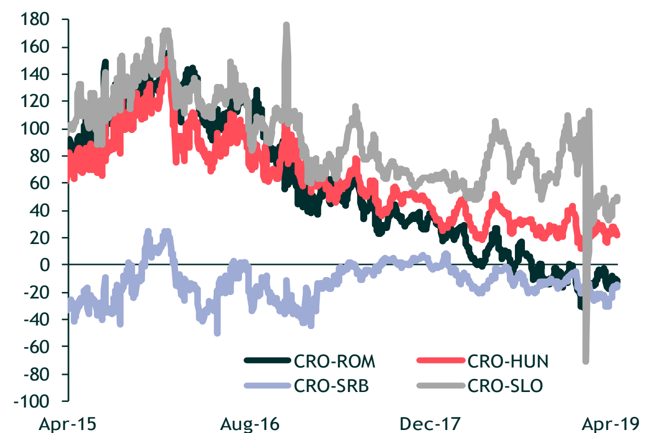
Change in export shares (2020F-2010, %)



Budget balance and public debt (% of 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	2018	2019F	2020F
Activity									
Nominal GDP (HRKbn, current prices)	330,8	331,8	331,6	339,6	351,3	365,6	381,8	394,4	412,2
Nominal GDP (EURbn)	44,0	43,8	43,5	44,6	46,7	49,0	51,5	53,5	56,1
Nominal GDP (USDbn)	56,5	58,1	57,7	49,5	51,6	55,2	60,8	61,5	67,3
GDP per capita (EUR)	10.311	10.293	10.254	10.616	11.180	11.882	12.594	13.139	13.847
GDP per capita (USD)	13.233	13.663	13.608	11.772	12.372	13.385	14.872	15.111	16.616
Real GDP (constant prices YoY, %)	-2,3	-0,1	-0,1	2,3	3,5	2,9	2,6	2,5	2,8
Private consumption (YoY, %)	-3,0	-1,9	-1,6	1,0	3,4	3,6	3,5	3,0	2,8
Fixed investment (YoY, %)	-3,3	1,4	-2,8	3,8	6,5	3,8	4,1	6,3	6,0
Industrial production (YoY, %)	-5,4	-1,7	1,1	2,6	5,0	1,9	-1,0	2,4	2,7
Unemployment rate (ILO, average %)	16,6	17,3	17,3	16,3	13,1	11,2	8,4	7,8	7,3
Prices									
CPI inflation (average % YoY)	3,4	2,2	-0,2	-0,5	-1,1	1,1	1,5	0,5	1,4
CPI inflation (end-year % YoY)	4,7	0,3	-0,5	-0,6	0,2	1,2	0,8	1,2	1,2
PPI inflation (average % YoY)	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,3	2,1	2,3
Net wage rates (% YoY, nom., €)	-0,4	-0,1	-0,4	1,5	3,0	4,9	5,5	4,6	4,5
Fiscal balance (% of GDP)									
State budget balance	-5,2	-5,3	-5,1	-3,2	-1,0	0,8	0,2	0,4	0,0
Public debt	69,4	80,5	84,0	83,7	80,5	77,8	74,6	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	18,767	19,677	21,473	22,785	25,143	26,590	28,083	29,176
Import of goods and services (EURbn)	18,126	18,601	18,855	20,448	21,462	24,070	26,038	27,980	29,149
Merchandise trade balance (EURbn)	-6,296	-6,587	-6,512	-6,974	-7,385	-8,254	-9,274	-10,284	-11,086
Merchandise trade balance (% of GDP)	-14,3	-15,0	-15,0	-15,6	-15,8	-16,8	-18,0	-19,2	-19,8
Tourism receipts (EURbn)	6,859	7,203	7,402	7,962	8,635	9,493	10,097	10,656	11,029
Current account balance (EURbn)	-0,050	0,414	0,858	2,020	1,205	1,795	1,354	1,030	1,043
Current account balance (% of GDP)	-0,1	0,9	2,0	4,5	2,6	3,7	2,6	1,9	1,9
Net FDI (EURbn)	1,2	0,9	0,7	0,2	1,9	1,2	0,7	1,9	2,0
FDI (% of GDP)	2,8	1,9	1,6	0,5	4,2	2,4	1,3	3,6	3,5
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	40,247	39,037	38,671	39,456
Government (EURbn)	12,705	14,647	15,841	18,049	16,253	16,504	15,905	15,338	16,017
Private (EURbn)	32,592	31,157	30,575	27,335	25,415	23,742	23,132	23,333	23,439
Gross external debt (% of GDP)	102,9	104,6	106,8	101,7	89,3	82,1	75,8	72,3	70,4
Gross external debt (% of exports)	247,3	244,1	235,9	211,4	182,9	160,1	146,8	137,7	135,2
Exchange rates and money growth									
USD/HRK (end-year)	5,73	5,55	6,30	6,99	7,17	6,27	6,47	6,17	5,95
USD/HRK (average)	5,85	5,71	5,75	6,86	6,80	6,62	6,28	6,41	6,13
EUR/HRK (end-year)	7,55	7,64	7,66	7,64	7,56	7,51	7,42	7,40	7,38
EUR/HRK (average)	7,52	7,57	7,63	7,61	7,53	7,46	7,41	7,38	7,35
Money supply M1 (% YoY)	0,9	11,5	9,6	11,4	18,2	19,1	20,7	16,6	12,9
Broad money M4 (% YoY)	3,6	4,0	3,2	5,2	4,7	2,1	5,5	4,6	4,4
Domestic credit (% YoY, euros)	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	3,6	3,8	3,6
ZIBOR 3M interest rate (average %)	3,55	1,54	0,99	1,27	0,90	0,65	0,43	0,30	0,40
HRK 1Y yield (average %)	3,93	2,54	1,86	1,50	0,96	0,43	0,09	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	2018	2019F	2020F
Balance sheet									
Assets (EURm)	54.395	54.338	54.719	54.536	54.689	54.416	57.165	59.120	61.170
Assets (%, YoY)	-1,7	-0,1	0,7	-0,3	0,3	-0,5	5,1	3,4	3,5
Assets (% of GDP)	123,6	124,0	125,9	122,2	117,2	111,0	111,0	110,6	109,1
Gross loans (EURm)	37.678	37.543	36.561	35.941	34.125	32.706	33.871	35.167	36.429
Gross loans (%, YoY)	-2,6	-0,4	-2,6	-1,7	-5,1	-4,2	3,6	3,8	3,6
Gross loans (% of GDP)	85,6	85,7	84,1	80,5	73,1	66,7	65,8	65,8	65,0
Deposits (EURm)	30.087	30.959	31.874	33.660	35.237	36.355	38.920	41.134	43.165
Deposits (%, YoY)	2,7	2,9	3,0	5,6	4,7	3,2	7,1	5,7	4,9
Deposits (% of GDP)	68,4	70,7	73,3	75,4	75,5	74,2	75,6	76,9	77,0
Loan-to-deposit ratio (%)	125,2	121,3	114,7	106,8	96,8	90,0	87,0	85,5	84,4
Capital adequacy ratio (%)	20,9	21,0	21,8	20,9	23,0	23,8	22,9	22,4	21,7
Performance									
Net interest income (EURm)	1.449	1.359	1.365	1.405	1.462	1.487	1.350	1.383	1.407
Net interest income (%, YoY)	-10,3	-6,2	0,4	2,9	4,1	1,7	-9,2	2,5	1,7
Total operating income (EURm)	2.103	2.023	2.029	2.054	2.326	2.273	2.109	2.139	2.189
Total operating income (%, YoY)	-8,8	-3,8	0,3	1,2	13,2	-2,3	-7,2	1,4	2,3
Pre-provision profit (EURm)	972	918	933	920	1.183	1.141	1.034	1.035	1.046
Pre-provision profit (%, YoY)	-13,7	-5,6	1,6	-1,4	28,6	-3,6	-9,4	0,1	1,1
Provision charges (EURm)	501	821	705	1.573	381	610	277	242	233
Profitability and efficiency									
Net interest margin (%)	2,6	2,5	2,5	2,6	2,7	2,7	2,4	2,3	2,3
Pre-tax ROAA (%)	0,9	0,2	0,5	-1,2	1,5	1,0	1,4	1,4	1,4
Pre-tax ROAE (%)	6,2	1,3	3,8	-9,3	11,8	7,0	9,8	10,1	10,4
Cost-to-income ratio (%)	53,8	54,6	54,0	55,2	49,1	49,8	51,0	51,6	52,2
Operating expense (% of assets)	2,1	2,0	2,0	2,1	2,1	2,1	1,9	1,9	1,9
Credit quality and provisioning									
NPL ratio (%)	13,9	15,7	17,1	16,7	13,8	11,3	9,8	8,9	8,2
NPL coverage (%)	42,6	46,2	51,3	56,9	63,7	61,5	59,4	58,9	57,9
Provision charges (% of loans)	1,3	2,2	1,9	4,3	1,1	1,8	0,8	0,7	0,7
Provision charges (% of PPP)	51,5	89,4	75,5	171,0	32,2	53,5	26,8	23,4	22,2

Source: CNB, Addiko research

Recovery of credit activity

After long de-leveraging stream, the overall credit activity finally recovered manifesting 3.6% yoy growth, driven by increased borrowing of the private sector, with the public sector also contributing positively (3.1% yoy). The strongest positive contribution to credit growth came from 5.9% yoy 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 eked-out modest 0.2% yoy growth, leveraging on higher firms' profits and easier credit standards, particularly in the SME segment. At the same time deposits jumped 7.1% yoy owing to strong collection in the retail segment (5.6% yoy), followed by strong contribution from corporate clients (8.5% yoy). Regarding profits, NII decreased 9.2% yoy since substantially lower funding costs (-51.4% yoy) proved insufficient to compensate for interest income slump (-20.3% yoy). Nonetheless, pre-tax profit recorded 43.8% yoy growth, boosted by lower loan loss provisions (-54.6% yoy).

Credit growth remains strong

In 2019 we expect credit recovery to continue at 3.8%-alike yoy pace, driven by both retail and corporate sector. We see corporate credit growth picking-up on improved investment prospects, soaring construction activity and higher EU funding. Despite stronger labour market and private consumption prospects, we expect slight moderation in retail credit growth mostly on the account of new CNB measures aimed at mitigating potential risks arising from booming unsecured long-term cash loans, which have so far led the credit recovery of the retail segment. These imply new stricter rules for non-purpose cash loans applications with ≥5Y maturity, just as in case of housing loans approvals. We see deposit growth moderating towards 5.7%, mostly owing to low interest rates, though growth remains supported by improved labour market outlook and rising wages, with continued strong contribution from tourism and remittances inflows. Regarding profits, we expect more moderate profit increase supported by new lending cycle, though strong bank competition will keep margins under pressure.

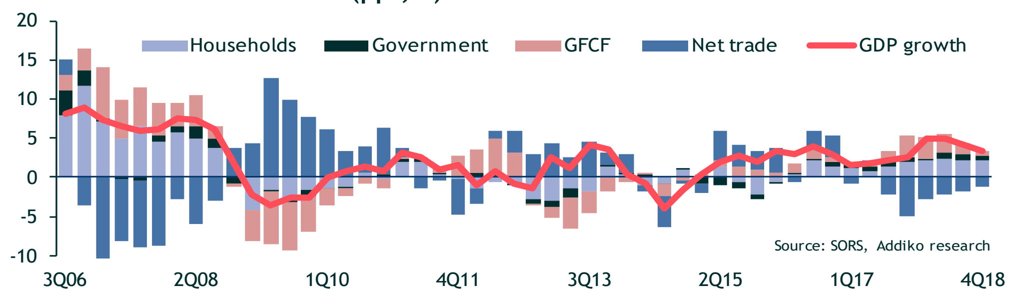
Steady Growth and Later Tightening

We cut 2019 GDP growth forecast to 3.0% owing to foreign demand concerns, though growth remains underpinned by strong private consumption and steady investments trend. In 2019 we expect a balanced budget on steady public capex growth and entitlement spending, while strong nominal growth, solid primary surplus, cheaper debt service and firm dinar will bring public debt to just above 50% of GDP. Following extended ECB/Fed dovishness, renewed RSD appreciation pressures and domestic inflation undershooting, we see room for the NBS' rate cut in Q3 and/or long-awaited reduction of the RSD part of mandatory reserves. Long-term dinar yields have some downside potential due to ongoing fiscal discipline, lower amortization and improved sovereign rating-relevant indicators.

Steady domestic demand offsets external weakness

While GDP growth slowed a bit further in Q4 (3.4% yoy), we find the breakdown encouraging: both private consumption and exports. Moreover, the FY18 expansion stood at 4.3%, the strongest pace in ten years and in line with CESEE average. As before, the main driver in Q4 private consumption was buoyed by faster wage and re-leveraging dynamics, and remittances on top of steady private job creation (4%+ yoy). Among factors behind the slowdown we see poorer industrial output (-1.5% yoy) amid energy/mining outages, and slower investment growth in response to uncertain external outlook (2019) and from a high base. Despite faster 10.5% yoy export growth, net trade contributed negatively amid stubborn import pressures (a flip side of soaring demand). While foreign demand and industrial output slumped (car manufacturing!), steady consumption and investment, sizable fiscal stimulus to households and new FDI-driven export capacity support GDP growth at 2.5-3% yoy in 1H19, in our view.

Serbia: contributions to GDP (pps, %)



Domestic demand stays growth's key underpin

We cut 2019 GDP growth forecast to 3.0% on foreign demand concerns amid still-strong imports (i.e. another -2pp net trade contribution) and the genuine mining and energy output slump. The slowdown also reflects the removal of positive one-offs such as the above-average harvest, inventory build-up and base effect caused by 1H17 energy outages. Notwithstanding that, our 2019 GDP projection is underpinned by even stronger domestic demand and private consumption in particular, thanks to higher wages/pensions, record remittances, employment gains and re-leveraging. While slower than originally expected, amid less acute needs for equipment acquisition, steady investment growth has legs on industrial FDI, state-sponsored EUR2.5bn railway/road construction and energy projects, real estate development, high firms' profits, cheap funding and corporate tax cuts. In common to both growth pillars, fiscal space, SOE reforms and infrastructure capex pose the main upside risks, ahead of any fiscal concerns. As everywhere, risks to our baseline are a bit more on the downside in the case of even more severe euro zone downturn and negative EM sentiment in its impact on funding conditions and FDI. More negative inventory contribution won't be unusual when export markets are wobbly. Last but not least, we are monitoring whether the recent operating problems in mining, electricity output stoppages and spill over across industries continue, since this may produce 0.5-1pp negative influence on the overall 2019 growth, just as it did in 2017.

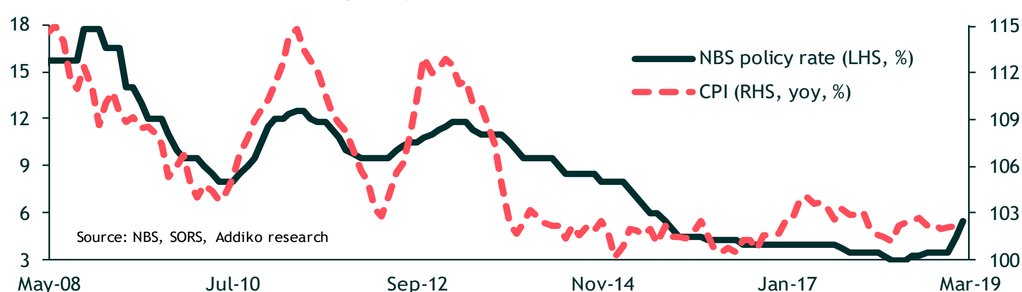
Inflation downside again?

Despite soaring vegetable prices, headline inflation stays within the lower part of the 3.5%+/-1.5pp NBS' target band amid subdued import prices, stronger local retailers' rivalry after Lidl's entry and stable RSD. The aforementioned factors' persistence, coupled by high base effects (vegetables, fuel) and lower than assumed administrative prices due to sound fiscal situation, will in our view dump inflation to (or slightly below) 1.5% in Q3, leaving the NBS target very sensitive to downside surprises in import inflation and agriculture prices and the RSD strength. Also, we expect Serbian inflation development below that of many CESEE peers, which bodes well for price competitiveness. If any, upside risks stem from stronger domestic demand, fiscal expansion and soaring wages, which have though failed to move core inflation much above 1%. We see the average 2019 CPI at 2.0%, with the risks to the projection slightly skewed to the downside, especially in the absence of food prices supply-side shocks. We also reduce 2020 CPI forecast to 2.4% on account of lower assumptions for Brent oil and import prices.

External position continues to improve

While we tempered external demand outlook embedded in Serbian forecast, we still expect competitiveness and export market share gains, hefty export capacity build-up, and in particular robust agriculture and IT exports to support Serbian export growth to mid-to-high single digits. Cooling external demand alongside stronger consumer goods and elevated capex-related imports lead to 2019 C/A gap widening (~5.5% of GDP), before a normalization below 5% in 2020 as exports and remittances re-accelerate. Meanwhile, further industrial reallocations from abroad, few privatization projects, foreign retailers' expansion, other real estate projects and higher non-resident banks' profit are driving FDI to 6.5% of GDP. FDI over-financing, state external de-leveraging and portfolio inflows on policy-induced optimism support improvement in the net international investment position. Hefty FDI in tradable sectors accelerate Serbia's transition to investment, with export-led growth model targeting exports at CEE-alike 75-80% of GDP in five years in our view, and C/A gap reduction to 1-2% of GDP in the medium term.

Serbia: CPI inflation and NBS policy rate



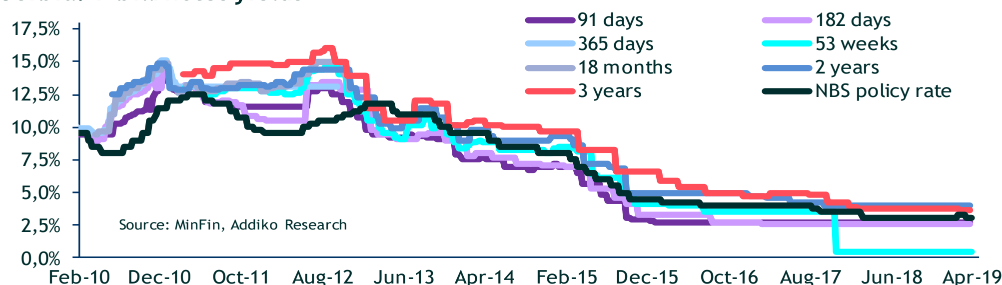
There is room for NBS' rate cut(s)...

Stably low inflation outlook, uncertain global backdrop (Fed/ECB policy, trade tensions, oil prices) and stable RSD left the NBS on hold. Also risk-relevant, Serbia continues to run budget surplus alongside flattish C/A deficit and the banking sector's de-risking. Most regional central banks are less likely to hike in the near future (e.g. NBP, NBR) after more dovish main central banks' rhetoric. While gradual reflation story stays intact, the NBS cut 2019 inflation forecast to 2.0%, and lowered the projected 2020 CPI path by more than 0.5pp, mainly due to lower fresh food and fuel prices (and substantial base effects) after much better harvest in 2018 and lower oil price assumptions. With the recent further ECB rates forward guidance extension (well) into 2020, re-pricing out of most Fed hikes, renewed appreciation pressures on the RSD and domestic inflation undershooting, we see room for the NBS' rate cut in Q3 and/or long-awaited reduction of the RSD part of mandatory reserves. As the current economic expansion is not much credit-driven, we see NBS rates unchanged through 2020 or at least some quarter(s) after the start of the ECB's own normalization process. Before any rate cuts, the NBS may want to see headline 'EM risk positive' news on US-China trade tensions, Brexit saga resolution and the key central banks' dovishness. Our baseline wouldn't work if the Fed/ECB hike faster/sooner to curb inflation, and EM spreads re-widen to halt capital outflows. Conversely, additional ECB easing with more explicit state-contingent guidance (linking policy rates to inflation outlook) may allow further NBS easing in any of the aforementioned forms.

... amid continued dinar's strength?

A brief EUR/RSD upward volatility owed to high energy imports at the turn of the year due to local electricity generation problems, foreigners' sales of RSD bonds (ahead of major RSD110bn redemption in February) and banks' FX purchases to meet IFRS 16 obligations. The cross finally appears breaking the lower bound of the 118-118.50 range as FX-linked bank lending resumed as a major theme in the local FX market as the NBS finally imposed less stringent measures to cap unsecured consumer credit. Dovish Fed/ECB rhetoric kept the wheels spinning for the carry-trade in favour of low-rated and long-dated EM assets, as US HY bonds also returned almost 5% to date. That said, despite some political volatility, Serbian bonds performed well as investors honour macro/fiscal fundamentals, sounder external position, re-rating prospects and attractive yield premium after having lagged the rallies in the rest of the CESEE universe.

Appreciation pressures might continue due to improved EMFX sentiment, ongoing decent FX-linked bank lending activity, resumption of non-residents' purchases of long-term RSD bonds and steady risk appetite thanks to dovish Fed, constructive US-China and IMF-Serbia news flow and M&A flows. Besides, the recent risk of snap elections is offset by opinion polls showing President Vucic's SNS party winning again handily, which together with Brexit extension and softer outcomes, leaves political risks at bay. While, moreover, C/A deficit is widening, we expect strong FDI over-financing, stronger export growth and revival in remittances in 2H19 alongside stronger corporate demand for FX-linked credit and improved portfolio inflows to stabilize the dinar going forth. Since fairly efficient two-way FX management has reduced RSD sensitivity to regional FX risk episodes, this suggests range-bound trading inside 117-118 in the next quarters. Our constructive RSD outlook in the medium term is driven by growth potential re-pricing, fiscal and external (C/A) position de-risking, sovereign re-rating process and further improvement in appetite for Serbian assets.



Serbian rates have downside potential on fiscal and political de-risking

Notwithstanding accelerated banks' RSD lending, we expect the NBS' active policy mix (FX swaps, reduction in the RSD part of mandatory reserves) to reverse the recent upside in short-term rates to record lows again. Following a bumper budget surplus and some revival in issuance activity early this year, we expect the MinFin to continue with 3/7Y reopening opportunistically in the rest of the year, in a bid to refinance FX(-linked) redemptions as the budget development does not require immediate issuance. In 1Q19, Serbia predominantly sold 3Y and 7Y RSD bonds as part of efforts to raise the RSD share in public debt, which is heading toward 35% (on our calculations) after the late 2018 USD bond redemption. Given the ongoing fiscal discipline and lower amortization (no foreign bond redemptions) this year, better sovereign rating-relevant indicators and real yield premium over CESEE peers, long-term dinar yields have some downside potential. Meanwhile, the key risk for EM assets involves stronger USD amid global growth/trade concerns but the Fed's departure from rate hikes in 2019 and the recent decline in USD credit spreads bring substantial comfort to EM risk and in turn high-beta Serbian rates. Come what may, once global growth outlook and market volatility stabilize and the weaker USD actualizes carry in Serbian bonds, we see stronger interest for Serbian assets on the back of stronger growth/trade potential, ongoing fiscal healing, IMF-driven reforms, sovereign re-rating prospects and EM indices'' inclusion this year.

Farewell to budget surpluses...

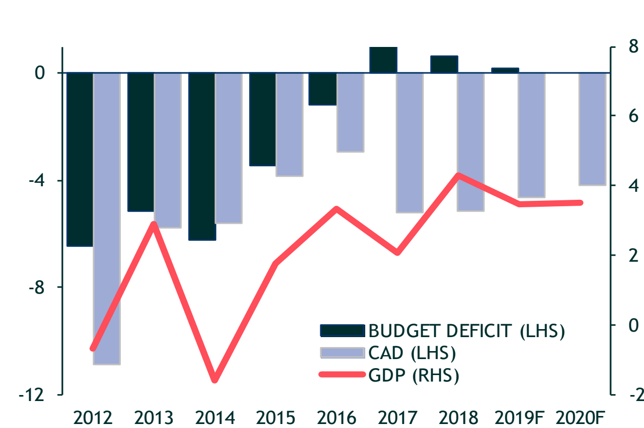
The 2018 budget surplus of 0.6% of GDP (vs. -0.5% deficit plan) beat most expectations, which alongside 30pp lower funding cost and 2.5% stronger dinar (on average) saw public debt slump to 53.8% of GDP. In that vein, strong front-loaded fiscal adjustment (almost 6% in 2015-2018) reflects persistent tax revenue (notably wage contributions and VAT) overperformance, SOE dividends, falling interest bill, subsidy cuts and lower social transfers. While stronger tax-rich domestic demand supports 6%-alike tax growth (and 7% higher VAT intake), and interest spending slumps by another 12.5% yoy, we still see the budget close to balance in 2019 on steady public capex outlays, steep wages (+9% yoy) and pension hikes, and 1pp employers' unemployment contribution cut. Thankfully, public wage hikes under the new PCI deal with the IMF are pending on implementation of the new public wage system in 2020, more flexible public employment framework and automatic pension indexation. The key pre-condition for successful (GDP/inflation-based) pension indexation implementation, anchoring pension outlays within the targeted 9.5-10.5% of GDP in our view, is a firm resistance to populist demand for relaxing the rules for early retirement. The 2019 budget may over perform slightly the official 0.5%/GDP deficit target amid upside surprises in tax-rich demand, accommodative funding and smarter utilization of ample fiscal space. Strong nominal growth, solid primary surplus (~2% of GDP), cheaper debt service and firm dinar, will see further drop in public debt just above 50% of GDP. Stronger growth potential upon one of the strongest public debt reductions in CESEE universe and steady correction of external imbalances support the country's re-rating process.

...Hello pro-growth fiscal policy?

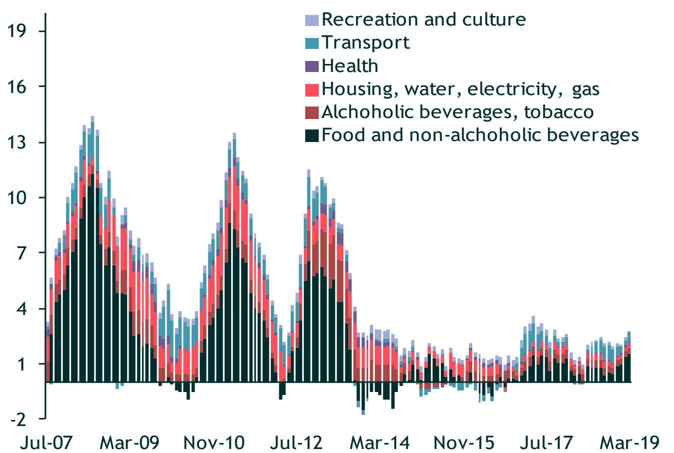
Better-than-expected fiscal results are though not wholeheartedly accompanied by bolder reforms (notably when it comes to SOEs, despite intensified privatization activity) and instead encourage entitlement spending. This may affect GDP growth and reduce fiscal space as soon as the cycle slows substantially or monetary normalization starts. That said, the implementation of public administration, labour market and SOE reforms and entitlement spending conditionality on economic circumstances are in the focus of the voluntary policy coordination with the IMF. For most reforms though the time horizon remains vague. The main goal going forth is smart deployment of ~1pp/GDP fiscal space on the way to the IMF-enshrined -0.5% budget deficit in the medium term after several years of surpluses. The IMF also supports investments in railways and energy capacity expansion as an important pre-condition for sustained FDI inflow, in our view. After the current GDP growth and entitlement spending hump and flurry of tangible investment, Serbia needs to stick to pro-reformist agenda, refocus to intangible investments (more important for growth-enhancing productivity gains) and complementary competitiveness reforms. Alongside red tape and non-wage cost cuts, and higher non-taxable income thresholds for private sector jobs, Serbia needs tax incentives to stimulate innovations and SMEs and pro-ARD policies in order to move up the value chain and accelerate productivity gains.

Serbia's data trends

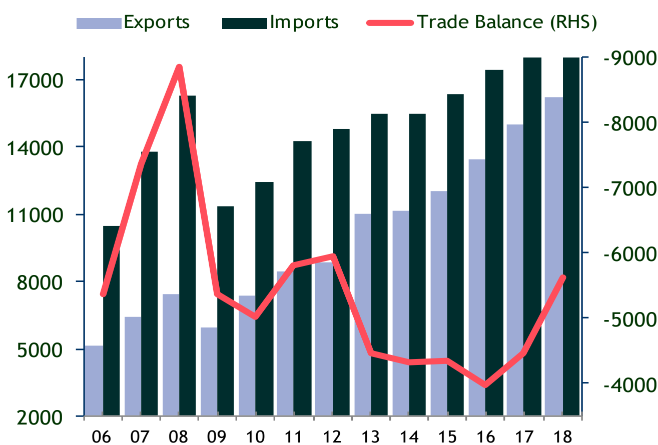
Budget and C/A gaps (% of GDP) vs. GDP growth (%)



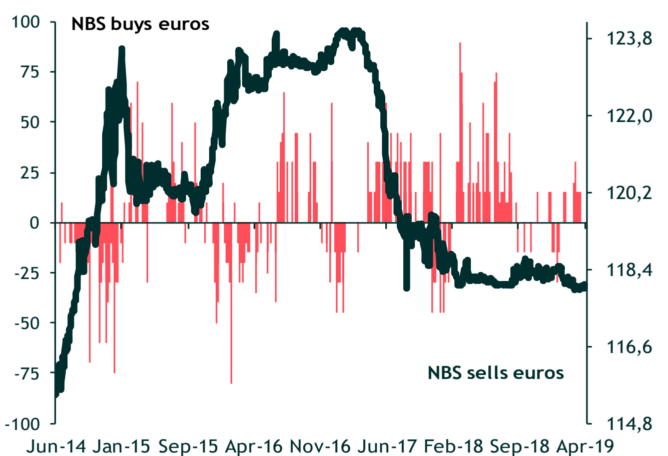
CPI contribution - key categories (pp)



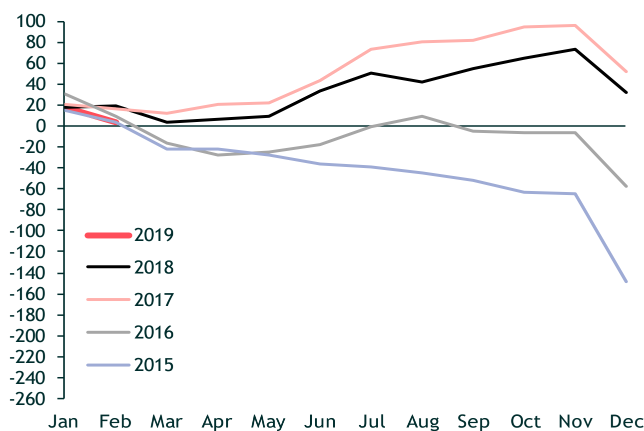
Trade balance (EURbn)



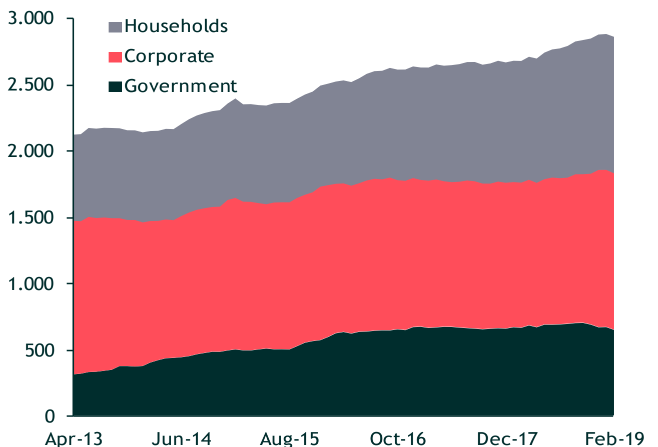
NBS activity in the market



Consolidated government budget balance (RSDbn)



Credit distribution by sector (RSDbn)



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

SELECTED ECONOMIC FORECASTS

	2012	2013	2014	2015	2016	2017	2018	2019F	2020F
Activity									
Nominal GDP (RSDbn,current prices)	3.810	4.121	4.161	4.312	4.521	4.754	5.060	5.326	5.645
Nominal GDP (EURbn)	33,7	36,4	35,5	35,7	36,7	39,2	42,8	45,2	48,2
Nominal GDP (USDbn)	43,2	48,4	47,0	39,6	40,7	44,2	50,6	52,0	57,8
GDP per capita (EUR)	4.688	5.095	4.985	5.047	5.216	5.596	6.076	6.421	6.841
GDP per capita (USD)	6.019	6.768	6.605	5.597	5.777	6.319	7.185	7.301	8.117
Real GDP (constant prices YoY, %)	-0,7	2,9	-1,6	1,8	3,3	2,0	4,3	3,0	3,5
Private consumption (YoY, %)	-1,9	-1,6	-0,1	-0,5	1,3	2,0	3,3	3,6	3,2
Fixed investment (YoY, %)	13,9	-12,0	-3,4	4,9	5,4	7,3	9,2	9,0	8,6
Industrial production (YoY, %)	-2,2	5,4	-6,4	8,4	4,7	3,5	1,3	4,5	4,5
Unemployment rate (ILO, average %)	23,9	22,1	19,2	17,7	15,3	13,5	12,7	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	2,4
CPI inflation (end-year % YoY)	12,2	2,2	1,7	1,5	1,6	3,0	2,0	2,3	2,2
PPI inflation (average % YoY)	5,6	3,6	0,7	0,2	-0,4	3,0	2,1	2,6	2,5
Net wage rates (% YoY, nominal, euros)	-1,8	-1,8	-4,3	-3,3	1,8	3,5	8,8	6,8	4,0
Fiscal balance (% of GDP)									
State budget balance	-6,4	-5,1	-6,2	-3,5	-1,2	1,1	0,6	0,0	-0,5
Public debt	52,6	55,3	64,2	69,5	67,6	59,3	53,8	51,5	49,0
Gross public funding needs	14,5	15,1	16,5	15,7	13,1	8,2	7,5	6,8	7,6
External balance									
Export of goods and services (EURbn)	11,469	13,937	14,451	15,728	17,385	19,312	17,637	23,082	24,514
Import of goods and services (EURbn)	16,992	17,782	18,096	18,643	19,597	22,343	20,889	27,535	29,187
Merchandise trade balance (EURbn)	-5,634	-4,159	-4,111	-3,645	-3,119	-3,997	-4,153	-5,883	-6,478
Merchandise trade balance (% of GDP)	-16,7	-11,4	-11,6	-10,2	-8,5	-10,2	-9,7	-13,0	-13,5
Remittances, net (EURbn)	1,989	2,217	1,931	2,155	1,953	2,151	2,257	2,852	2,995
Current account balance (EURbn)	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,223	-2,334	-2,366
Current account balance (% of GDP)	-10,9	-5,8	-5,6	-3,5	-2,9	-5,2	-5,2	-5,2	-4,9
Net FDI (EURbn)	0,8	1,3	1,2	1,8	1,9	2,4	3,2	2,9	3,2
FDI (% of GDP)	2,2	3,6	3,5	5,1	5,2	6,2	7,5	6,5	6,5
FDI cover (%)	20,5	61,9	62,3	146,2	176,7	117,9	143,4	126,0	133,1
Gross international reserves (EURbn)	10,915	11,189	9,907	10,378	10,205	9,962	11,262	11,753	12,282
Import cover (months of imports)	7,7	7,6	6,6	6,7	6,2	5,4	6,5	5,1	5,0
Debt indicators									
Gross external debt (EURbn)	25,645	25,644	25,679	26,234	26,494	25,578	26,901	27,016	27,162
Government (EURbn)	12,185	13,120	14,140	15,295	15,680	13,910	13,423	12,936	12,149
Private (EURbn)	13,460	12,525	11,539	10,939	10,815	11,667	13,478	14,080	15,013
Gross external debt (% of GDP)	76,1	70,4	72,4	73,5	72,1	65,3	62,9	59,8	56,4
Gross external debt (% of exports)	223,6	184,0	177,7	166,8	152,4	132,4	152,5	117,0	110,8
Exchange rates and money									
USD/RSD (end-year)	86,18	83,13	99,46	111,64	117,93	99,30	103,08	97,92	94,35
USD/RSD (average)	88,12	85,17	88,54	108,88	111,17	107,47	100,02	102,44	97,67
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	18,6	12,3	11,1
Broad money M3 (% YoY)	0,7	3,7	3,0	5,0	9,9	7,9	14,8	7,4	6,3
Domestic credit (% YoY, euros)	0,8	-5,2	-2,3	2,4	1,0	6,2	9,7	6,9	6,0
NBS policy rate (average %)	10,10	10,90	8,75	5,63	4,13	3,81	3,06	2,88	2,75
NBS policy rate (end-year %)	11,25	9,50	8,00	4,50	4,00	3,50	3,00	2,75	2,75
6M BELIBOR interest rate (average %)	11,97	10,44	8,53	6,40	3,65	3,60	3,12	3,06	2,75

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	2018	2019F	2020F
Balance sheet									
Assets (EURm)	27.775	27.467	27.333	28.178	29.106	30.378	33.631	35.375	37.309
Assets (%, YoY)	0,2	-1,1	-0,5	3,1	3,3	4,4	10,7	5,2	5,5
Assets (% of GDP)	82,5	75,4	77,1	78,9	79,3	77,5	78,6	78,3	77,5
Gross loans (EURm)	17.148	16.255	15.879	16.253	16.412	17.431	19.122	20.447	21.665
Gross loans (%, YoY)	0,8	-5,2	-2,3	2,4	1,0	6,2	9,7	6,9	6,0
Gross loans (% of GDP)	50,9	44,6	44,8	45,5	44,7	44,5	44,7	45,2	45,0
Deposits (EURm)	13.310	13.634	13.967	14.728	16.159	17.404	20.105	21.596	22.919
Deposits (%, YoY)	1,6	2,4	2,4	5,4	9,7	7,7	15,5	7,4	6,1
Deposits (% of GDP)	39,5	37,4	39,4	41,2	44,0	44,4	47,0	47,8	47,6
Loan-to-deposit ratio (%)	128,8	119,2	113,7	110,4	101,6	100,2	95,1	94,7	94,5
Capital adequacy ratio (%)	19,9	20,9	20,0	20,9	21,8	22,6	22,3	21,9	21,4
Performance									
Net interest income (EURm)	971	1.014	1.024	1.032	973	997	1.056	1.150	1.213
Net interest income (%, YoY)	-7,9	4,4	1,1	0,8	-5,7	2,4	5,9	8,9	5,5
Total operating income (EURm)	1.411	1.391	1.436	1.466	1.387	1.564	1.587	1.702	1.758
Total operating income (%, YoY)	-5,6	-1,5	3,3	2,1	-5,4	12,8	1,5	7,3	3,3
Pre-provision profit (EURm)	578	512	534	568	501	627	666	649	722
Pre-provision profit (%, YoY)	-8,1	-11,4	4,3	6,3	-11,7	25,2	6,2	-2,5	11,2
Provision charges (EURm)	310	501	494	480	333	61	34	36	42
Profitability and efficiency									
Net interest margin (%)	3,5	3,7	3,7	3,7	3,4	3,4	3,3	3,3	3,3
Pre-tax ROAA (%)	1,0	0,0	0,1	0,3	0,6	1,9	2,0	1,8	1,9
Pre-tax ROAE (%)	5,0	0,2	0,8	1,7	3,3	10,7	11,1	10,7	11,8
Cost-to-income ratio (%)	59,0	63,2	62,8	61,3	63,9	59,9	58,0	61,8	58,9
Operating expense (% of assets)	3,0	3,2	3,3	3,2	3,1	3,1	2,9	3,1	2,9
Credit quality and provisioning									
NPL ratio (%)	18,6	21,4	21,5	21,6	17,0	9,8	5,7	5,1	4,6
NPL coverage (%)	50,0	50,9	54,9	62,3	67,8	58,1	60,2	61,5	61,8
Provision charges (% of loans)	1,8	3,0	3,1	3,0	2,0	0,4	0,2	0,2	0,2
Provision charges (% of PPP)	53,7	97,7	92,5	84,6	66,6	9,8	5,1	5,5	5,8

Source: NBS, Addiko research

Credit growth accelerated

Credit growth accelerated to 9.7% yoy thanks to strong contribution from the private sector, additionally supported by public sector credit growth (13.3% yoy). Retail loans surged 12.8% yoy 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 recovered more substantially in the last few months of the year (big ticket loan for Belgrade airport in Dec), displaying 7.2% yoy growth, despite significant write-offs of non-performing loans which contributed to further decline of NPL ratio to 5.7% (from 9.8% 2017YE). Meanwhile, deposit growth picked-up 15.5% yoy driven by soaring corporate deposits (20.6% yoy) and strong acceleration on the retail side (9.5% yoy). Regarding profits, banks recorded yet another record result with 11.7% yoy pre-tax profit growth amounting to EUR632m, courtesy of stronger NII (5.9% yoy) and decreasing provision charges.

Moderating credit growth, but economic prospects remain supportive

In 2019, we expect credit growth moderating towards 7%, but still supported by strong consumer sentiment and private consumption outlook, while strong investment prospects bode well for continued corporate lending recovery. Besides economic growth and positive labour market developments, credit activity remains underpinned by favourable financial conditions and intensified bank competition, particularly in the aftermath of continued NPL reductions which cleared the space for new lending and contributed to easier credit standards. Bank loan surveys support increased loan demand view, although household consumer loans with longer maturities might experience a slowdown due to new NBS regulatory measures introduced this year. Regarding deposit growth, in 2019 we expect slower deposit collection around 7.4% yoy, mostly owing to high base effects but also on the account of increased consumption and investment propensity, particularly since the interest rates on savings remain close to their record lows. Despite intensified credit activity which should bring about strong NII growth, we see somewhat lower pre-tax income level going forth, burdened by costs of expected CHF conversion following the adoption of the special law (banks scheduled to take over 23% of principal reduction cost upon conversion of remaining maturities to EUR).

Solid Growth despite Political Risks

We lowered 2019 GDP growth forecast to 3.0% mostly based on weaker external demand momentum and subsequent delays in private capex, followed by slight deceleration of private consumption. We expect the budget to stay in surplus amid 1H19 temporary financing plan, contained spending and delayed public capex, while C/A gap continues to widen on stronger both consumer and investment import demand.

GDP growth at 3% in 2018

GDP growth proved steady at 3.0% yoy in 4Q18 (and 3.1% for the FY18) despite poor industrial output performance, slowing goods exports and the subsequent unwinding of stockpiles. Importantly though, household consumption maintained similarly robust momentum thanks to accelerating wage and job growth (almost 5% yoy and 3% yoy, respectively), 14% higher foreign tourist nights and steady non-resident remittances. The aforementioned stagnant goods export dynamics in response to EU demand slump, temporary Aluminij outages and Kosovo tariffs are accompanied by temporarily slower import growth as well, leaving goods import cover little changed (yoy) at 62.0%. Industry slowed mainly in the energy generation, non-durables and intermediates. In 1Q19, high-frequency indicators point to GDP growth slowdown toward 2% yoy via further industry downturn and deteriorating external trade conditions.

We expect GDP to decelerate on weaker external demand

The economy has proved more resilient to ongoing political volatility as legislative bodies at both federal and national levels are formed, paving the way for executive bodies' formation after a face-saving compromise over the NATO MAP activation. We nevertheless lower 2019 GDP growth forecast to 3.0% (prev. 3.5%) amid substantially weaker external demand impulse and some private capex delays in response to that, an important driver of consumer strength. Weaker EU demand aside, we expect abolition of food export bans for the EU markets and higher energy capacity will smooth exports slowdown, but given strong domestic demand, net trade contribution will be more negative. Accelerating investments in spite of political issues will underpin growth largely via energy projects (just approved Tuzla TPP ~EUR1bn deal, Ugljevik TPP, few HPPS), EBRD-co-funded (road) infrastructure works (with a 3Y EUR700m loan) and residential construction. While slowing somewhat, private consumption stays underpinned by stronger labour market, re-leveraging and tourism inflow. The risks to growth are mainly political should ongoing tensions hamper reforms and delay external IMF and other IFI financing. After the national government formation and Brussels' feedback to the EU questionnaire both in Q2, B-H can restart reforms and target EU candidacy 2020, albeit with late accession prospects.

New government will need to focus on reforms

Standard and Poor's recently upgraded the outlook for B-H's 'B' rating to positive, amid better economic prospects, as soon as the new cabinet reinstated the IMF program with a renewed focus on structural, electoral and judicial reforms. Ratings are also supported by prudent fiscal stance, public debt reduction and steady growth prospects. Among quick win solutions, red tape, direct tax and administrative burden cuts are on priority list, hopefully followed by better SOE governance, more efficient public capex allocation, new labour market reforms and in turn positive confidence effects. Sustained revival of the IMF-enshrined reform agenda may lead to a rating upgrade later this year (or early 2020) as well as repricing of the growth and income prospects. All mentioned above is crucial for convergence prospects, credibility on B-H's EU accession path and rating upgrades. If the government is not formed soon, and reforms are delayed, B-H's rating outlook would be brought back to 'stable' (not our base case though).

Healthy fiscal developments continue

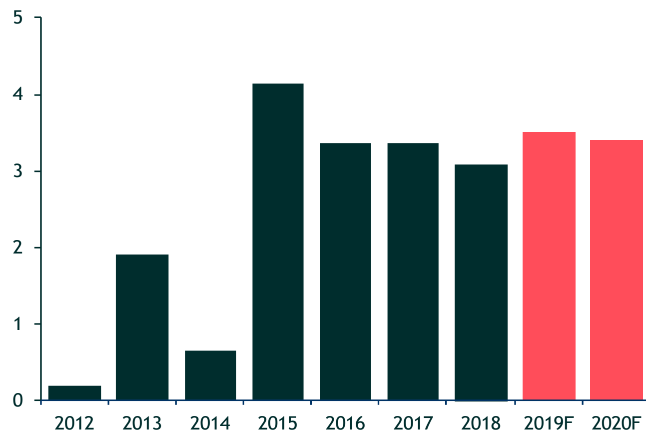
B-H likely saw a general government surplus around 1% of GDP (and public debt cut to 37% of GDP) thanks to steady tax intake (7.2% stronger road taxes), contained spending and public capex under-execution amid political standstill. Given 1H19 temporary financing regime, expenditure constraints in 2019 (with delays in public infrastructure capex) and tax-rich strong domestic demand, we again see the budget surplus at 1% of GDP, albeit with the risks more on the downside in the event of stronger public capex execution. We also expect spending appetite (including war veteran outlays) to wane when the new cabinet resumes IMF talks, with the new IMF stand-by likely subject to prior policy actions (e.g. in the area of SOE and fiscal reforms) after hitherto insufficient compliance. That said, policy focus and counter-cyclical measures (against weaker external demand) will be on creating fiscal space for capex through spending rationing, SOE reforms, labour tax/red tape cuts harmonized between the entities, etc.

External position deteriorating on import related demand

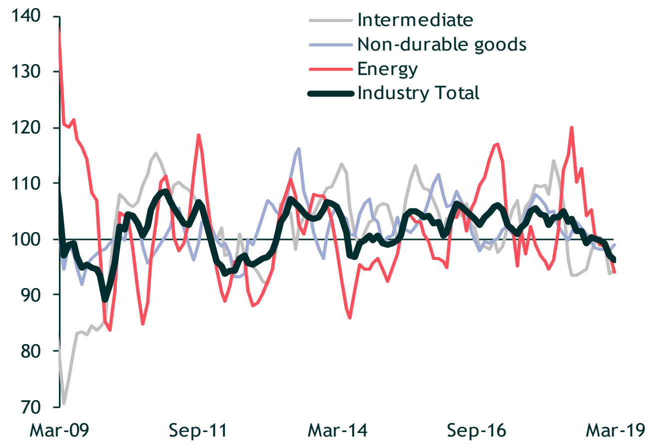
The C/A deficit fell to EUR700m (4.0% of GDP) in 2018 on sharply higher services surplus and stabilizing goods trade deficit. External risks are further contained by higher FX reserves (7+ months of import cover) as well as FDI cover amid stronger real-estate markets and improved business climate prospects upon political stabilization. In 2019, we see modest C/A gap widening to 4.8% of GDP on firmer both consumer and investment-related import demand. At the same time, inflation has stabilized just below 1% on waning food inflation and much weaker contribution from miscellaneous items, which already prompted us to revise down 2019 average forecast to 1.6% (prev. 1.8%). Somewhat higher inflation in 2019 owes to stronger domestic demand, higher wages and the long overdue (still) gradual electricity price hikes in the RS bloc.

Bosnia and Herzegovina's data trends

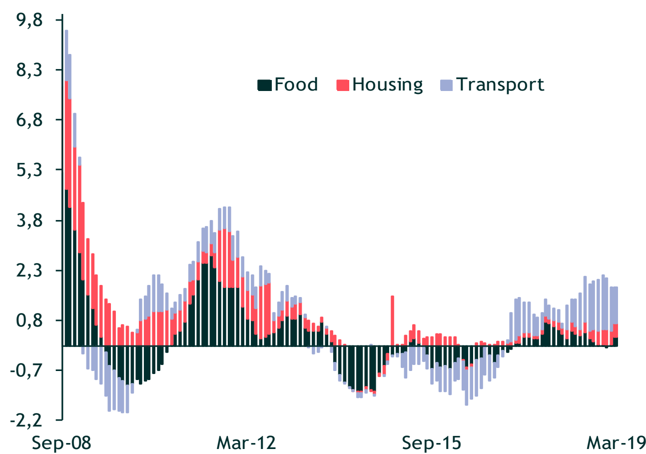
Real GDP growth (%, YoY)



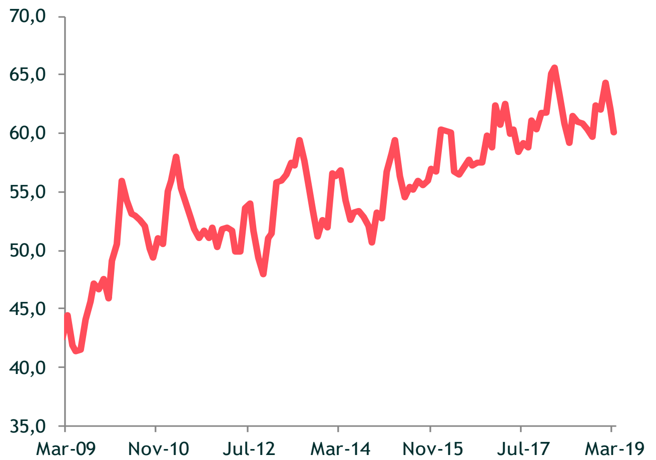
Industrial production (%, yoy, s-a, 3mma)



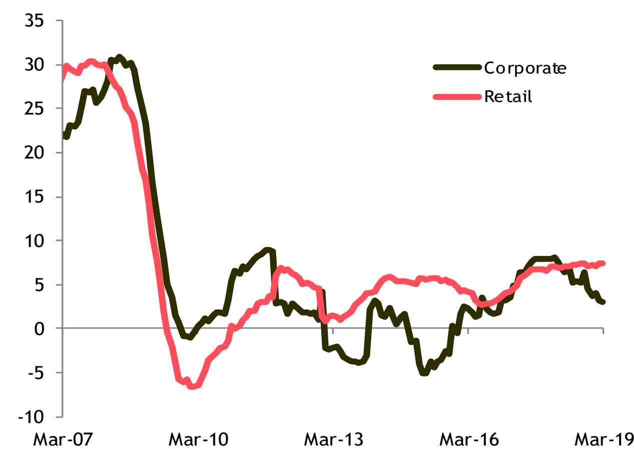
Key CPI contributions (pps)



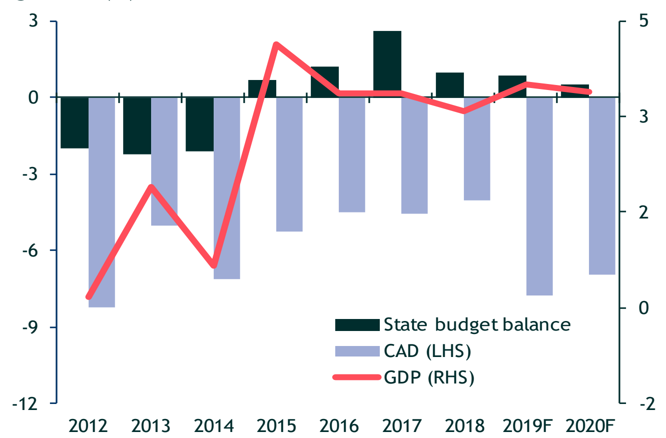
Merchandise import cover (%, 3mma)



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	2018	2019F	2020F
Activity									
Nominal GDP (BAMbn, current prices)	27,6	28,2	28,3	29,7	31,0	32,5	34,0	35,5	37,3
Nominal GDP (EURbn)	14,1	14,4	14,5	15,2	15,9	16,6	17,4	18,2	19,1
Nominal GDP (USDbn)	18,1	19,2	19,3	16,9	17,6	18,8	20,5	20,9	22,9
GDP per capita (EUR)	3.863	4.005	4.064	4.298	4.514	4.726	4.939	5.166	5.428
GDP per capita (USD)	4.968	5.320	5.399	4.767	4.998	5.337	5.840	5.941	6.513
Real GDP (constant prices YoY, %)	0,2	1,9	0,7	4,1	3,4	3,4	3,1	3,0	3,0
Private consumption (YoY, %)	-0,7	0,0	1,9	1,8	2,3	1,6	1,4	2,6	2,6
Fixed investment (YoY, %)	2,1	-1,2	11,5	-3,5	2,5	5,8	7,0	6,4	0,0
Industrial production (YoY, %)	-5,2	6,6	1,8	3,5	4,4	3,1	1,6	3,4	3,7
Unemployment rate (ILO, average, %)	28,0	27,4	27,5	27,7	25,4	20,5	18,4	17,5	17,0
Prices									
CPI inflation (average % YoY)	2,1	-0,1	-0,9	-1,0	-1,1	1,2	1,4	1,6	2,0
CPI inflation (end-year % YoY)	1,8	-1,2	-0,4	-1,3	-0,3	1,3	1,3	2,0	2,1
PPI inflation (average % YoY)	1,3	-2,2	-0,2	0,6	-0,9	1,8	3,2	2,4	2,6
Net wage rates (% YoY, nominal)	1,2	0,1	0,4	0,0	0,9	1,8	3,1	3,3	3,2
Fiscal balance (% of GDP)									
State budget balance	-2,0	-2,2	-2,0	0,7	1,2	2,6	1,0	0,8	0,5
Public debt	43,4	44,5	45,0	45,5	44,1	39,0	36,9	35,3	34,0
External balance									
Export of goods and services (EURbn)	4,337	4,620	4,754	5,080	5,450	6,429	6,936	7,325	7,655
Import of goods and services (EURbn)	-7,481	-7,419	-7,927	-7,794	-8,345	-9,542	-10,119	-10,428	-11,004
Merchandise trade balance (EURbn)	-3,977	-3,630	-4,026	-3,677	-3,958	-4,267	-4,441	-4,552	-4,818
Merchandise trade balance (% of GDP)	-28,2	-25,1	-27,8	-24,2	-24,9	-25,7	-25,6	-25,1	-25,2
Remittances (EURbn)	1,070	1,111	1,181	1,216	1,247	1,353	1,380	1,430	1,473
Current account balance (EURbn)	-1,159	-0,728	-1,033	-0,796	-0,711	-0,754	-0,701	-0,876	-0,874
Current account balance (% of GDP)	-8,2	-5,0	-7,1	-5,2	-4,5	-4,5	-4,0	-4,8	-4,6
Net FDI (EURbn)	0,3	0,3	0,2	0,4	0,2	0,3	0,3	0,5	0,6
FDI (% of GDP)	2,4	1,8	1,2	2,6	1,6	1,5	1,9	2,9	3,1
FDI cover (%)	29,7	35,5	16,9	50,4	35,0	34,0	47,1	60,0	68,7
Gross international reserves (EURbn)	3,328	3,614	4,001	4,400	4,873	5,398	5,943	6,342	6,856
Import cover (months of imports)	5,3	5,8	6,1	6,8	7,0	6,8	7,0	7,3	7,5
Debt indicators									
Gross external debt (EURbn)	10,980	11,064	10,289	12,416	12,847	12,838	12,834	13,124	13,452
Government (EURbn)	3,780	4,013	3,951	4,378	4,318	4,424	4,046	3,896	3,996
Private (EURbn)	7,200	7,051	6,339	8,038	8,529	8,414	8,788	9,228	9,456
Gross external debt (% of GDP)	77,9	76,6	71,0	81,7	80,9	77,2	73,9	72,2	70,5
Gross external debt (% of exports)	253,2	239,5	216,4	244,4	235,7	199,7	185,0	179,2	175,7
Exchange rates and money growth									
USD/BAM (end-year)	1,48	1,42	1,61	1,79	1,87	1,64	1,71	1,63	1,58
USD/BAM (average)	1,52	1,47	1,47	1,76	1,77	1,73	1,65	1,70	1,63
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	14,9	13,2	10,4
Broad money M2 (% YoY)	3,4	7,9	7,3	8,0	8,3	9,5	9,4	8,9	7,8
Domestic credit (% YoY)	4,1	0,5	2,8	2,4	2,0	7,1	5,8	5,2	4,8
EURIBOR 3M interest rate (average %)	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,32	-0,29

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	2018	2019F	2020F
Balance sheet									
Assets (EURm)	11.414	11.794	12.299	12.756	13.344	14.440	15.828	16.714	17.555
Assets (%, YoY)	1,9	3,3	4,3	3,7	4,6	8,2	9,6	5,6	5,0
Assets (% of GDP)	81,0	81,7	84,9	83,9	84,1	86,9	91,1	92,0	92,0
Gross loans (EURm)	8.151	8.194	8.423	8.624	8.795	9.419	9.965	10.487	10.994
Gross loans (%, YoY)	4,1	0,5	2,8	2,4	2,0	7,1	5,8	5,2	4,8
Gross loans (% of GDP)	57,8	56,7	58,1	56,7	55,4	56,7	57,4	57,7	57,6
Deposits (EURm)	6.814	7.285	7.861	8.452	9.077	10.057	11.120	12.161	13.091
Deposits (%, YoY)	2,6	6,9	7,9	7,5	7,4	10,8	10,6	9,4	7,7
Deposits (% of GDP)	48,3	50,5	54,2	55,6	57,2	60,5	64,0	66,9	68,6
Loan-to-deposit ratio (%)	119,6	112,5	107,1	102,0	96,9	93,7	89,6	86,2	84,0
Capital adequacy ratio (%)	17,0	17,8	16,3	14,9	15,8	15,7	17,5	16,7	15,9
Performance									
Net interest income (EURm)	389	385	383	398	411	424	433	471	492
Net interest income (%, YoY)	-1,8	-1,0	-0,5	3,9	3,3	3,3	2,0	8,9	4,3
Total operating income (EURm)	610	618	623	642	680	728	735	780	809
Total operating income (%, YoY)	-1,5	1,2	0,8	3,1	6,0	7,0	1,0	6,2	3,6
Pre-provision profit (EURm)	207	184	213	206	222	288	256	276	286
Pre-provision profit (%, YoY)	-0,8	-11,1	15,8	-3,6	8,1	29,4	-11,0	7,8	3,6
Provision charges (EURm)	130	192	117	171	91	94	65	61	64
Profitability and efficiency									
Net interest margin (%)	3,4	3,3	3,2	3,2	3,1	3,1	2,9	2,8	2,8
Pre-tax ROAA (%)	0,7	-0,1	0,8	0,3	1,0	1,4	1,3	1,3	1,3
Pre-tax ROAE (%)	4,8	-0,5	5,6	1,9	7,0	9,8	9,2	10,1	10,4
Cost-to-income ratio (%)	66,0	70,2	65,7	67,9	67,3	60,5	65,2	64,6	64,6
Operating expense (% of assets)	3,6	3,7	3,4	3,5	3,5	3,2	3,2	3,1	3,1
Credit quality and provisioning									
NPL ratio (%)	13,5	15,1	14,2	13,7	11,8	10,0	8,8	8,1	7,6
NPL coverage (%)	65,9	66,7	69,7	71,2	74,4	76,7	77,4	78,2	79,0
Provision charges (% of loans)	1,6	2,3	1,4	2,0	1,0	1,0	0,7	0,6	0,6
Provision charges (% of PPP)	62,8	104,1	55,1	83,1	41,1	32,6	25,4	22,2	22,5

Source: CBBH, banking agencies, Addiko research

Retail sector remains the key credit growth driver

In 2018 total loans increased by 5.8% yoy, with the strongest positive contribution coming from accelerated credit activity in the retail segment (+7.3% yoy), amid increased demand for consumer loans on continued employment and wage growth, alongside favourable financing conditions. Corporate lending decelerated to 3.7% yoy, while public sector picked-up pace to 7.8% yoy. Loan book quality improved further and NPL ratio decreased to 8.8% level (vs. 10.0% at YE17). At the same time, deposit collection increased by 10.6% yoy, driven by strong growth from both corporate (10.4% yoy) and retail (7.8% yoy) side, courtesy of improved labour market conditions and increased remittances, while public sector deposits displayed continued strong growth (26.3% yoy) supported by favourable fiscal trends. Following record profit level in 2017, pre-tax profit decreased slightly (-1.6% yoy) amounting to EUR191m on somewhat lower NII growth (2.2% yoy), offset by slightly higher non-interest expenses (1.9% yoy).

Slower credit and deposit growth ahead

Looking ahead, in 2019 we see credit activity slowing down towards 5.2% level. Credit growth remains supported by positive labour market developments and private consumption outlook, alongside increased business optimism and investment recovery, with further decline in interest rates. At the same time we expect banks to continue cleaning their balance sheets through NPL sales, write-offs and recovery practices, bringing down the NPL ratio towards the 8% mark. We see somewhat slower deposit collection going forth, decelerating towards 9.4% mainly owing to high base effects, as well as improved consumption and investment outlook. Regarding profits, we expect the ongoing credit cycle to bring about NII recovery, resulting in somewhat higher profit level next year, assuming contained opex and lower provision charges.

Entering 2019 on Strong Footing

We upgraded 2019 GDP forecast to 3.5% thanks to stronger carry-over, continuous strong investment dynamics, another record tourism season and stabilising private consumption. We expect further budget deficit reduction to 1.5% of GDP on moderating highway construction and cheaper public debt service, with public debt below 65% of GDP in 2020 upon highway project completion. In 2019, we expect inflation moderating towards 2.1% on reduced oil price pressures and fading effects of administrative hikes.

2018 ended on a strong note

GDP growth exceeded expectations and accelerated in 2H18, wrapping up the 2018 with 4.8% average. Hefty investments related to highway construction, energy and tourism sectors once again proved themselves as the key growth driver, accompanied by strong manufacturing and private consumption. Industry results notably reflect robust energy generation enhanced through two new wind-power plants and favourable weather conditions, while food processing and metal industry also showed decent recovery in the aftermath of KAP capex upon re-privatisation and stronger EU funding in agriculture. Private consumption accelerated thanks to another stellar tourist season, employment growth and higher remittances. Strong exports growth proved insufficient to offset steady import acceleration on equipment-related capex, resulting in further widening of the goods trade deficit (44% of GDP).

Growth expectations revised higher

We lift 2019 GDP growth forecast to 3.5% amid stronger carry-over effects, continued strong investment dynamics and decent private consumption. With highway construction prolonged into 2020, we expect strong construction activity to continue, alongside robust performance in the tourism, energy and metal processing sectors. Private consumption growth remains on strong footing amid further employment gains, hefty tourism revenues, rising remittances and households' re-leveraging. Net trade contribution will remain negative despite stronger export capacity in the energy sector (electricity cable towards Italy) and tourism services, due to further investment-driven imports expansion. The key upside risks involve even stronger tourism results and/or rising electricity exports and construction, with possible rating upgrade prospects on reduced fiscal risks, EU talks progress and competitiveness gains, as well as benign external environment. Downside risks mainly include tourism underperformance, unstable external backdrop and higher MinFin contingent liabilities.

Budget deficit on downward trajectory

In 2018, budget deficit shrank to 3.4% of GDP (from -5.5% of GDP in 2017) on higher tax revenues driven by stronger VAT intake (+12.4% yoy) after VAT hikes and stricter tax compliance. Meanwhile, budgetary outlays remain driven by soaring public capex, extending beyond highway construction to EU-co-funded local infrastructure projects. In 2019, we see further deficit reduction towards 1.5% of GDP on moderating highway project dynamics and even cheaper debt service after new 5Y and 7Y bond issuance on the local market. After the highway project completion, 2020 budget will in our view return to surplus for the first time in ten years, and we see public debt below 65% of GDP (from 71% at the end of 2018). Possible delays in highway construction and additional cost overruns ahead of 2020 elections pose the biggest risks to the budget balance.

Inflation moderates in 2019

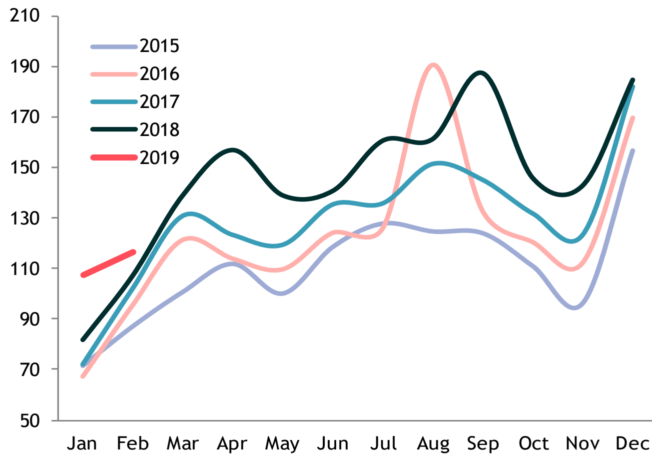
Following the VAT/excise duty-hike-induced summer peak (3.4% yoy), inflation pressures eased through 2H18, resulting in the 2018 average at 2.5%. In 2019, we see inflation moderating toward 2% on reduced oil price pressures and fading effects of administrative hikes. Upside risks manly relate to even stronger foreign tourist demand-pull pressures and renewed pick-up in oil prices.

Lower C/A deficit ahead

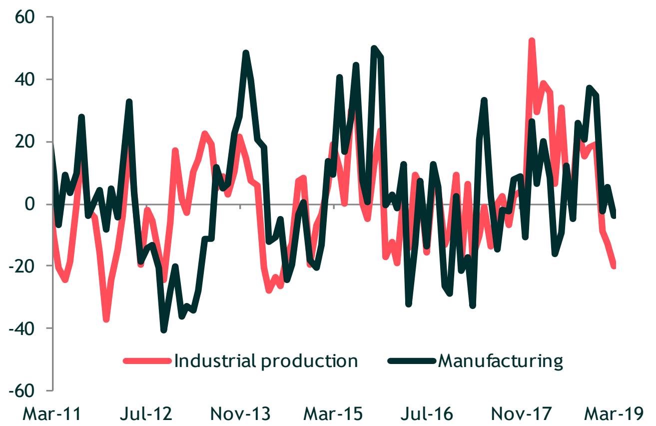
In 2018, C/A deficit increased 14.6% to EUR793m (-17.2% of GDP) mostly owing to wider trade deficit, courtesy of strong capex-related imports. The gap was partly offset by record FC tourism receipts (+8.6% yoy) and accelerated remittances inflow (+13.5% yoy). FDI share in GDP narrowed to 7.1% as net FDIs decreased 32.4% yoy to EUR328m, mostly attributable to the EPCG re-privatization/intercompany debt effects, however the long-term average remains among the highest across CESEE. Looking ahead, we see somewhat lower C/A deficit in 2019-2020 toward 16.0% of GDP on strong tourism and energy-driven exports, with capex-related import pressures gradually abating. Attractive taxes/concessions for investors, alongside hotel development pipeline and renewable energy projects will see FDI share in GDP picking-up above 10% in the medium term, helping more sustained downward convergence of the C/A deficit.

Montenegrin data trends

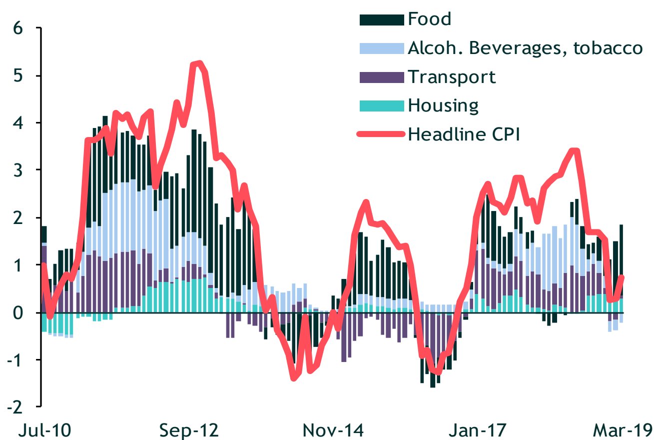
Budget revenue movements (EURm)



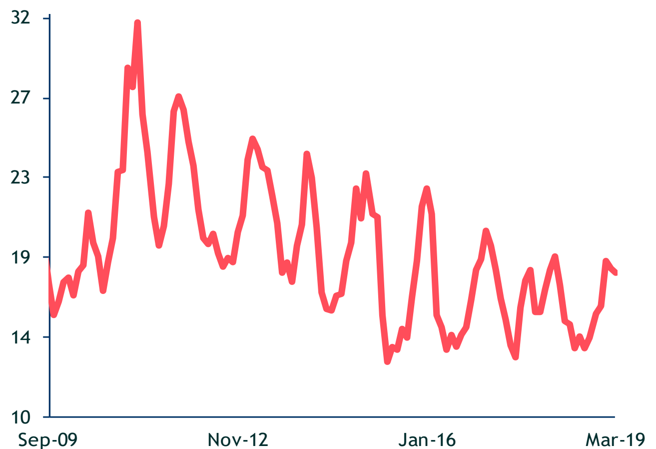
Industrial production (%, YoY)



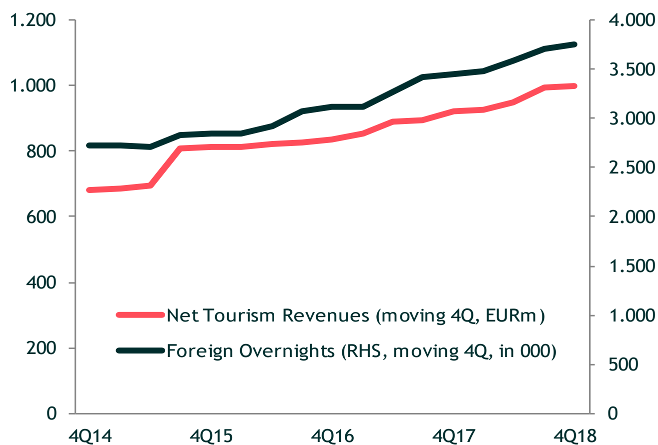
CPI by key contributions (pps)



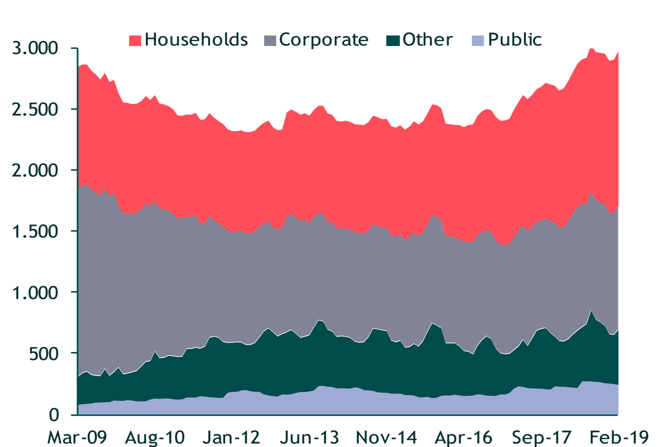
Merchandise import cover (%, 3mma)



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	2018	2019F	2020F
Activity									
Nominal GDP (EURbn,current prices)	3,2	3,4	3,5	3,7	4,0	4,3	4,6	4,9	5,1
Nominal GDP (USDbn)	4,1	4,5	4,6	4,1	4,4	4,9	5,5	5,6	6,2
GDP per capita (EUR)	5.114	5.415	5.564	5.875	6.355	6.907	7.422	7.843	8.264
GDP per capita (USD)	6.577	7.191	7.391	6.516	7.037	7.799	8.776	9.020	9.917
Real GDP (constant prices YoY, %)	-2,7	3,5	1,8	3,4	2,9	4,7	4,9	3,5	3,0
Private consumption (YoY, %)	-3,9	1,6	2,9	2,2	5,4	3,9	4,5	3,3	2,9
Fixed investment (YoY, %)	-2,4	10,7	-2,6	12,0	38,4	18,7	14,8	11,5	3,5
Industrial production (YoY, %)	-7,1	10,6	-11,4	7,9	-4,4	-4,2	22,4	5,0	4,5
Unemployment rate (ILO, average %)	19,7	19,5	18,0	17,6	17,7	16,1	15,2	14,8	14,4
Prices									
CPI inflation (average % YoY)	4,1	2,2	-0,7	1,5	-0,3	2,4	2,6	2,1	2,3
CPI inflation (end-year % YoY)	5,1	0,3	-0,3	1,4	1,0	1,9	1,5	2,8	2,5
PPI inflation (average % YoY)	1,8	1,7	0,2	0,3	-0,1	0,4	1,7	1,7	2,7
Net wage rates (% YoY, nominal)	0,7	-1,7	-0,5	0,7	3,8	2,5	0,1	2,4	2,4
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,5	-6,0	-3,0	-8,0	-3,4	-5,5	-3,4	-1,5	2,5
Public debt	53,4	57,5	59,9	66,2	64,4	64,2	70,8	68,0	64,8
Gross public funding needs	n/a	9,5	5,1	14,0	16,8	13,9	20,4	11,8	10,3
External balance									
Export of goods and services (EURbn)	1,338	1,390	1,388	1,539	1,605	1,765	1,999	2,139	2,278
Import of goods and services (EURbn)	-2,109	-2,066	-2,074	-2,214	-2,494	-2,773	-3,113	-3,320	-3,459
Merchandise trade balance (EURbn)	-1,384	-1,329	-1,376	-1,464	-1,658	-1,860	-2,050	-2,198	-1,745
Merchandise trade balance (% of GDP)	-43,5	-39,5	-39,8	-40,0	-41,9	-43,3	-44,4	-45,0	-33,9
Tourism receipts (EURbn)	0,643	0,666	0,682	0,813	0,836	0,922	1,001	1,063	1,148
Current account balance (EURbn)	-0,486	-0,383	-0,429	-0,401	-0,642	-0,692	-0,793	-0,832	-0,826
Current account balance (% of GDP)	-15,3	-11,4	-12,4	-11,0	-16,2	-16,1	-17,2	-17,0	-16,1
Net FDI (EURbn)	0,5	0,3	0,4	0,6	0,4	0,5	0,3	0,4	0,5
FDI (% of GDP)	14,5	9,6	10,2	16,9	9,4	11,3	7,1	8,2	10,3
FDI cover (%)	95,0	84,6	82,5	154,4	57,9	70,0	41,3	48,1	64,2
Gross international reserves (EURbn)	0,318	0,395	0,514	0,641	0,780	0,877	1,079	1,221	1,279
Import cover (months of imports)	1,8	2,3	3,0	3,5	3,8	3,8	4,2	4,4	4,4
Debt indicators									
Gross external debt (EURbn)	4,959	5,093	5,353	5,559	6,121	6,715	7,668	8,192	8,445
Government (EURbn)	1,295	1,352	1,646	2,061	2,187	2,364	2,484	2,539	2,346
Private (EURbn)	3,665	3,742	3,707	3,498	3,934	4,351	5,184	5,653	6,099
Gross external debt (% of GDP)	155,9	151,5	154,8	152,1	154,8	156,2	166,0	167,8	164,2
Gross external debt (% of exports)	370,6	366,4	385,6	361,2	381,3	380,5	383,6	382,9	370,7
Exchange rates and money growth									
EUR/USD (end-year)	1,32	1,38	1,21	1,09	1,05	1,19	1,15	1,20	1,24
EUR/USD (average)	1,29	1,33	1,33	1,11	1,11	1,13	1,18	1,15	1,20
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	8,5	7,4	6,3
ECB reference rate (end-year %)	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,00	0,00
EURIBOR 3M interest rate (average, %)	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,32	-0,32	-0,29

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

SELECTED BANKING SECTOR DATA

	2012	2013	2014	2015	2016	2017	2018	2019F	2020F
Balance sheet									
Assets (EURm)	2.808	2.959	3.136	3.472	3.790	4.182	4.407	4.605	4.769
Assets (%, YoY)	-0,1	5,4	6,0	10,7	9,2	10,3	5,4	4,5	3,5
Assets (% of GDP)	88,3	88,0	90,7	95,0	95,9	97,3	95,4	94,3	92,7
Gross loans (EURm)	2.342	2.414	2.367	2.386	2.416	2.701	2.930	3.148	3.347
Gross loans (%, YoY)	-0,7	3,1	-1,9	0,8	1,3	11,8	8,5	7,4	6,3
Gross loans (% of GDP)	73,6	71,8	68,5	65,3	61,1	62,8	63,4	64,5	65,1
Deposits (EURm)	1.981	2.098	2.308	2.625	2.872	3.267	3.459	3.628	3.786
Deposits (%, YoY)	9,0	5,9	10,0	13,7	9,4	13,8	5,9	4,9	4,4
Deposits (% of GDP)	62,3	62,4	66,7	71,8	72,6	76,0	74,9	74,3	73,6
Loan-to-deposit ratio (%)	118,2	115,1	102,6	90,9	84,1	82,7	84,7	86,8	88,4
Capital adequacy ratio (%)	14,7	14,4	16,2	15,5	16,0	16,4	16,5	16,1	15,8
Performance									
Net interest income (EURm)	106	104	111	117	122	125	139	148	153
Net interest income (%, YoY)	-0,1	-1,6	6,6	5,3	4,2	2,4	11,4	6,6	2,9
Total operating income (EURm)	178	156	158	171	175	189	194	207	214
Total operating income (%, YoY)	-19,5	-12,0	1,2	8,3	1,9	8,2	2,8	6,6	3,2
Pre-provision profit (EURm)	65	48	46	52	53	59	48	58	64
Pre-provision profit (%, YoY)	-43,2	-26,7	-2,6	11,5	2,6	11,3	-18,4	20,7	9,3
Provision charges (EURm)	121	44	21	53	44	22	17	15	13
Profitability and efficiency									
Net interest margin (%)	3,8	3,6	3,6	3,5	3,4	3,1	3,2	3,2	3,2
Pre-tax ROAA (%)	-2,0	0,1	0,8	-0,1	0,3	0,9	0,7	1,0	1,1
Pre-tax ROAE (%)	-18,7	1,0	6,0	-0,4	2,0	7,4	6,1	8,2	9,6
Cost-to-income ratio (%)	63,5	69,6	70,7	69,8	69,6	68,7	75,2	71,9	70,2
Operating expense (% of assets)	4,0	3,8	3,7	3,6	3,3	3,3	3,4	3,3	3,2
Credit quality and provisioning									
NPL ratio (%)	17,6	17,5	15,9	12,6	10,3	7,3	6,9	6,2	5,7
NPL coverage (%)	40,0	39,1	39,5	39,3	41,3	38,3	40,0	42,1	43,4
Provision charges (% of loans)	5,1	1,9	0,9	2,2	1,8	0,9	0,6	0,5	0,4
Provision charges (% of PPP)	185,7	92,5	45,6	103,2	82,2	37,2	35,2	26,1	20,4

Source: CBCG, Addiko research

All segments contributing positively to credit growth

In 2018 total loans increased by 8.5%, with all sectors contributing positively. Retail lending picked-up to 12.0% yoy driven by cash loans growth, amid increased employment and improved consumer sentiment. Corporate credit accelerated to 7.2% yoy, mostly attributable to high construction activity, followed by strong contributions from the public sector (13.5% yoy), while the volatile ‘other’ segment decelerated (3.1% yoy). Increased credit activity resulted in improvement of loan portfolio quality as NPL ratio fell to 6.9% (vs. 7.3% 2017YE). Meanwhile, deposit collection increased by 5.9% yoy owing to strong growth in the retail segment (7.8% yoy), leveraging on strong tourism inflows and improving labour market, while corporate deposits surprised with 1.8% yoy fall. After record profit level achieved in 2017, pre-tax profit decreased 15.8% yoy to EUR31m as strong NII upsurge (11.4% yoy) and lower provisioning costs (-22.7% yoy) were offset by sharp decline in other income and higher operative expenses.

Credit activity remains strong

Looking ahead, in 2019 we see somewhat slower lending dynamics around 7.4% 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 closer to the 6% mark. We expect slower deposit collection pace at around 5.0%, mostly due to high base effects and strong investment outlook. Regarding profits, strong NII growth and lower impairments will reflect in higher pre-tax profit level, assuming contained opex growth.

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
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
PIT	Personal Income Tax
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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