SEE Outlook Quarterly

by Economic Research Department

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Addiko Bank

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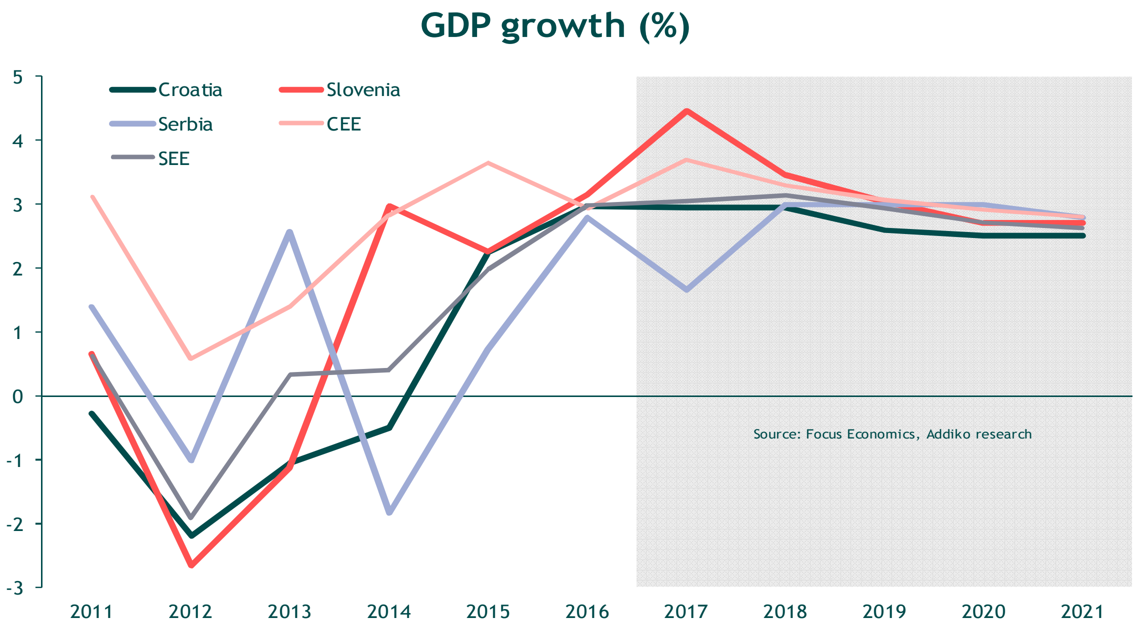
Addiko Bank

17 September 2017

STRONGER-FOR-LONGER RECOVERY?



FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017

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Consensus Economics Forecast Accuracy Award Winner 2014 Croatia

EXECUTIVE SUMMARY

Bottom LINE: We keep 2017 growth forecast in Slovenia, Croatia and Montenegro unchanged. , We cut 2017 GDP forecast in Serbia by 0.8pp to 1.7% due to soft 1H17, shut-downs in Fiat and about 20% lower agricultural output. The 0.4pp downgrade for Bosnia-Herzegovina to 2.7% arises from delayed public capex. Serbia, Bosnia-Herzegovina and Montenegro will see growth acceleration in 2018, driven by personal consumption and investments. In Croatia, we see the underlying 3% growth intact on above trend euro zone growth, stronger tourism, steady consumption and accelerating capex While the growth in Slovenia peaked in 2017, it will remain above-potential at 3.5% with firmer global activity, stronger capex, post-crisis catch up effects and domestic demand the main drivers. That said, the SEE region (on average) is set to grow just above 3% both in 2017 and 2018. Inflation is set to increase in 2017 in all countries, with the weakest price pressures seen in Croatia (0.8% on average) as price wars for Agrokor's retail space put downside pressures. We see somewhat lower budget deficit in Slovenia and Serbia this year, modest widening in Montenegro, no change in Croatia, while Bosnia-Herzegovina will see surplus fading somewhat.

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

*vs USD

KEY POINTS:

1. In Slovenia, we keep 4.5% GDP growth call in 2017 with upside risks from positive surprises in capex, while in 2018 we keep 3.5% GDP growth forecast on the back of firmer global activity, stronger capex , post-crisis catch up effects and domestic demand. In Croatia, we reiterate 2017 growth forecast at 3.0%, while in 2018 we see the underlying 3% growth intact on above trend euro zone growth, stronger tourism, steady consumption and accelerating capex. In Serbia, we cut our 2017 GDP forecast by 0.8pp to 1.7% due to soft 1H17, shut-downs in Fiat and about 20% lower agricultural output while for 2018 we kept growth forecast unchanged at 3.0% on the back of broad based acceleration in external and domestic demand. In Bosnia-Herzegovina, we cut 2017 and 2018 growth forecast by 0.4pp to 2.7% and 3.1%, respectively on the back of delayed public capex. In Montenegro, we keep 2017 growth forecast at 3.2%, and see acceleration to 3.4% in 2018, driven by personal consumption and investments.

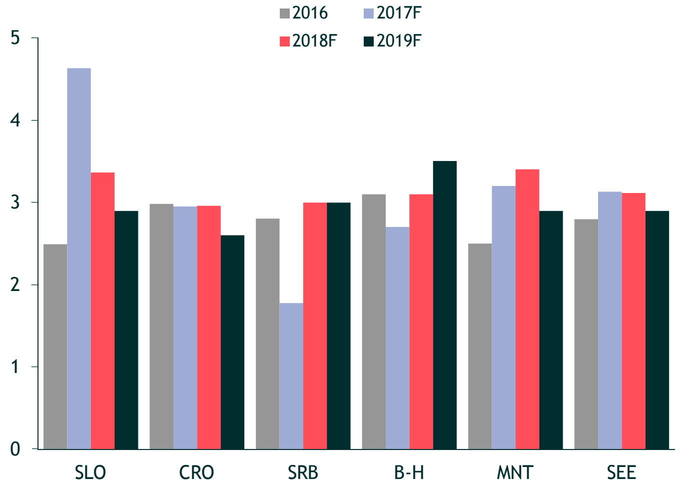
2. As for fiscal performance in Slovenia, while the budget deficit and public debt fall further, fiscal stance is slightly expansionary into in 2018, as reforms and privatization have been back-loaded after mid-2018 parliamentary elections. In Croatia, budget is on track to end 2017 with sub-1% of GDP deficit, and we see more of the same in 2018 when the deficit gap cut to 0.5% of GDP rests on cyclical strong revenue and stronger role of EU funding in public capex. In Serbia, we see this year's budget deficit at 0.8% of GDP followed by modest widening to 1.2%/GDP in 2018 due to public capex acceleration, 5-7% public wage and yet to be defined pension hikes.

3. Slovenian inflation stabilized just above 1% as strong domestic demand, tighter labor market and closing output gap suggest that core inflation will hover around 1.5% during 2018, while inflation could be slightly higher in 2H18 and wrap up 2018 at 1.5%. In Croatia, after an average 0.8% in 2017 , we expect CPI inflation to pick up to only 1.2% on average in 2018 with headline CPI inflation contained through a longer lag of price wars for Agrokor's retail space. In Serbia, we see the average 2017 CPI at 3.2%, with inflation pressures arising from stronger domestic demand, tighter labor market, higher industrial goods prices, 2% electricity price hike in October, fading base effect and NBS's expansive policy while in 2018 we see similar outcome.

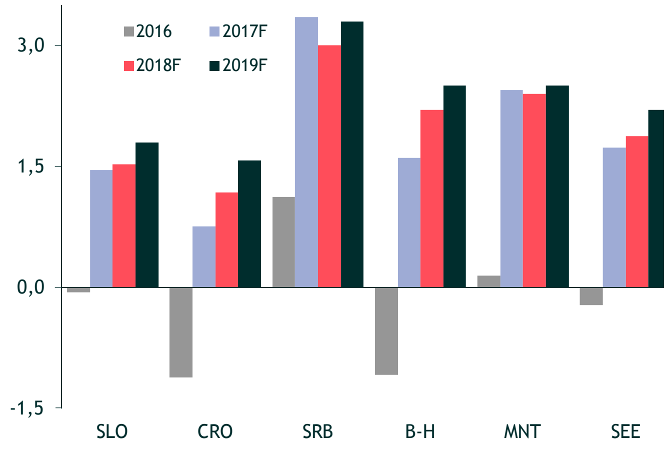
4. The ECB QE tapering seen in 1H18 must be communicated cautiously, ECB prefers open-ended QE strategy, and even once QE program is over, interest rates will stay close to record lows for. We see Slovenian yields in sync with the expected normalization in core yields, but given fairly cautious QE tapering dynamics, repricing of growth potential and continuing and material fiscal strength of the Slovenian economy, we expect a continuous favorable spreads development ahead. We expect the CNB to hold easing bias by maintaining ample kuna liquidity (at 4-5% of GDP) in its ongoing support to credit availability. With 2017 funding needs almost done, our bullish near-term outlook for Croatian bonds rests on macro/fiscal over performance, stronger local reforms activism and stronger structural fiscal adjustment prospects under EC-enabled fast-track for the euro adoption, viable Agrokor restructuring prospects and ensuing rating upgrade(s). In Serbia, We expect the NBS to keep the key interest rate at the current low in the next six to nine months, and we see one 25bp NBS rate hike in 3Q18, followed by two more in 2019. We see potential for further spread tightening in Q4, followed by gradual dinar rates normalization in 2018 in line with stronger bank lending and the Fed/NBS policy normalization.

SEE data trends

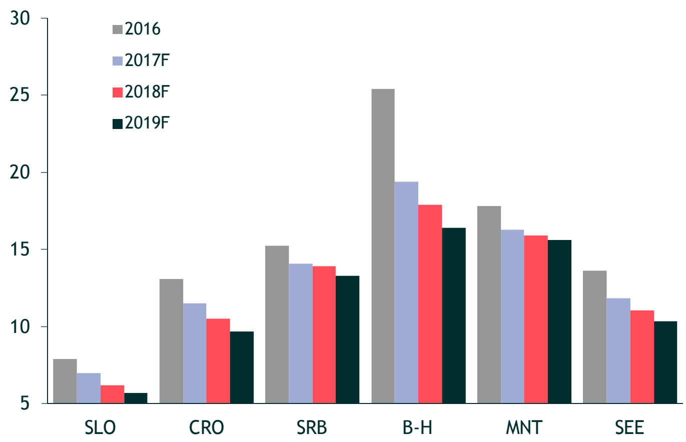
Real GDP growth (%)



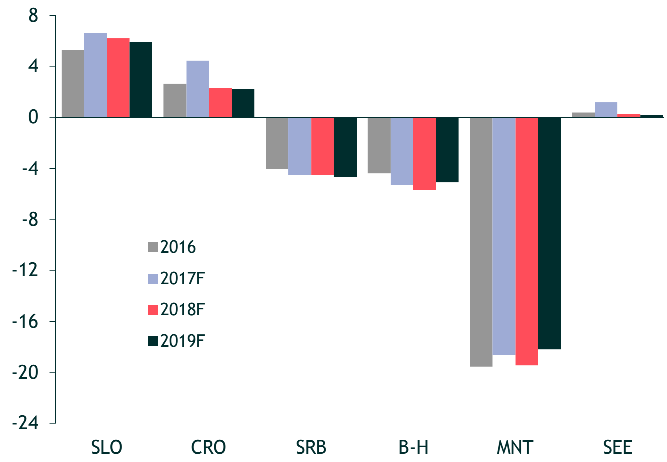
CPI inflation (average, %, YoY)



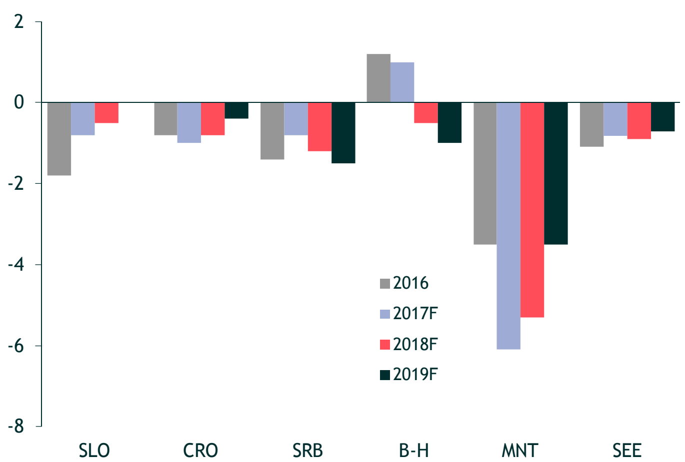
Unemployment rate (ILO, average, %)



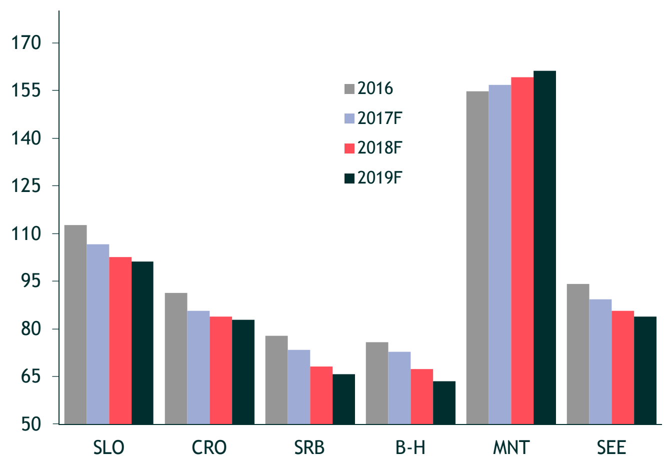
Current account balance (% of GDP)



Government balance (% of GDP)



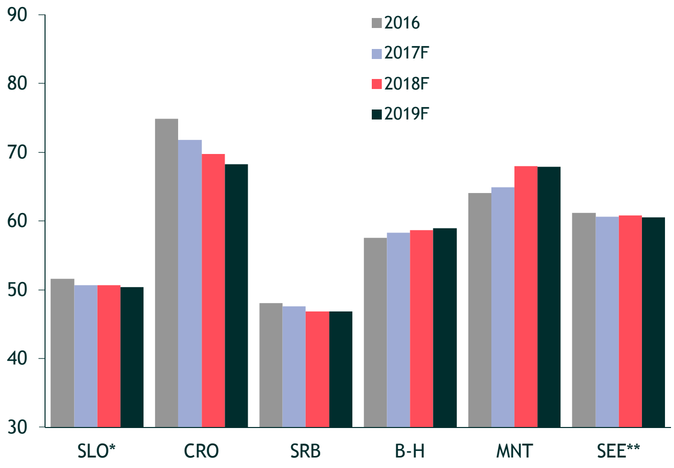
Gross foreign debt (% of GDP)



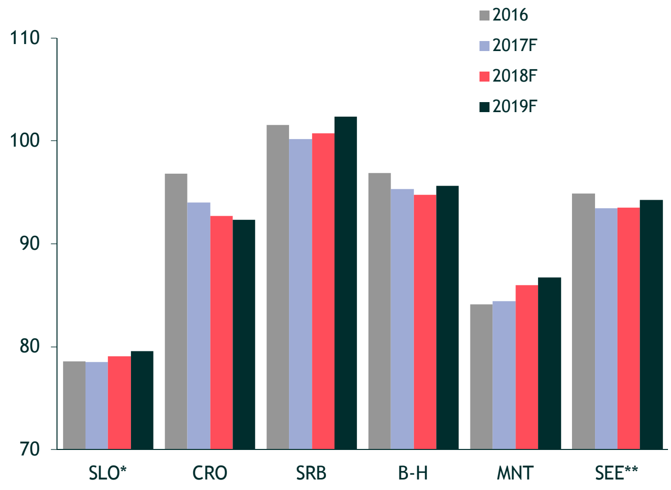
Source: National sources, Addiko research

SEE banking sector trends

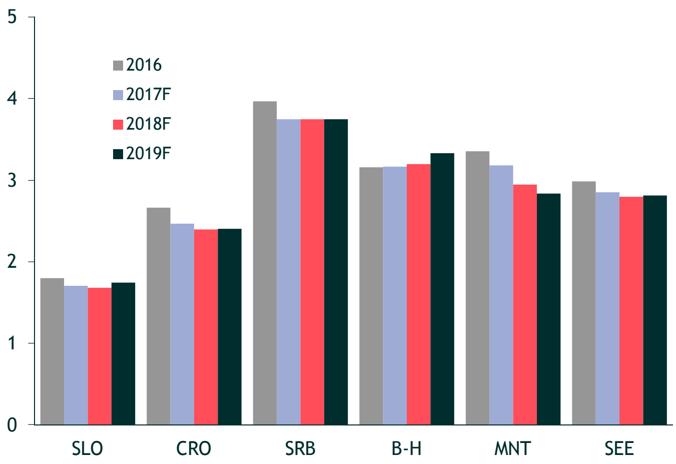
Gross loans (% of GDP)



Loan-to-deposit ratio (%)

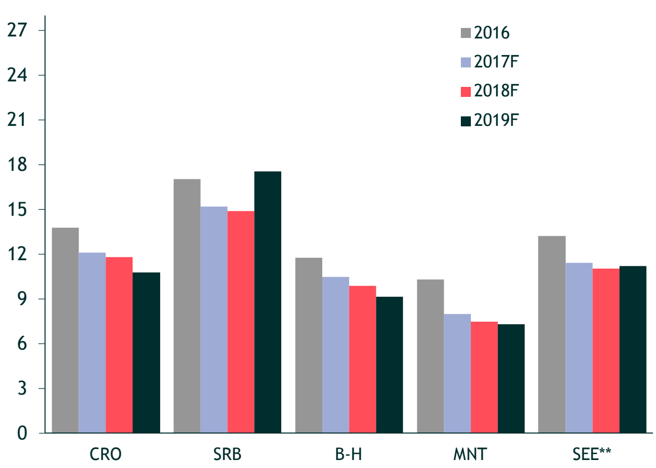


Net interest margin (%)

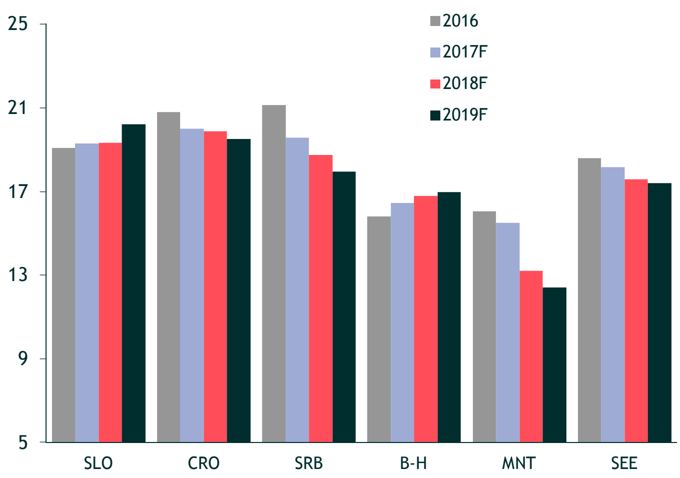


Cost-to-income ratio (%)

NPL ratio (%)



Capital adequacy ratio (%)



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

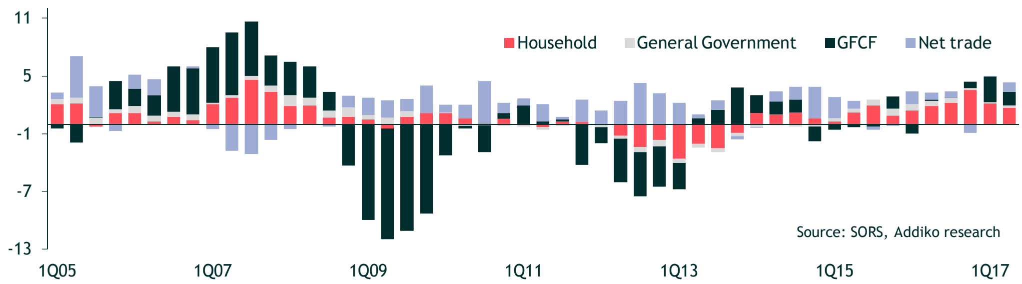
Boom Times

We hold above-consensus 4.5% GDP growth call for 2017 on soaring domestic as well as external demand accompanied by re-leveraging and broad-based investment demand acceleration. While the budget deficit and public debt decline further, fiscal stance is slightly expansionary looking into 2018, as reforms and privatiaztion have been back-loaded after mid-2018 parliamentary elections. Superior macro/fiscal picture versus EMU peripherals, broadly improved ratings and ample domestic banks' bid suggest ongoing Slovenian bonds outperformance despite the global monetary policy normalization.

Growth may be peaking, but remains above potential

The Q2 GDP (+1.1% qoq/5.2% yoy seasonally adjusted, prev. 5.0% yoy) met expectations, driven by domestic demand, but net exports contribution actually improved the most. Private consumption was fuelled by private employment, disposable income growth, foreign tourists' consumption, resurgent retail credit, cheaper debt service and housing market recovery. While slowing after Q1, investments (+7.4% yoy) stay a way above trend thanks to greater banks' supply of long-term loans, easier SMEs' access to credit, new EU funding cycle, record firms' profits, and strong demand outlook. The biggest positive mover - export - reflects larger-than-expected pick-up in the euro zone's demand, competitiveness gains and climbing up the value chain. As broader sentiment gauges forebode GDP growth well above trend, i.e. 0.7% qoq/4% yoy pace in H2, we reiterate above-consensus 4.5% GDP growth call for 2017. The balance of risks is a bit on the upside as capex in particular could spring positive surprises going forth.

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



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

We keep 3.5% GDP growth forecast for 2018 since firmer global activity, evidence of post-crisis catch-up effects and increasingly investment-driven domestic demand in the driving seat (encouraging from the vantage point of growth sustainability) prop up foreign demand. The last three months saw an 0.3pp upgrade of the euro zone's growth forecast for 2018 (0.6pp to date) on reduced political fears and investor belief that ECB QE exit velocity won't take away the key growth tailwind, which creates upside risks to export and investment. Competitiveness has improved in terms of export market shares, technology adoption and integration into high value-added global supply chains, despite faster wage growth in tighter labour market. Private consumption is set to grow at 3.5% pace on robust sentiment, decent employment, rising disposable income and re-leveraging. High capacity constraints, robust demand outlook, fiscal stimulus, firms' optimism, stronger EU funding, cheap finance and ample earnings all drive investment, including export capacity build-up. Despite strong import-intensive local demand, resilient exports ensure positive net trade contribution in 2018, just as stronger supply side is driving potential growth higher. While the risks to our forecasts are balanced, uncertainties from Brexit, US protectionism and the growing lack of labour locally are the main risks to the downside. Positive surprises on global growth, fiscal expansion ahead of mid-year elections, even stronger rebound in capex, but also privatization after elections are upside risks.

Inflation remains stuck around EMU average

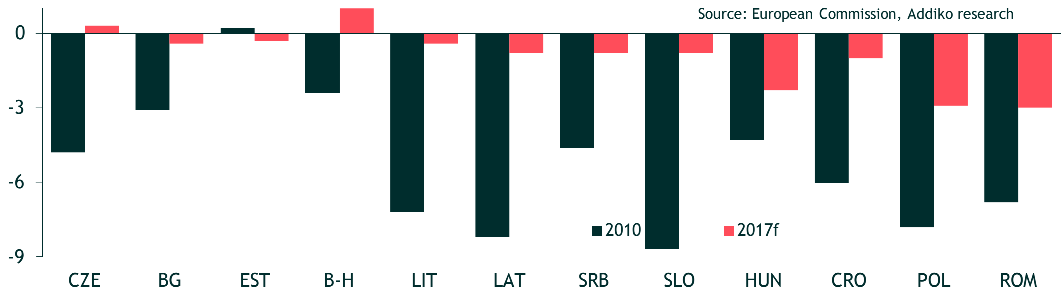
The recent subduedness in seasonal food and energy prices has meant that headline inflation stabilized on the downside just above 1%. With crude oil prices likely to continue hovering around USD50/bbl and taking on board the stronger euro, the energy component is unlikely to add something to inflation in the rest of this year and will even push inflation lower in 1H18. Looking at trends in food commodities, food price inflation is also unlikely to have much of an upward impact on inflation. To be sure, inflation has clearly troughed as strong domestic demand, tighter labour market and closing output gap suggest that core inflation will hover around 1.5% throughout 2018, while headline inflation could be slightly higher in 2H18 and wrap up the FY18 at 1.5% (in line with the EMU average). Given the risk that an overshoot of the euro FX rate could push inflation back below 1.5%, caution remains warranted in removing ECB policy accommodation.

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

Further increase in C/A surplus in 2017 owes to steady external demand (including for tourism) and the new EU funding. The next year will in our view see some moderation as import-intensive domestic demand will maintain similarly strong momentum and together with commodity price stabilization lead to a bout of trade surplus shrinkage. As long as net external debt drops sharply and banks' liquidity is abundant, we expect a further improvement in the net international investment position to -25% of GDP, which is a lot better compared to Baa-rated median and highlights much lower external vulnerabilities relative to pre-crisis period.

With ongoing near-record C/A surpluses, hefty 11%/GDP fiscal reserve and the MinFin active in the sovereign debt restructuring, currently in the process of the third USD bonds swap with cheaper Eurobonds and a possible net new issuance, funding position is extremely positive, and the average debt duration is extended significantly. With huge ECB accomodativeness still in place, Slovenia may use every opportunity for early 2018 (re)financing early next year. Meanwhile, FDI flows have practically came to a halt and NLB bank's IPO is delayed again as the approaching election cycle, the government's intransigence on buying controlling stakes in 'strategic' SOEs and generouss regulation do not inspire investors. Narrowing the group of 'strategic' SOEs that are not available for sale, incentivizing bank consolidation and competitiveness reforms are of utmost importance to boost FDI stock and integrate further into the global value chains, both comparatively weak by international standards.

Slovenia: fiscal deficits (% of GDP)



Fiscal consolidation exhibits a marked improvement

Faster narrowing in the budget deficit in the year to July (-82.1% yoy to EUR107.9m) is driven by buoyant tax revenue (+8.3% yoy), especially CIT and VAT, alongside -0.4% yoy lower spending. Despite public wages, pensions and social transfers hikes, and healthcare overruns, public spending cuts reflect interest expenditure savings thanks to USD bond buybacks (soon above 60% of total exposure) and some public capex under-execution. Stronger-than-planned GDP growth, first ever positive impact from BAMC and high interest savings will in our view offset higher public wage bill and entitlement spending ahead of mid-2018 elections, stronger EU-funded capex, and finally cut 2017 budget gap below 1% of GDP. Politics are not supportive for fiscal consolidation in 2018 when the structural deficit widens close to 2% of GDP on a large change in output gap, soaring public capex, higher entitlement outlays, 2.7% pension indexation and higher bonuses. In fact, above-planned pension indexation allowed by 2.5%+ GDP growth from 2016, higher local government spending and higher capex and transfers potentially worth EUR100m pose the biggest risks to fiscal slippage. While fiscal consolidation in 2018 (by just 0.3pp to 0.5% of GDP, in our view) rests on the ongoing domestic demand overshooting, full impact of interest rate savings of 0.3% of GDP FX-adjusted and some savings in procurement, the focus should soon move on frontloading of entitlement reforms to prevent overheating.

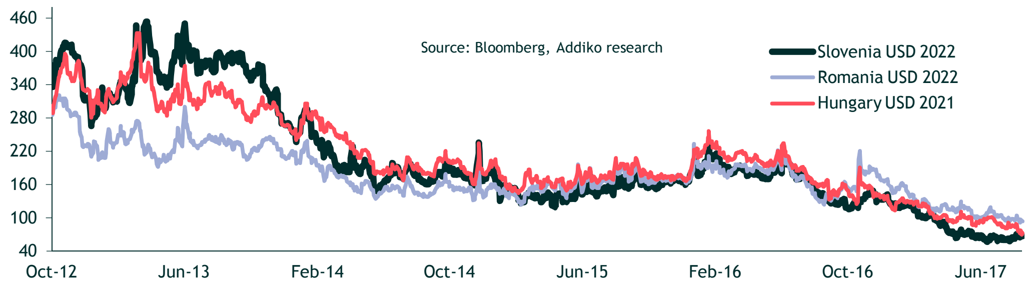
... but public and interest costs stay on a firm downward trend

Upon the last year's drop below 80% of GDP on strong deficit reduction, we expect public debt to fall further in 2018-2019 below 70% of GDP as the deficit converges to zero, GDP growth surprises on the upside and the MinFin deploys apart of its hefty cash reserve (11% of GDP). This effectively brings the adjusted net public debt close to 60% in 2019, with BAMC activity and eventual privatization after elections posing positive risks for even lower debt. As exemplified before, pre-funding operations for 2018 will likely combine further USD bond buybacks and lengthening of the euro yield curve. Importantly, pro-active debt management strategy has not only lowered vulnerability to an interest shock, but also led to further reduction in the sovereign's interconnectedness with the banking sector. Public debt cuts could be stronger in the medium run should reform-driven consolidation gain momentum (notably in pension system and healthcare), and if proceeds from privatization (NLB, Telekom Slovenije) and the expected BAMC asset resolution are applied to debt reduction. Further bank and corporate (both SOE and private ones) restructuring, with an overall ambitious low NPL targets, are equally important to reduce risks to public finances over the medium term.

Risk aversion and inflation undershooting lower yields...

The renewed risk aversion (due to US political, geo-political tensions, etc.) and unwelcome downward inflation revisions in the euro zone have supported bond markets incl. Slovenian longer maturities. The focus has also been on widening in peripheral spreads, led by Italy, given reassessment of domestic political risks, supply set-up for September and an unwind of carry trades from the summer in an illiquid market. That said, Slovenia outperformed politically-sensitive peripheral issuers (Italy, Spain and even more constructive Portugal), despite the ECB's overbought of periphery bonds this summer and indecisive ECB. For Slovenia, GDP growth over performance, very active debt management, faster public debt stabilization, S&P's rating upgrade to A+ in June followed by the recent two-notch Moody's upgrade and much cheaper debt service as a result all support sentiment going forth.

Slovenian spreads in tandem with peers

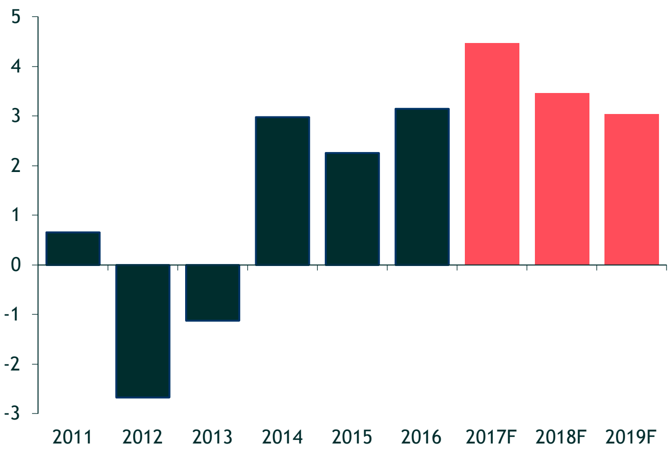


... as ECB is eyeing monetary normalization

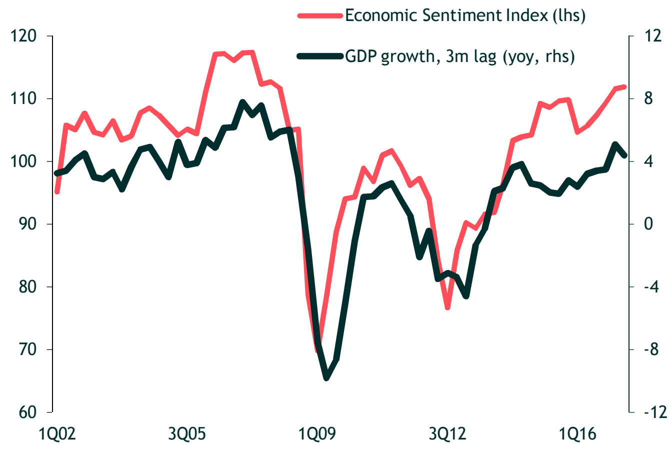
Booming economy has raised prospects of the ECB's game plan on QE tapering, but the euro rally, subdued inflation outlook and sanguine 'credit impulse' complicate the next policy steps. This means QE tapering largely seen in 1H18 (unless the euro appreciates noticeably) must be communicated cautiously, ECB prefers open-ended QE strategy, and even once QE program is over, interest rates will stay close to record lows for longer as inflation outlook undershoots. In that vein, we see Slovenian yields in sync with the expected rise in core yields, but given fairly cautious QE tapering dynamics, repricing of growth potential and continuing and material fiscal strength of the Slovenian economy, we expect a continuous favorable spreads development ahead. With the almighty monetary QE bazooka at its exit rout, Slovenian spreads may though not easily avoid 30-50bp widening during risk-off episodes, in our view. Worth following going forth are Slovenia's key policy challenges, including post-election frontloading of (entitlements) reforms to avoid overheating and resumption of privatization (starting with NLB) to cut public debt and contingent liabilities faster. Also, prefunding for 2018 can be done opportunistically without material pressures on rates given the fully funded 2017 and strong cash buffer. As such, positive risks for bond performance include further USD bond buybacks and the euro curve lengthening on optimism after S&P and Moody's upgrades that would further lower interest outlays. In the medium term, we see Slovenian bonds outperforming on superior macro/fiscal over performance relative to EMU peripherals and increasingly tagged as semi-core story.

Slovenia's data trends

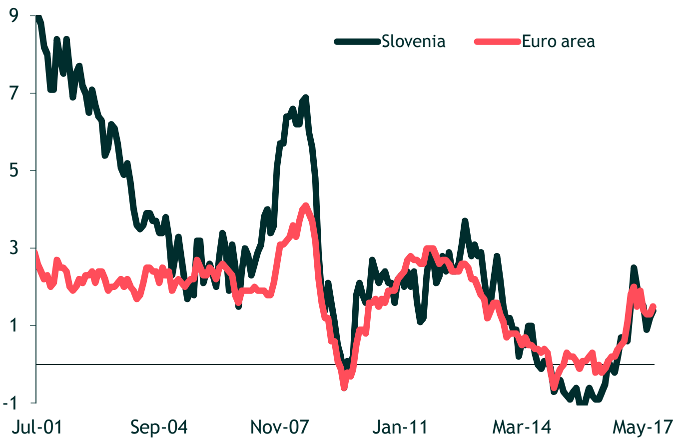
Real GDP growth (% YoY)



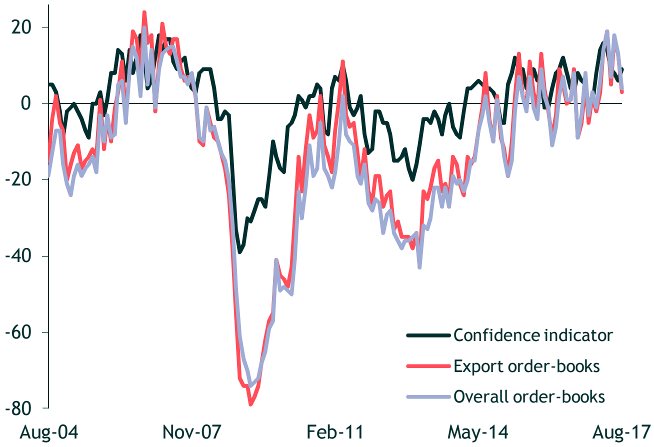
Economic confidence vs. GDP growth



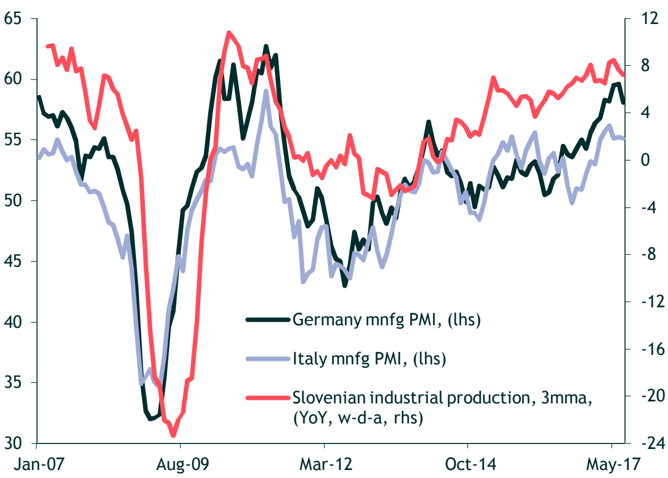
CPI inflation dynamics (% YoY)



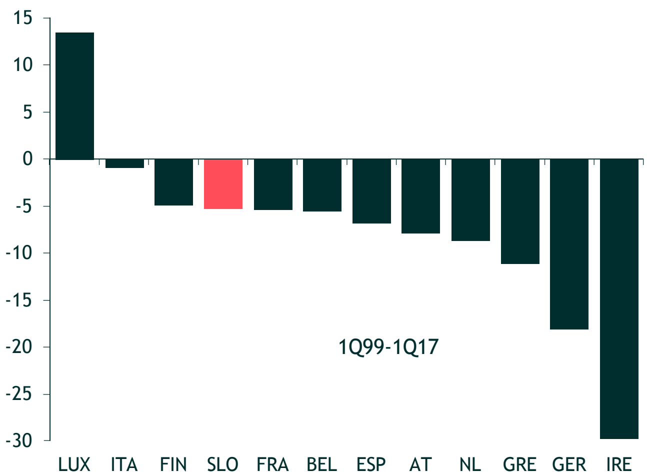
Business sentiment in manufacturing



PMI vs Industrial production - Slovenia



Unit labour cost for the total economy



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Activity									
Nominal GDP (EURbn, current prices)	36,9	36,1	36,2	37,6	38,8	40,4	42,8	44,9	47,1
Nominal GDP (USDbn)	51,4	46,4	48,1	50,0	43,1	44,8	47,8	50,5	54,2
GDP per capita (EUR)	17.972	17.538	17.592	18.242	18.834	19.582	20.721	21.671	22.683
GDP per capita (USD)	25.028	22.554	23.364	24.234	20.889	21.685	23.127	24.326	26.086
Real GDP (constant prices YoY, %)	0,6	-2,7	-1,1	3,0	2,3	3,1	4,5	3,5	3,0
Private consumption (YoY, %)	0,0	-2,4	-4,2	1,9	2,1	4,3	3,8	3,4	2,9
Fixed investment (YoY, %)	-4,9	-8,8	3,2	1,1	-1,6	-3,6	8,4	6,5	5,7
Industrial production (YoY, %)	1,3	-0,8	-0,9	1,7	5,1	7,9	7,3	6,9	6,0
Unemployment rate (ILO, average %)	8,2	8,9	10,1	9,7	9,0	7,9	7,0	6,2	5,7
Prices									
CPI inflation (average % YoY)	1,8	2,6	1,8	0,2	-0,5	-0,1	1,5	1,5	1,8
CPI inflation (end-year % YoY)	2,3	2,7	0,7	0,2	-0,5	0,5	1,5	1,6	1,7
PPI inflation (average % YoY)	4,5	0,9	0,3	-0,6	-0,2	-1,5	1,9	2,1	2,4
Net wage rates (% YoY, nominal)	2,1	0,4	0,6	0,8	0,7	1,9	3,5	3,0	2,7
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,7	-4,1	-15,1	-5,4	-2,9	-1,8	-0,9	-0,6	-0,2
Public debt	46,6	53,9	71,0	80,9	83,1	79,7	75,6	72,2	68,6
Gross public funding needs	10,5	8,2	19,3	14,5	6,4	9,6	6,9	5,4	5,1
External balance									
Export of goods and services (EURbn)	25,948	26,363	27,010	28,520	29,905	31,401	33,347	35,015	36,748
Import of goods and services (EURbn)	25,516	24,934	24,569	25,641	26,569	27,690	29,584	31,329	32,927
Merchandise trade balance (EURbn)	-0,974	-0,081	0,708	1,181	1,476	1,537	1,413	1,335	1,471
Merchandise trade balance (% of GDP)	-2,6	-0,2	2,0	3,1	3,8	3,8	3,3	3,0	3,1
Tourism receipts (EURbn)	1,975	2,008	2,043	2,060	2,098	2,190	2,362	2,476	2,569
Current account balance (EURbn)	0,068	0,930	1,732	2,179	1,698	2,108	2,526	2,562	2,544
Current account balance (% of GDP)	0,2	2,6	4,8	5,8	4,4	5,2	5,9	5,7	5,4
Net FDI (EURbn)	0,6	0,5	0,0	0,6	1,3	0,9	0,5	1,0	1,1
FDI (% of GDP)	1,7	1,3	0,1	1,6	3,3	2,2	1,1	2,1	2,3
FDI cover (%)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0,767	0,722	0,669	0,837	0,760	1,400	2,100	2,750	3,340
Import cover (months of imports)	0,4	0,3	0,3	0,4	0,3	0,6	0,9	1,1	1,2
Debt indicators									
Gross external debt (EURbn)	41,669	42,872	41,658	46,314	46,627	44,805	44,455	44,205	44,005
Government (EURbn)	8,748	11,092	15,459	22,416	24,824	22,953	23,253	23,703	24,953
Private (EURbn)	28,534	25,709	23,457	21,815	19,587	18,395	17,702	17,202	17,852
Gross external debt (% of GDP)	112,9	118,8	115,0	123,1	120,1	110,9	103,8	98,4	93,4
Gross external debt (% of exports)	160,6	162,6	154,2	162,4	155,9	142,7	133,3	126,2	119,7
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,15	1,14	1,17
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,12	1,12	1,15
Money supply M1 (% YoY)*	1,5	4,4	0,1	18,5	24,9	17,1	11,5	14,6	14,2
Broad money M3 (% YoY)*	3,5	-1,4	-1,3	6,1	4,6	7,1	3,3	4,5	4,5
Domestic credit (% YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,2	4,7	4,2
ECB reference rate (end-year %)	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,17
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,25
SLO 5Y yield (average %)	3,96	4,55	4,35	2,14	0,84	0,20	0,25	0,45	0,80
SLO 10Y yield (average %)	4,98	6,01	5,87	3,28	1,67	0,82	1,10	1,35	1,70

* Since 2007 ECB data

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	48.748	46.125	40.344	38.714	37.383	37.052	38.098	38.570	39.147
Assets (%, YoY)	-3,1	-5,4	-12,5	-4,0	-3,4	-0,9	2,8	1,2	1,5
Assets (% of GDP)	132,1	128,1	112,3	103,7	96,9	93,2	90,3	87,2	84,5
Net loans (EURm)	32.875	30.964	24.338	21.540	20.275	20.535	21.397	22.409	23.346
Net loans (%, YoY)	-4,6	-5,8	-21,4	-11,5	-5,9	1,3	4,2	4,7	4,2
Net loans (% of GDP)	89,1	86,0	67,8	57,7	52,6	51,6	50,7	50,6	50,4
Deposits (EURm)	24.170	23.856	22.550	24.426	25.140	26.133	27.249	28.340	29.348
Deposits (%, YoY)	2,8	-1,3	-5,5	8,3	2,9	3,9	4,3	4,0	3,6
Deposits (% of GDP)	65,5	66,3	62,8	65,4	65,2	65,7	64,6	64,0	63,3
Loan-to-deposit ratio (%)	136,0	129,8	107,9	88,2	80,6	78,6	78,5	79,1	79,5
Capital adequacy ratio (%)	11,8	11,4	13,7	17,9	18,6	19,1	19,3	19,3	20,2
Performance									
Net interest income (EURm)	1.018	886	708	832	746	670	636	633	649
Net interest income (%, YoY)	-2,0	-12,9	-20,1	17,5	-10,4	-10,1	-5,1	-0,6	2,6
Total operating income (EURm)	1.447	1.566	1.091	1.231	1.158	1.128	1.110	1.116	1.135
Total operating income (%, YoY)	-1,9	8,2	-30,3	12,8	-6,0	-2,6	-1,6	0,5	1,7
Pre-provision profit (EURm)	670	823	370	544	472	464	453	464	474
Pre-provision profit (%, YoY)	-5,4	22,8	-55,0	47,0	-13,3	-1,5	-2,4	2,3	2,1
Provision charges (EURm)	1.207	1.599	3.809	650	313	85	85	84	85
Profitability and efficiency									
Net interest margin (%)	2,1	1,9	1,6	2,1	2,0	1,8	1,7	1,7	1,7
Pre-tax ROAA (%)	-1,1	-1,6	-8,0	-0,3	0,4	1,0	1,0	1,0	1,0
Pre-tax ROAE (%)	-13,3	-20,3	-92,9	-2,7	3,7	8,4	7,8	7,5	7,2
Cost-to-income ratio (%)	53,7	47,4	66,1	55,8	59,3	58,8	59,1	58,4	58,2
Operating expense (% of assets)	1,6	1,6	1,7	1,7	1,8	1,8	1,7	1,7	1,7
Credit quality and provisioning									
NPA ratio (%)	11,4	15,0	13,7	11,5	9,9	5,5	4,5	4,3	4,0
NPA coverage (%)	58,6	60,4	91,6	58,2	59,7	52,5	74,4	91,1	108,0
Provision charges (% of loans)	2,4	3,4	8,8	1,6	0,8	0,2	0,2	0,2	0,2
Provision charges (% of PPP)	180,1	194,3	1.029,2	119,5	66,4	18,3	18,6	18,2	18,0

Source: BSI, Addiko research

Solid private lending growth...

Lending activity increased modestly in the year to June, with net loans up 0.7% ytd (vs +1.3% yoy in 2016) due to strong public sector de-leveraging (-15.8% ytd) amid very active foreign debt management. However, private lending contributed positively, with retail credit up 3.3% ytd on the back of both consumer and housing loans amid better labour conditions and low interest rates. Despite popular cross-border borrowing, corporate lending increased 2.0% ytd on stronger capex financing, low interest rates and easier financial conditions. As ytd lending activity met our expectations, we keep 5.2% yoy credit growth forecast amid robust macro environment, better labor market outlook, increased consumer optimism, strong real estate outlook, easier financial conditions, private capex and low private sector's indebtedness. That said, corporate has strongly improved its equity ratio to 49%. SMEs and domestically-orientated firms will support corporate lending as well. We see credit growth acceleration to 4.7% yoy in 2018 on the back of corporate re-leveraging amid decent private capex, while the expected SMEs NPL resolution will support lending activity in that segment. NPL ratio declined to 5.0% in Q2 (vs 5.5% at YE16), and we expect further decline to 4.0% in 2018 amid NPL sales, higher write-offs, collateral liquidation and SME NPL resolution.

Pre-tax profits seen around 2016 levels

Deposit collection grew 1.3% ytd (vs +3.9% yoy in 2016) thanks to 2.6% ytd stronger household deposit intake given job and wages growth and the entrenched propensity to save. Corporate deposits stayed unchanged due to private capex needs, while public deposits sank 16.0% ytd. In 2017, we see deposit collection growth acceleration to 4.3% on slower public deposits outflows and strong private sector deposit collection as retail deposit growth stays around last year's level on bright labor market outlook. Strong earnings will support corporate deposits, although they are set to decelerate due to capex needs. Deposit collection growth is set to moderate to 4.0% in 2018 amid high-base effect and slower private deposit growth. As for profits, low interest rates environment will likely see further NII decline in 2017-2018, while higher non-interest income and lower provisioning (after high impairments in previous years) and more active NPL resolution will maintain pre-tax profits around 2016 levels.

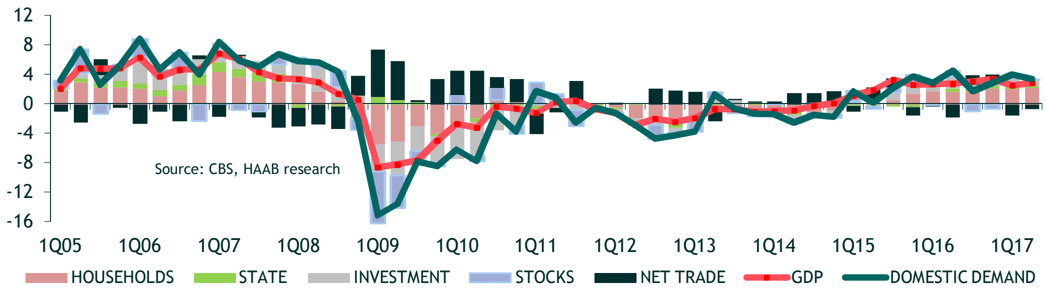
Broad Based Growth Momentum Continues

Despite the moment of truth for Agrokor, we keep above-consensus 3% GDP grow call for 2018 on above-trend and EU demand, deeper trade inroads, tourism, steady consumption, stronger capex and policy-led optimism. Encouragingly, macro/fiscal over performance, stronger local reforms activism and stronger structural fiscal adjustment prospects under EC-enabled fast-track for the euro adoption and viable Agrokor restructuring support rating upgrade(s). This alongside potential delay in the ECB QEs exit, hunt for carry in low volatility environment and EM resilience may well trigger a positive market response in the form of further Croatian risk tightening in the near term.

Growth momentum continues, despite Agrokor scares

The economy has proved resilient to Agrokor wobbles, driven by external cyclical recovery, stellar tourist season, robust private spending, better funding conditions and employment. With strong external headwinds and record-breaking tourism earnings offsetting any downside from Agrokor issues, we reiterate above-consensus 2017 GDP growth forecast at 3.0%. At the same time, private consumption does not only rest on tourist season (its boost to retailing and real incomes), but consumers benefit from improved labour market, re-leveraging, tax cuts, remittances and lower propensity to save. Robust overall demand outlook, stronger bank lending underscored by easier SMEs' access to credit, EU funding, soaring construction orders (+49.7% yoy in H1), record firms' profit (+13.9% yoy in 2016) and low interest rates all fuel investments. While goods exports keep momentum in H2 on steady euro zone demand, robust domestic demand and commodity price normalization will see net trade contribute neutrally.

Croatia: contributions to GDP (in pps)



We stay above-consensus for 2018, productivity growth needed

After a honeymoon provided by HDZ-led political forces consolidation, lower policy uncertainty and a stellar tourism, the growing populists demands (real estate tax abortion, expropriation of banks, etc) will make it difficult for the government's thin majority to tackle bolder reforms ahead. These are necessary to break the low-potential-growth-loop via policies for 'growth over-shooting', and reset long-term expectations. What it takes is not just about accommodative policy long into the recovery, but a demonstrable proof that competitiveness can be sustained well above received wisdom would have it. In that vein, the cabinet moves forward with key reforms in public sector and education, SOE restructuring, comprehensive red tape cuts and more active (quasi)sovereign debt management to cut interest rates further. While Agrokor restructuring may have a stronger impact in 2018, we see the underlying 3% growth intact thanks to above-trend and broad-based EU demand, deeper trade integration, tourism, steady consumption and stronger capex on the wings of EU funding, construction and policy-induced optimism. The risks to our baseline forecasts are bit more on the downside, given difficult-to-quantify effects of Agrokor and intertwined firms' restructuring, growing crisis of a lack of available quality labour due to high emigration, and bank unfriendly policy-making. Upside risks stem from stronger external backdrop, tourism, EU funding and FDI, plus fiscal easing.

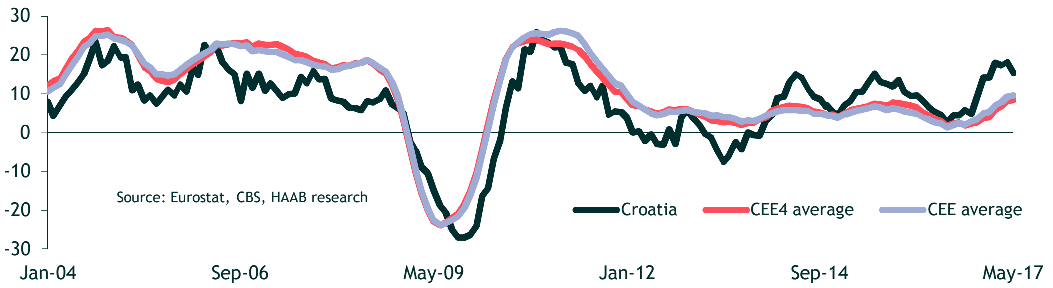
Inflation normalizing slowly after years of deflation

We see headline CPI inflation contained through a longer lag of price wars for Agrokor's retail space, increase trade opens and a renewed slowdown in energy and seasonal food inflation. There are, however, upside risks from post-election administrative (e.g. electricity) price hikes and wage pressures from tighter labor market, tax cuts and public wage hikes, and the resulting closing of output gap in early 2018, which the CNB will monitor but views as no obstacle to accommodative policy (next page). While higher processed food inflation from abroad and fading effects from past commodity price declines enable recovery in inflation in 2H17, this should be again smoothed by stronger euro (against the USD) in import prices, and energy inflation should continue to put downward pressure well into 2018. All in all, after an average 0.8% in 2017 (one of the lowest in the EU), we expect CPI inflation to pick up to only 1.2% on average in 2018.

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

Stronger euro zone investment and consumer demand bode well for goods export growth this year and next one. Stronger productivity growth in private sector relative to wages since 2011 (or ~25% NEER (deflated by unit labour cost) depreciation) has neared limits, requiring further competitiveness gains in red tape cuts and generally in non-price area. Stronger consumer demand, private capex and corporate credit recovery, and high import content of exports lift imports as well, leading to higher trade gap and C/A surplus moderation compared to 2017 when it is inflated by much lower income deficit courtesy of foreign-owned banks' losses on hefty Agrokor-related provisioning (~1.5% of GDP). Despite that, we see new record in tourism FC receipts and EU transfers, and C/A surplus around 2.5% of GDP. The external debt slump and lower borrowing needs after Agrokor-related write-offs, stronger banks' net external position and external de-leveraging (as part of balance sheet restructuring, NPL sales), and decent portfolio/FDI flows will see further improvement in net international investment position.

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



CNB hold easing bias

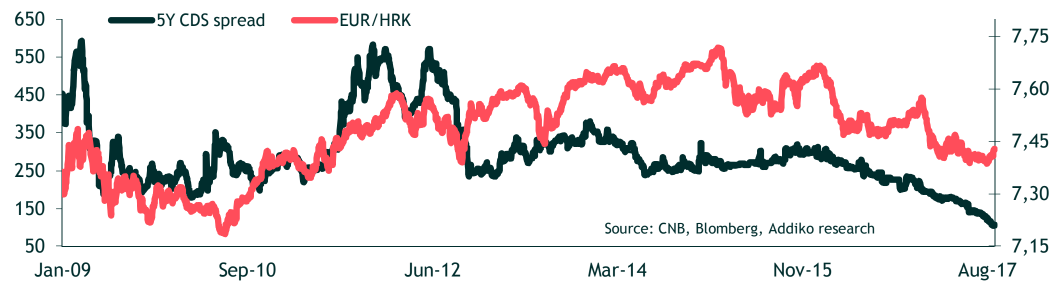
Despite the expected ECB's QE exit plan by year-end, we expect the CNB to hold easing bias by maintaining ample kuna liquidity (at 4-5% of GDP) in its ongoing support to credit availability. After creating HRK5.3bn in four FX deals through heavy tourist-related FC supply, we expect the CNB's proven ability in bringing down the kuna yield curve and liquidity cost for banks, and addressing pent up demand for kuna credit vindicate further easing via enhanced REPO facility and collateral pooling, FX transactions and mandatory reserve cuts. While the latter would fit into early EMU entry strategy, what is also positive - discussion is shifting slowly from 'the need to sustain lofty accommodation' to how to deliver it. Crucial for promotion of popular fixed-rate kuna credit is the right kind of platform to provide banks ample long-term kuna funding, be it through long-term FX swaps/interventions, NDF instruments, longer REPO or interest rate swaps what most banks prefer. If anything, collateral pooling raises policy space and flexibility to adjust the degree of accommodation, if and when needed, in either direction. This is consistent with our long held view of a slow exit thereafter and lower rates for longer. From a risk perspective, monetary easing is allowed by strong banks' external positions, steady FX outlook and reduced fiscal risk. Liquidity easing is accompanied by fiscal incentives for NPL sales and looser risk classification rules to IFRS norms, allowing sharp reduction of provisions and cost of risk as well as debt collection, further restructuring of funding and in turn cheaper lending.

EURHRK bottoms above 7.40, seasonal normalization in sight

Hefty FC inflow out of another record tourist season and soaring goods exports are largely behind strong appreciation pressures on the kuna, stopped only after four FX interventions this summer (totaling EUR612m) due to its competitiveness considerations. Substantial fiscal risk mitigation, record C/A surplus and banks' net foreign assets, and stronger demand for kuna credit have also underpinned the kuna. Short-end rates stay at historic lows due to persistent record interbank liquidity, monetary easing prospects and stable kuna. The markets' solace that DM policy makers will deliver less tightening and continued strong inflows into EM fixed income funds have supported EM/CESEE debt, despite acceptance that valuations now look stretched. Croatian bonds outperformed visibly given the ongoing fiscal over performance, cheaper refinancing of state road firms in sight, smartly bought time for Agrokor restructuring and better rating prospects.

Despite robust C/A and stronger external position outlook, we see FX rate normalization in the upper half of the 7.40-7.55 band through Q4. Namely, banks' guesswork over final Agrokor-related provisioning needs and banks' structural bid as long as FX-linked loan backflow (potentially inflated by state road firms' early repayment) outpaces new kuna business leave FX demand skewed to the upside. Depreciation pressures are limited as tourist-related and other exporters' FX supply, plus stronger EU funding, continue in Q4 and beyond, and hence tame stronger upward moves. Given, moreover, sharply higher CNB FX reserves this year, reduced sovereign risk and prefunding prospects in early 2018, we'd not see stronger volatility for the time being. Lastly, given ~25% NEER (deflated by unit labour cost) depreciation in the last 5-7 years, the CNB may want to put more emphasis to hard-won price competitiveness, which also helps them to deal with the FX reserve P&L question after the euro strengthening against the USD.

Croatia: 5Y CDS spreads and EUR/HRK



Further spread tightening upon EM sentiment and rating upgrade(s)

The CNB hefty liquidity provision and further easing (prospects), liquidity flooding after early repayment of state road firms' loans, and stable kuna outlook combined, we see short-end rates record low. Despite rising demand for bank kuna lending and roll-over of FX-linked loans, new financing volume is insufficient to push rates up. With 2017 funding needs largely closed, sound (re)financing options and favorable conditions for larger and longer (up to 15Y) kuna bond issue ahead of hefty supply in November (HRK20bn+) and EUR0.5-1bn road firms' debt roll-over by year-end and comfortable euro benchmark issuance prospects in 1Q18, Croatian spreads may tighten further. Our bullish near-term outlook rests on macro/fiscal over performance, ~3pp/GDP lower funding needs in 2018, stronger local reforms activism and stronger structural fiscal adjustment prospects under EC-enabled fast-track for the euro adoption, viable Agrokor restructuring prospects and ensuing rating upgrade(s). All mentioned alongside the strong euro-induced delay in the ECB QEs exit, ongoing hunt for carry in low volatility environment and the subsequent EM resilience may well trigger a positive market response in the form of further Croatian 5Y CDS spreads 30bp-alike tightening in the next 3-6 months, before the expected normalization of the central banks' balance sheets induces some yield curve steepening. The major disruptors to our benign baseline include volatility over Agrokor concerns (on the order of 100-150bp), and a sizeable reversal in US rates normalization of many one-offs (hurricanes, US politics, debt ceiling fears) pressurizing term premium risk in the UST curve.

Public finances in better health...

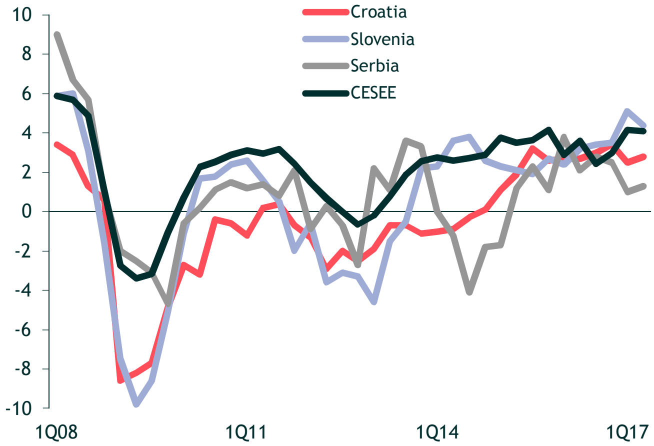
Fiscal accounts show a further improvement in 1H17, with the budget deficit down 33% yoy to just HRK1.6bn (0.4% of GDP) thanks to stronger-than-expected revenues (+3.6% yoy) and lower-than-planned outlays (+2.0% yoy). That said, revenues are driven by VAT (+5% yoy) and CIT (+17% yoy) intake, 4% higher wage contributions, EU transfers (+16% yoy) and SOE dividends. While tax-rich local demand will yet surprise on the upside in Q3 amid terrific tourist season, not all the trends can be extrapolated in H2. Namely, public wage hikes (above 2% plan), healthcare overruns and stronger EU-sponsored capex and defense spending will reverse hithero prudence in expenditure. Still, the budget is on track to end 2017 with sub-1%/GDP deficit. We see more of the same in 2018, when the deficit cut to 0.5% of GDP rests on cyclically strong revenue and stronger role of EU funding in public capex, but the current spending will accelerate and along with one-offs pose upside risks to deficit. Namely, Agrokor's collapse and banks' NPL write-offs in their impact on CIT and VAT relief for micro firms will affect revenues, while healthcare overruns, wage and pension hikes, defense outlays and social transfers are all driving expenditures. The biggest unknowns are higher transfers to war veterans, contingent liabilities during Agrokor restructuring and a number of court cases for anti-market practices beyond 2018. In our base case with stronger nominal GDP growth and ever lower interest outlays, public debt is seen below 80% of GDP, which together with the recent EDP exit and improved reforms outlook paves the way for ratings upgrade.

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

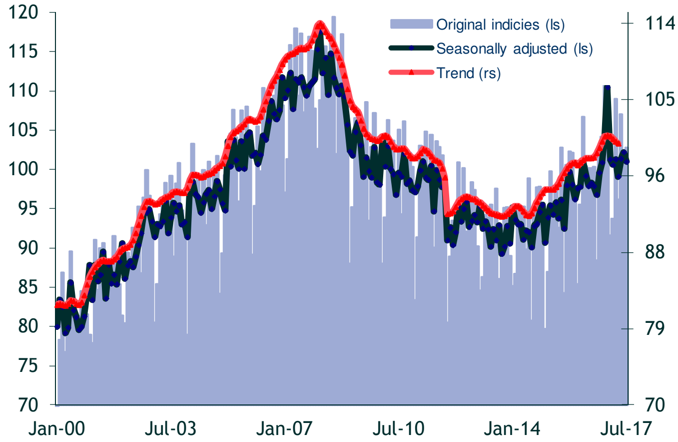
Cognizant of the growing pressure on (current) expenditures and little space for tax-driven consolidation, we expect sustainable public finances rest on public sector (incl. SOEs) and entitlement reforms, notably in healthcare and pension system. All of it with the genuine aim to build 5%+/GDP in the next years, arrest sovereign risk premium and anchor public debt on sustainable trajectory. That said, not only expenditure-based as opposed to revenue-based consolidation can better anchor the budget, it doesn't necessarily have to be contractionary, especially if it boosts investors' confidence, stabilizes labour market and income expectations, removes fears of future harsher ones and therefore stimulates private demand. For this to happen and sustain 3%-alike GDP growth, spending-based plans will have to be accompanied by convincing growth enhancing reforms like the liberalization of the product and labour markets, simplified tax system, rebalancing of the fiscal pressure away from labour to consumption and non-performing assets and strengthening the credit channel via permanent incentives for NPL workouts, equity capital raising and faster insolvency mechanism. A failure mainly in pro-business and far-reaching public sector reforms may disintegrate benefits from the current spending rationing, hurt authorities' credibility and prompt the renewed spike in public debt as soon as GDP growth drops back to potential (1-2%) and the global reference interest rates pick up.

Croatia's data trends

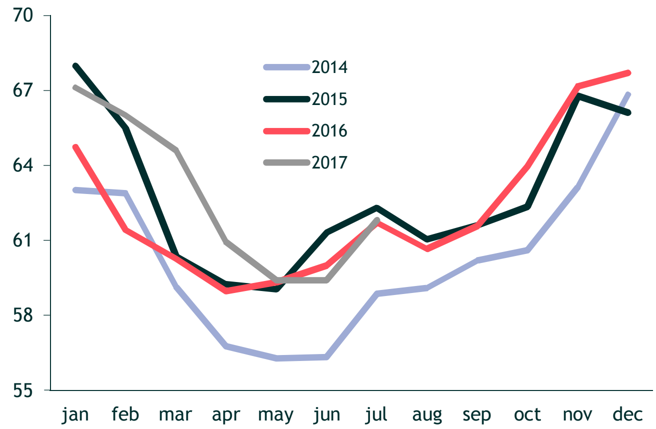
CRO growth in line with CESEE



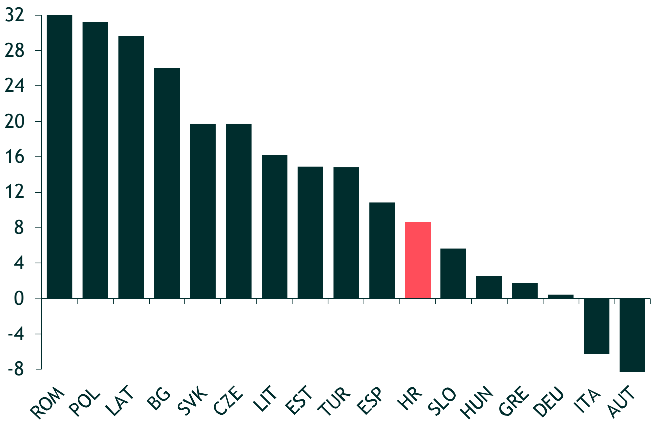
Industrial production, 2010=100



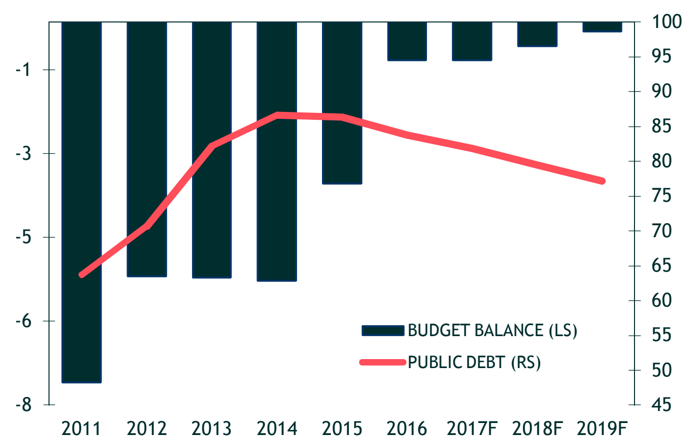
Merchandise import cover (% 3mma)



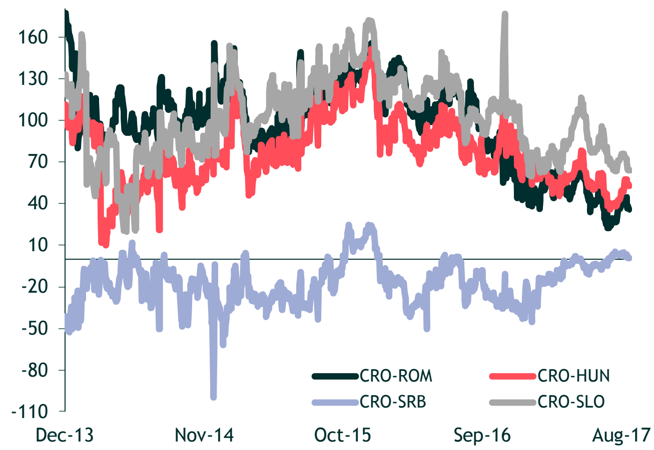
Change in export shares vs EU countries, 2017-2008,(%)



Budget balance and public debt (%/GDP)



Spread on CRO USDs vs peers (bp)



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Activity									
Nominal GDP (HRKbn, current prices)	332,6	330,5	329,6	328,1	335,5	345,2	360,0	377,0	394,9
Nominal GDP (EURbn)	44,7	44,0	43,5	43,0	44,1	45,8	48,3	50,6	53,1
Nominal GDP (USDbn)	62,2	56,5	57,8	57,1	48,9	50,7	53,9	56,8	61,0
GDP per capita (EUR)	10.453	10.300	10.225	10.147	10.404	10.812	11.388	11.941	12.517
GDP per capita (USD)	14.542	13.233	13.571	13.475	11.537	11.965	12.711	13.404	14.394
Real GDP (constant prices YoY, %)	-0,3	-2,2	-1,1	-0,5	2,2	3,0	3,0	3,0	2,6
Private consumption (YoY, %)	0,3	-3,0	-1,9	-1,6	1,0	3,3	3,3	2,9	2,6
Fixed investment (YoY, %)	-2,7	-3,3	1,4	-2,8	3,8	5,1	5,1	6,4	5,9
Industrial production (YoY, %)	-1,2	-5,5	-1,7	1,4	2,5	5,0	2,7	3,0	3,4
Unemployment rate (ILO, average %)	13,7	15,9	17,3	17,3	16,3	13,1	11,5	10,5	9,7
Prices									
CPI inflation (average % YoY)	2,3	3,4	2,2	-0,2	-0,5	-1,1	0,8	1,2	1,6
CPI inflation (end-year % YoY)	2,1	4,7	0,3	-0,5	-0,6	0,2	0,3	1,4	1,7
PPI inflation (average % YoY)	6,4	7,0	0,5	-2,7	-3,9	-4,1	2,0	2,2	2,2
Net wage rates (% YoY, nom., €)	-0,2	-0,4	-0,1	-0,4	1,5	2,9	3,6	3,7	2,5
Fiscal balance (% of GDP)									
State budget balance	-7,5	-5,3	-5,3	-5,4	-3,4	-0,8	-0,8	-0,5	-0,2
Public debt	63,7	70,7	82,2	86,6	86,3	83,7	81,8	79,4	77,2
Gross public funding needs	n/a	n/a	24,8	18,2	19,9	16,3	19,6	16,6	15,2
External balance									
Export of goods and services (EURbn)	18,126	18,336	18,768	19,679	21,511	22,785	24,902	26,156	27,459
Import of goods and services (EURbn)	18,301	18,111	18,573	18,828	20,411	21,421	23,272	24,755	26,336
Merchandise trade balance (EURbn)	-6,382	-6,296	-6,587	-6,512	-6,974	-7,345	-8,051	-8,671	-9,345
Merchandise trade balance (% of GDP)	-14,3	-14,3	-15,1	-15,1	-15,8	-16,0	-16,7	-17,1	-17,6
Tourism receipts (EURbn)	6,617	6,859	7,203	7,402	7,962	8,635	9,455	9,876	10,271
Current account balance (EURbn)	-0,298	-0,015	0,446	0,891	2,102	1,198	2,256	1,276	1,107
Current account balance (% of GDP)	-0,7	0,0	1,0	2,1	4,8	2,6	4,7	2,5	2,1
Net FDI (EURbn)	1,1	1,2	0,8	0,7	0,3	1,9	1,3	1,6	1,8
FDI (% of GDP)	2,5	2,8	1,9	1,6	0,6	4,2	2,8	3,2	3,4
FDI cover (%)	375,1	8.286,0	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	11,195	11,236	12,908	12,688	13,707	13,514	14,694	15,964	17,364
Import cover (months of imports)	7,3	7,4	8,3	8,1	8,1	7,6	7,6	7,7	7,9
Debt indicators									
Gross external debt (EURbn)	46,397	45,297	45,803	46,416	45,384	41,668	41,144	41,887	43,534
Government (EURbn)	11,449	12,705	14,647	15,841	18,049	16,230	17,230	17,980	18,580
Private (EURbn)	34,949	32,592	31,157	30,575	27,335	25,438	23,914	23,907	24,954
Gross external debt (% of GDP)	103,7	103,0	105,3	107,9	102,9	90,9	85,2	82,7	82,0
Gross external debt (% of exports)	256,0	247,0	244,1	235,9	211,0	182,9	165,2	160,1	158,5
Exchange rates and money growth									
USD/HRK (end-year)	5,82	5,47	5,55	6,30	6,99	7,17	6,56	6,60	6,41
USD/HRK (average)	5,34	5,85	5,71	5,75	6,86	6,80	6,68	6,63	6,47
EUR/HRK (end-year)	7,53	7,55	7,64	7,66	7,64	7,56	7,54	7,52	7,50
EUR/HRK (average)	7,43	7,52	7,57	7,63	7,61	7,53	7,46	7,45	7,44
Money supply M1 (% YoY)	7,3	0,9	11,5	9,6	11,4	18,1	7,8	5,5	4,0
Broad money M4 (% YoY)	5,65	3,57	4,00	3,16	5,15	4,71	2,90	2,40	2,00
Domestic credit (% YoY, euros)	4,01	-2,55	-0,36	-2,61	-1,68	-5,07	0,96	1,94	2,58
ZIBOR 3M interest rate (average %)	3,19	3,55	1,54	0,99	1,27	0,90	0,61	0,30	0,25
HRK 1Y yield (average %)	3,72	3,93	2,54	1,86	1,50	0,96	0,43	0,35	0,36
HRK 10Y yield (average %)	6,63	6,26	4,30	4,00	4,09	3,60	2,73	2,46	2,60

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	55.395	54.123	54.564	54.719	54.512	54.689	54.963	55.512	56.068
Assets (%, YoY)	3,8	-2,3	0,8	0,3	-0,4	0,3	0,5	1,0	1,0
Assets (% of GDP)	123,8	123,1	125,4	127,2	124,3	120,0	114,5	110,3	106,3
Gross loans (EURm)	38.665	37.678	37.543	36.561	35.946	34.125	34.451	35.119	36.024
Gross loans (%, YoY)	4,0	-2,6	-0,4	-2,6	-1,7	-5,1	1,0	1,9	2,6
Gross loans (% of GDP)	86,4	85,7	86,3	85,0	81,9	74,9	71,8	69,8	68,3
Deposits (EURm)	29.139	30.001	31.014	31.881	33.666	35.237	36.642	37.892	39.014
Deposits (%, YoY)	-0,3	3,0	3,4	2,8	5,6	4,7	4,0	3,4	3,0
Deposits (% of GDP)	65,1	68,2	71,3	74,1	76,7	77,3	76,3	75,3	73,9
Loan-to-deposit ratio (%)	132,7	125,6	121,0	114,7	106,8	96,8	94,0	92,7	92,3
Capital adequacy ratio (%)	19,2	20,6	21,0	21,0	19,0	20,8	20,0	19,9	19,5
Performance									
Net interest income (EURm)	1.540	1.449	1.360	1.366	1.405	1.457	1.478	1.482	1.349
Net interest income (%, YoY)	3,7	-5,9	-6,2	0,5	2,9	3,6	1,5	0,2	-9,0
Total operating income (EURm)	2.249	2.015	1.923	1.922	1.910	2.153	2.246	2.256	2.130
Total operating income (%, YoY)	2,0	-10,4	-4,5	0,0	-0,6	12,7	4,3	0,4	-5,6
Pre-provision profit (EURm)	1.127	972	920	934	919	1.184	1.277	1.303	1.194
Pre-provision profit (%, YoY)	3,1	-13,7	-5,4	1,6	-1,7	28,9	7,8	2,0	-8,4
Provision charges (EURm)	500	501	780	645	1.534	355	485	470	445
Profitability and efficiency									
Net interest margin (%)	2,8	2,6	2,5	2,5	2,6	2,7	2,5	2,4	2,4
Pre-tax ROAA (%)	1,2	0,9	0,3	0,5	-1,1	1,5	1,4	1,5	1,3
Pre-tax ROAE (%)	8,4	6,2	1,9	3,9	-8,8	11,8	10,7	11,3	10,2
Cost-to-income ratio (%)	49,9	51,7	52,2	51,4	51,9	45,0	43,2	42,2	44,0
Operating expense (% of assets)	2,1	1,9	1,8	1,8	1,8	1,8	1,8	1,7	1,7
Credit quality and provisioning									
NPL ratio (%)	12,4	13,9	15,7	17,1	16,7	13,8	12,1	11,8	10,8
NPL coverage (%)	41,4	42,6	46,2	51,0	56,9	63,6	91,1	82,3	73,3
Provision charges (% of loans)	1,3	1,3	2,1	1,7	4,2	1,0	1,4	1,4	1,3
Provision charges (% of PPP)	44,4	51,5	84,8	69,0	167,0	30,0	38,0	36,1	37,3

Source: CNB, Addiko research

Lending activity in positive territory

Credit activity increased by 0.8% in the year to July , driven corporate lending (+2.7% ytd) after dropping 1.6% in 2016. We relate such performance to stronger investment activity on the back of easier SME's access to lending, EU funding, record firms' profits, soaring construction orders and business optimism. Retail loans increased 2.2% ytd (vs. -4.6% in 2016), reflecting strong consumer sentiment, stronger household consumption, improved labor market and citizens' lower propensity to save. We see lending growth in 2017 in the 1% region as lending drivers will be offset by NPL sales and write-offs recognized as tax deductible cost in 2017 (solely). In 2018, we see lending acceleration to 1.9% on the back of investment acceleration, favorable labor market movements, cleaner banks' balance sheets and ongoing CNB easing (bias) leading to ever lower interest rates. Retail lending will be driven by ca. HRK1.5bn of new housing loans (in our view) on the back of government subsidies. Agrokor problems pose downside risks, but it remains hard to estimate the exact impact. We see further decline in NPL ratio from 13.2% at the end of 2Q to 12.1% in 2017 as we expect the volume of tax-deductable write-offs and NPL sales (up to EUR2bn) will offset Agrokor-related NPL increase.

Stellar tourist season set to boost deposit growth

Deposit growth slowed to 1.8% ytd from 4.7% in 2016 mainly due to ever lower passive interest rates, increased AuM flows and lower propensity to save. The strongest positive contribution came from 5.2% ytd stronger corporate intake (+10.4% in 2016), while household deposits saw flattish performance (+0.2% ytd vs +2.0% in 2016). We see a solid 4.0% deposit increase in 2017 as another stellar tourist season will boost both corporate and household deposits. In 2018, we see deposit deceleration to 3.4% on the back of further decline in passive interest rates and high base after three years of double-digit corporate deposit growth. Notwithstanding low interest rate environment, banks increased net interest income by 1.4% yoy in 1H17 as funding cost slump (-31.4% yoy) offset 10.5% yoy lower interest income. However, operating income fell 4.9% yoy on the back of trading income slump (-63.8% yoy). The latter combined with higher opex (+3.4% yoy) and strong Agrokor-related provisioning led to a sharp drop in pre-tax profit (-64.0% yoy). That said, we expect pre-tax loss in 2017 followed by recovery in 2018 on the back of new lending and lower provisioning.

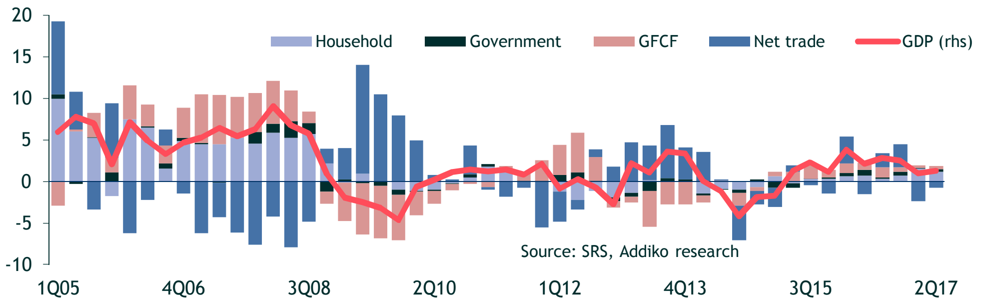
Economy to Accelerate After Supply Shocks

We cut our 2017 GDP forecast by 0.8pp to 1.7% due to soft 1H17, shut-downs in Fiat and its suppliers and about 20% lower agricultural output. For 2018 we kept growth forecast unchanged at 3.0% on the back of broad based acceleration in both external and domestic demand, accompanied with further C/A gap widening. We see 2017 average CPI at 3.2% followed by a similar outcome for 2018 as one-offs drop out. After the expected spread tightening in Q4, we see gradual dinar rates normalization in 2018 in line with stronger bank lending and the Fed/NBS policy normalization.

Painting a mixed picture for Q3 activity.

GDP growth disappointed again in Q2, rising barely 1.3% yoy after negatively revised 1.0% yoy in Q1, forming relatively poor 1.2% growth for the 1H17. While slowing to 1.6% yoy, personal consumption was the main growth driver amid private job creation, rising wages, cheaper debt service and re-leveraging. Investment growth continued at 2% yoy pace, despite accelerating public spending (+1.7% yoy) on revived infrastructure capex. Encouragingly though, export growth accelerated to 11.5% yoy, while import growth slowed to 10.3% yoy, lowering its negative net trade contribution to -0.7pp from -2.4pp in Q1. While industrial output and retail sales signaled a solid entry into Q3, trade balance is exposed to demand-driven import pressure and the economy will suffer from supply shocks, including a drought-inflicted agricultural output slump, 3-week production halt in Fiat and slowly normalizing energy sector (notably EPS). In that vein, Q3 activity remains a mixed bag with GDP growth in the 2% region, again driven by private consumption, somewhat stronger investment and public capex.

Serbia: contributions to GDP (pps, %)



Source: SRS, Addiko research

2017 GDP forecast lowered to 1.7%

In line with dismal 1H17, shut-downs in Fiat and its suppliers and about 20% lower agricultural output, we cut 2017 GDP forecast by 0.8pp to 1.7%. This still implies growth acceleration in 2H17, driven by private consumption on the back of further employment/wage growth, cheaper debt service and a strong pick up in retail lending. Investment outlook has improved on resurgent capacity-enhancing FDIs, intensified state-sponsored railway/road and irrigation systems construction, including faster land expropriation and settlement of old debt for infrastructure works. We also see faster export growth on stronger external demand, as demand-driven import pressures continue to build, leading to neutral contribution to growth. Since this year's growth is largely hit by one-off supply shocks from harsh climate to Fiat-related disruptions, we are comfortable with 2018 GDP growth forecast at 3.0% thanks to a broad-based acceleration in both external and domestic demand, the latter driven by stronger household consumption and investment acceleration against the backdrop of fiscal expansion (including wage/pension hikes), tighter labour markets, stronger bank lending to private sector, and the start of the new EUR2.5bn highway construction cycle. Competitiveness reforms, including tax cuts and SOE restructuring, coupled with further progress in EU talks and stronger infrastructure capex pose upside risks. Downside risks to our view stem from public capex under-execution, weaker SEE trade during Agrokor's dismantle and Fiat's pullout from Serbia at the beginning of 2018 (albeit the government may find alternative investor if need be).

The C/A deficit is set to widen to 4.5%/GDP in 2017, followed by a further widening in the

The current account deficit soared in 1H17 (+49.6% yoy) to EUR1,019m, as wider goods trade deficit offset better services balance. Goods trade gap rose 18.8% yoy as 11.1% yoy export growth could not offset 12.7% yoy higher imports, driven by stronger private consumption and corporate demand for equipment capex and intermediate goods. Services surplus rose 4.2% yoy, largely reflecting 18.0% yoy increase in foreign tourist receipts. Finally, primary income deficit widened by 14.2% yoy on the back of stronger non-residents' profit repatriation, while secondary income saw 6.1% yoy growth supported with higher remittances inflow (+5.5% yoy). All in all, we see about 0.5pp C/A deficit widening to 4.5% of GDP in 2017 followed by a further widening in the next years on the back of import-intensive investments and private consumption and the increasing number of foreign-owned companies' profit repatriation.

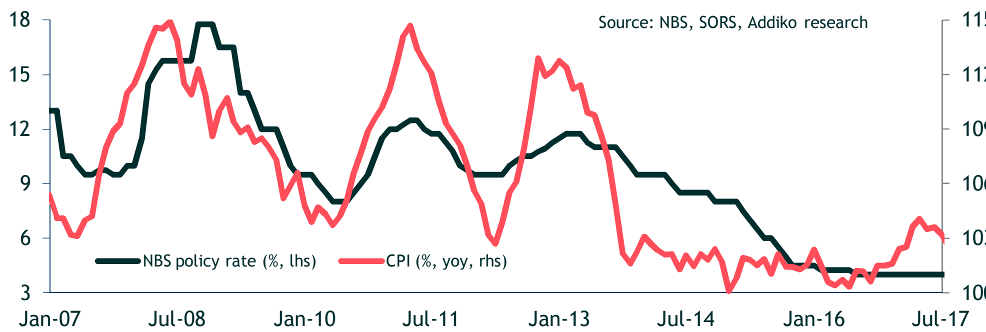
2017 FDI inflow seen at around 5% of GDP

Net FDIs rose 13.1% yoy in 1H17 to EUR992m thanks to further improvement in investment climate and improved foreign investors' perception of long-term investment prospects. Investment allocation is increasingly diversified, with the biggest amounts directed to manufacturing, financials, construction (BG Waterfront Project) and trade (IKEA). Meanwhile, net portfolio outflows are lower by EUR505m (-72.7% yoy) in 1H17 mainly thanks to RSD20bn 7Y domestic bond issue in May, attracting strong non-residents' appetite. We see FDI inflow in 2017 just a tad above EUR1.8bn or around 5% of GDP, more than enough to cover the entire C/A deficit. In line with the expected investment acceleration, net FDI is set to increase further in the next years, reaching 5-5.5% of GDP.

Has inflation bottomed?

After the April's 4.0% yoy peak, inflation has undershot recently (2.5% yoy in August) not least due to accelerating clothing deflation and seasonal factors as the recent drought damages have not (yet) found their way to food prices. At the same time, 'core' inflation sank to 1.5% yoy in August to the very bottom of the 3%+/-1.5pp NBS' target interval. Inflation pressures in H2 arise from stronger domestic demand, tighter labour market aggravated by 10% minimum wage hike, higher industrial goods prices, 2% electricity price hike in October, fading base effect and the NBS' expansive policy. Despite the latter, stronger-than-expected dinar and lower-than-expected energy and consumer import prices in general act in the opposite direction. The recent inflation undershooting induced us to lowered average CPI inflation forecast slightly to 3.2% followed by a similar outcome for 2018 CPI as one-offs drop out.

Serbia CPI inflation and NBS policy rate



NBS underpinned its dovish stance, tightening still quarters away.

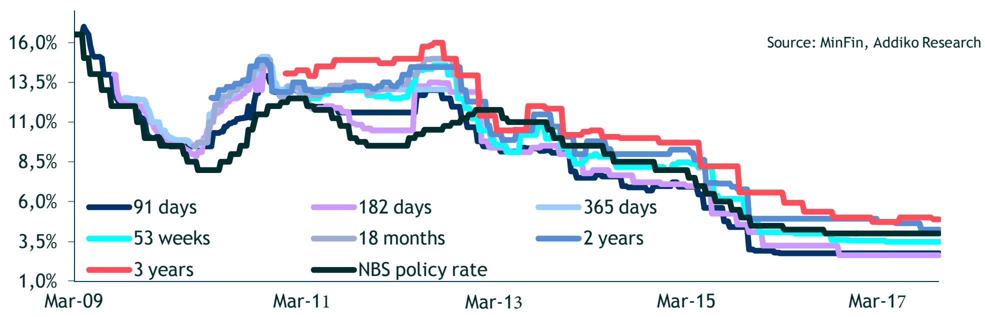
Having been on hold for 13 months, the NBS cut the key interest rate by 25bp to 3.75%, with lower than expected growth, downwardly revised inflation outlook for 2017-2018 (official wording) and the dinar 'overboughtness' amid reduced sovereign risk, strong portfolio flows and dovish Fed all behind. While inflation undershot recently, CPI is still well above inflation of the main trading partners, which combined with the strong dinar hits price competitiveness. Meanwhile, the NBS continued to withdraw excessive dinar liquidity via 1W REPO to ensure stability of short-end dinar rates. In return, interbank competition in depositing unused funds with the NBS keeps interest rates at record lows.

We expect the NBS to keep the key interest rate at the current low in the next six to nine months given a gradual recovery in inflation, renewed fiscal expansion, continuation of Fed tightening and the expected ECB QE tapering announcement, both driving investor expectations. While not part of our base case, we'd not exclude further monetary easing, including rate cut(s) and (potentially) other measures (see next paragraph), only in case of tighter broad monetary conditions due to excessive dinar strength that could over time dampen inflation. That said, we see one 25bp NBS rate hike in 3Q18, followed by two more in 2019. The Fed's rate hikes (one rate hike in Q4, followed by three more in 2018 and 2019) won't have too strong impact on Serbian assets, in our view, as long as the sovereign's risk premium is record low, reflecting hitherto fiscal overperformance and calmer politics. Furthermore, the ECB won't likely hike it key rates until 2019, which bodes well for regional assets including Serbian debt going forth. Upside risks to our view stem from possibly stronger Fed's hiking pace once the details of the US' fiscal expansion are known and more hawkish ECB in case of upside inflation surprises in the euro zone.

The EUR/RSD at the lowest levels since 2014

The EUR/RSD is trading just below 120, 3.5% stronger to date and the lowest since late 2014, which is driven by frontloaded RSD paper bids ahead of inclusion into JP Morgan's trading list, hitherto fiscal healing, stronger exports, higher remittances, benign global backdrop and quite politics (historically a positive factor for CESEE FX) as well as stronger local dinar bank lending. We'd however expect the NBS to lean against excessive dinar strength due to competitiveness considerations, intervening further in the FX market (after buying EUR485m in Q3 or EUR630m to date), accommodating policy (as it did with the recent REPO rate cut, effectively acting against the stretched one-way positioning) and possibly more dovish forward guidance – aiming to affect market expectations for RSD rates for the late 2018 period. That said, we see the EUR/RSD toward the upper end of the 119-123 range in Q4 in a seasonal fashion due to stronger domestic demand-driven and energy imports, and the Fed/ECB hawkishness into year-end. Our constructive RSD outlook stays supported by GDP growth acceleration, fiscal healing, evolving dinarization story, strong exports, appetite for Serbian assets and the expected dinar-debt inclusion in the JP Morgan EM index.

Serbia: T-bill/notes yields



FY17 budget deficit seen at 0.8% of GDP

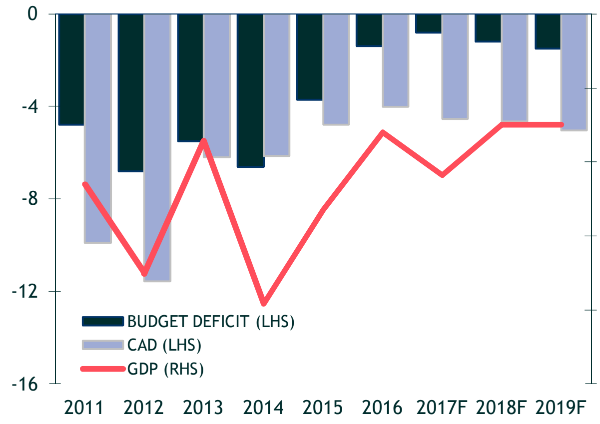
The consolidated budget hit a RSD74bn surplus (1.7% of GDP) in the year to July, with primary surplus at RSD156bn (3.5% of GDP). That said, revenues are driven by 8.5% yoy stronger tax intake on the back of better tax compliance, cyclically stronger CIT from record corporate profits as well as PIT amid labor market recovery. Expenditures (+1.3% yoy) stay contained as higher current spending (+2.3% yoy) is offset by 15.7% yoy capex slump as harsh weather early this year and a typical pre-election standstill have backloaded public investments in H2. All in all, we still see budget deficit at 0.8% of GDP this year followed by modest widening to 1.2% of GDP in 2018 due to public capex acceleration, 5-7% public wage and yet-to-be defined pension hikes, and a possible increase in the non-taxable income threshold after a 10% minimum wage hike. Further upside risks would include subsidy activation on behalf of Er Serbia should Etihad Airways decide to pull out of Serbia as it already did in many non-core markets. Finally, public debt decline is set to continue, ending 2017 around 67% of GDP, additionally supported with the stronger dinar. In 2018 we see further public debt reduction by roughly 1pp to 66% of GDP.

Serbian risk premium at record low

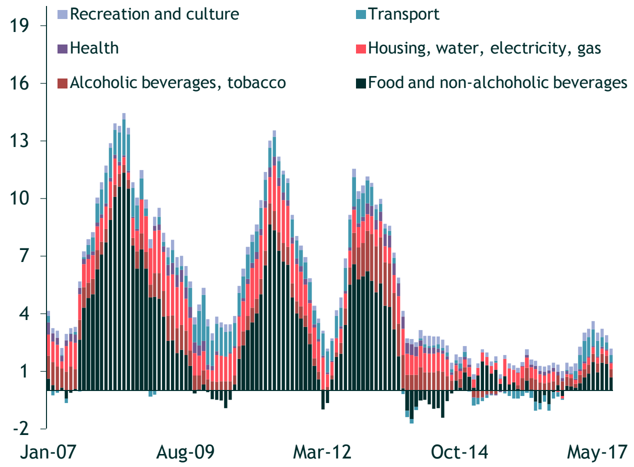
The MinFin increased T-bill/T-bond stock by RSD180bn (EUR1.5bn) to date at somewhat lower yields. It also extended the average T-bill/T-bond maturity by lowering the stock of <3Y debt (by -RSD175bn) and shifting into the 3-7Y bracket (+RSD355m). After a 40bp drop in Q2, Serbian risk premium (CDS spread) fell another 20bp to a record low 130bp. Beside strong global EM risk appetite for high-yielders, lower Serbian risk reflects multi-year improvement in fiscal and external imbalances, positive IMF's seventh review of Serbia's SBA and JP Morgan's market backing, but rating agencies could stay on the sidelines until PM Brnabic re-affirms the merits of a new stand-by (in late October), re-starts reforms, EU talks regain momentum and the growth soft patch has passed. Notwithstanding the attractiveness of a large benchmark Eurobond and in turn soaring FX reserves, we expect that refinancing of USD750m maturity in November in part out of hefty cash reserve (~3% of GDP) and partly via dinar bonds (7Y bond reopening?) on the assumed high interbank liquidity and stronger activity from non-resident investors after JP Morgan's market promotion, which may boost liquidity and bring about further yield compression. Early repayment of expensive EUR183m London Club debt would also boost sentiment. Following the expected further spread tightening in Q4 as explained before, we see gradual dinar rates normalization in 2018 in line with stronger bank lending and the Fed/NBS policy normalization. Further spread tightening potential will be limited by Fed/ECB policy uncertainty and already tight premium over CESEE issuers some of which are reversing monetary stance towards tightening mode, which won't go unnoticed by non-resident investors. Upside risks to rates stem from any jitters in EU/Kosovo talks, global risk-off episodes and Fed/ECB hawkishness and the lack of reforms now that the political situation has calmed down.

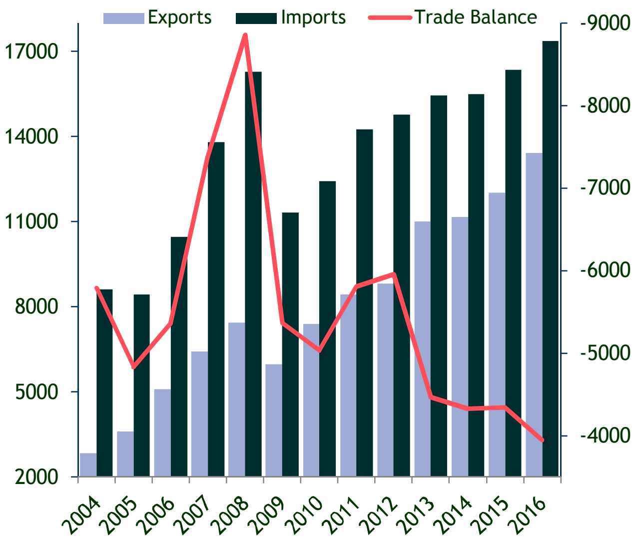
Serbia's data trends

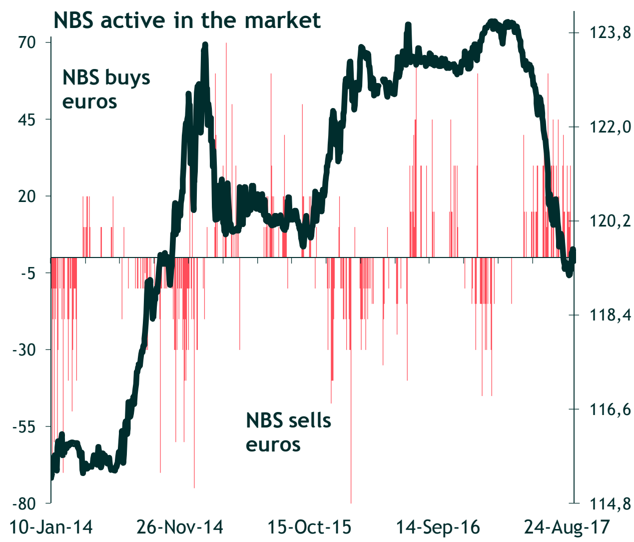
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



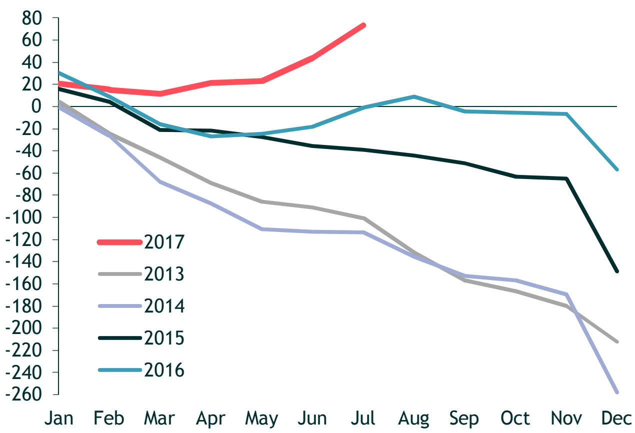
CPI contribution - key categories (pps)



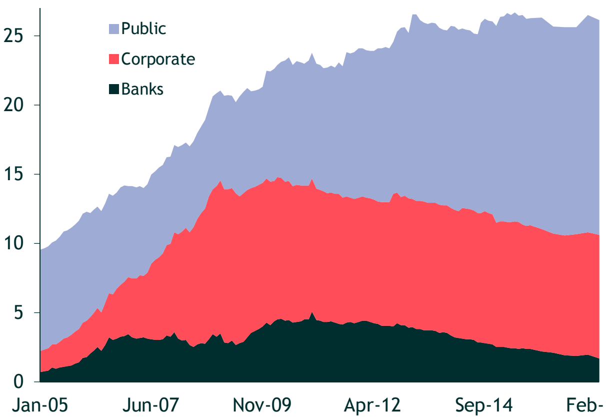




Consolidated government budget balance (RSDbn)



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



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Activity									
Nominal GDP (RSDbn,current prices)	3.408	3.584	3.876	3.908	4.043	4.200	4.394	4.651	4.938
Nominal GDP (EURbn)	33,4	31,5	33,9	32,3	33,3	34,1	35,9	38,2	40,3
Nominal GDP (USDbn)	46,5	40,7	45,5	44,1	37,1	37,8	40,1	42,9	46,4
GDP per capita (EUR)	4.620	4.401	4.783	4.521	4.690	4.834	5.099	5.432	5.725
GDP per capita (USD)	6.423	5.650	6.353	6.177	5.234	5.353	5.691	6.098	6.510
Real GDP (constant prices YoY, %)	1,4	-1,0	2,6	-1,8	0,7	2,8	1,7	3,0	3,0
Private consumption (YoY, %)	0,9	-2,1	-0,4	-1,3	0,4	0,8	1,8	2,6	2,8
Fixed investment (YoY, %)	4,6	13,2	-12,0	-3,6	5,5	5,0	3,1	5,5	6,0
Industrial production (YoY, %)	2,5	-2,2	5,5	-6,5	8,4	4,8	3,4	4,3	4,2
Unemployment rate (ILO, average %)	23,0	23,9	22,1	19,2	17,7	15,3	13,5	13,3	12,7
Prices									
CPI inflation (average % YoY)	11,0	7,8	7,8	2,1	1,4	1,1	3,2	3,0	3,3
CPI inflation (end-year % YoY)	7,0	12,2	2,2	1,7	1,5	1,6	3,4	2,8	3,0
PPI inflation (average % YoY)	14,2	5,6	3,6	0,7	0,2	-0,4	1,7	1,9	2,1
Net wage rates (% YoY, nominal,	1,1	-1,8	-1,8	-4,6	-4,1	0,6	1,7	3,0	2,0
Fiscal balance (% of GDP)									
State budget balance	-4,8	-6,8	-5,5	-6,6	-3,7	-1,4	-0,8	-1,2	-1,5
Public debt	45,4	51,6	56,8	67,9	71,9	70,2	67,3	66,1	65,2
Gross public funding needs	13,3	15,4	16,1	17,6	16,7	14,2	16,4	14,3	13,3
External balance									
Export of goods and services (EURbn)	n/a	11,498	13,937	14,451	15,618	17,314	19,283	20,831	22,312
Import of goods and services (EURbn)	n/a	16,993	17,782	18,096	18,899	19,895	22,032	24,044	25,689
Merchandise trade balance (EURbn)	n/a	-5,634	-4,159	-4,111	-4,006	-3,476	-3,656	-4,186	-4,309
Merchandise trade balance (% of GDP)	n/a	-17,9	-12,3	-12,7	-12,0	-10,2	-10,2	-10,9	-10,7
Remittances, net (EURbn)	n/a	1,989	2,217	1,931	2,155	1,953	2,109	2,215	2,325
Current account balance (EURbn)	-3,305	-3,640	-2,098	-1,985	-1,590	-1,370	-1,630	-1,782	-2,030
Current account balance (% of GDP)	-9,9	-11,5	-6,2	-6,1	-4,8	-4,0	-4,5	-4,7	-5,0
Net FDI (EURbn)	n/a	0,7	1,3	1,2	1,8	1,9	1,8	2,0	2,1
FDI (% of GDP)	n/a	2,1	3,8	3,8	5,4	5,5	5,1	5,2	5,2
FDI cover (%)	n/a	18,4	61,9	62,3	113,2	135,8	113,0	111,0	103,4
Gross international reserves (EURbn)	12,058	10,915	11,189	9,907	10,377	10,868	11,080	11,277	12,686
Import cover (months of imports)	n/a	7,7	7,6	6,6	6,6	6,6	6,0	5,6	5,9
Debt indicators									
Gross external debt (EURbn)	24,125	25,645	25,747	25,741	26,358	26,582	26,392	26,162	26,552
Government (EURbn)	10,773	12,185	13,166	14,198	15,289	15,680	15,550	15,400	15,600
Private (EURbn)	13,352	13,460	12,581	11,543	11,069	10,902	10,842	10,762	10,952
Gross external debt (% of GDP)	72,2	81,4	75,9	79,7	79,2	77,9	73,5	68,4	65,9
Gross external debt (% of exports)	n/a	223,0	184,7	178,1	168,8	153,5	136,9	125,6	119,0
Exchange rates and money									
USD/RSD (end-year)	80,87	86,18	83,13	99,46	111,64	117,93	106,17	107,19	103,85
USD/RSD (average)	73,34	88,12	85,17	88,54	108,88	111,17	109,67	108,35	106,52
EUR/RSD (end-year)	104,6	113,7	114,6	121,5	121,8	123,5	122,1	122,2	121,5
EUR/RSD (average)	102,0	113,7	114,3	121,0	121,5	123,1	122,4	121,6	122,5
Money supply M1 (% YoY)	16,9	-3,3	24,8	5,2	16,4	18,7	8,0	7,0	6,0
Broad money M3 (% YoY)	11,2	0,7	3,7	3,0	5,0	9,9	4,4	3,5	3,5
Domestic credit (% YoY, euros)	8,9	0,8	-5,2	-2,3	2,4	1,0	4,4	4,8	5,5
NBS policy rate (average %)	11,54	10,14	11,00	8,79	6,08	4,15	3,92	3,88	4,29
NBS policy rate (end-year %)	9,75	11,25	9,50	8,00	4,50	4,00	3,75	4,00	4,50
6M BELIBOR interest rate (average %)	13,13	12,00	10,40	8,53	6,43	3,65	3,65	3,69	4,08

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	25.211	25.322	24.827	24.545	25.060	25.690	26.384	27.176	28.127
Assets (%, YoY)	5,0	0,4	-2,0	-1,1	2,1	2,5	2,7	3,0	3,5
Assets (% of GDP)	75,4	80,3	73,2	76,0	75,3	75,3	73,3	70,9	69,6
Gross loans (EURm)	17.013	17.148	16.255	15.879	16.253	16.412	17.132	17.959	18.944
Gross loans (%, YoY)	8,9	0,8	-5,2	-2,3	2,4	1,0	4,4	4,8	5,5
Gross loans (% of GDP)	50,9	54,4	47,9	49,1	48,8	48,1	47,6	46,9	46,9
Deposits (EURm)	13.099	13.310	13.634	13.967	14.728	16.159	17.096	17.829	18.502
Deposits (%, YoY)	10,1	1,6	2,4	2,4	5,4	9,7	5,8	4,3	3,8
Deposits (% of GDP)	39,2	42,2	40,2	43,2	44,3	47,4	47,5	46,5	45,8
Loan-to-deposit ratio (%)	129,9	128,8	119,2	113,7	110,4	101,6	100,2	100,7	102,4
Capital adequacy ratio (%)	19,1	19,9	20,9	20,0	20,9	21,2	19,6	18,8	17,9
Performance									
Net interest income (EURm)	1.131	1.025	1.044	1.063	1.075	1.006	989	1.019	1.055
Net interest income (%, YoY)	7,6	-9,4	1,9	1,8	1,1	-6,4	-1,6	3,0	3,5
Total operating income (EURm)	1.590	1.484	1.435	1.489	1.520	1.393	1.445	1.488	1.539
Total operating income (%, YoY)	3,2	-6,7	-3,3	3,8	2,1	-8,4	3,8	3,0	3,4
Pre-provision profit (EURm)	617	571	504	529	574	467	510	539	575
Pre-provision profit (%, YoY)	9,6	-7,5	-11,6	4,8	8,6	-18,7	9,2	5,6	6,8
Provision charges (EURm)	313	339	510	490	494	294	294	298	314
Profitability and efficiency									
Net interest margin (%)	4,6	4,1	4,2	4,3	4,3	4,0	3,8	3,8	3,8
Pre-tax ROAA (%)	1,2	0,9	-0,1	0,1	0,3	0,7	0,8	0,9	0,9
Pre-tax ROAE (%)	5,9	4,3	-0,3	0,6	1,6	3,5	4,3	4,5	4,7
Cost-to-income ratio (%)	61,8	66,1	65,3	64,7	62,2	66,5	64,7	63,8	62,6
Operating expense (% of assets)	4,0	3,6	3,7	3,9	3,8	3,6	3,6	3,5	3,5
Credit quality and provisioning									
NPL ratio (%)	19,0	18,6	21,4	21,5	21,6	17,0	15,2	14,9	17,6
NPL coverage (%)	51,0	50,0	50,9	54,9	62,3	67,8	66,2	66,3	66,3
Provision charges (% of loans)	1,9	2,0	3,1	3,1	3,1	1,8	1,8	1,7	1,7
Provision charges (% of PPP)	50,7	59,4	101,1	92,8	86,0	62,9	57,5	55,4	54,5

Source: NBS, Addiko research

Stellar retail lending performance

Credit growth accelerated to 4.6% in the year to July (vs. 1.0% yoy in 2016), with the strongest positive contribution from 8.8% ytd stronger retail lending, driven by cash loans and followed by housing lending. Such performance owes to the ongoing private job growth, higher wages and ever low interest rates. Despite RSD2.5bn write-offs and RSD4.1bn corporate NPL sales in Q2, corporate lending grew 2.2% ytd thanks to relaxed SME credit standards and better business climate. Public lending negative performance continued as SOEs and the government opted for cheaper cross-border loans. That said, and bearing in mind the recent NBS repo cut that will help lower dinar interest rates, and the expected investment acceleration, we upgrade 2017 credit growth forecast by 1pp to 4.4%. In 2018, we expect further credit growth acceleration to 4.8%, driven by private consumption and investments acceleration, cleaner banks balance sheets, increased competition and low interest rate environment. The NPL ratio fell by 1.4pp to 15.6% in June, and we see it at 15.2% at end-2017 as banks plan further NPL sales or write-offs.

Strong NPL sales lowered banks' risk costs

As for funding, deposit growth slowed to to 1.7% ytd from 9.7% in 2016 on the back of 5.4% ytd lower public deposit collection and slowing private sector deposit collection. Despite supportive labor trends, retail deposits intake slowed to 2.3 ytd from 6.3% in 2016 as citizens on reduced propensity to save and stronger investment appetite. Furthermore, corporate deposits slowed to 2.6% ytd from 18.1% in 2016, fairly high base inflated by record corporate sector profits. In all, we lower 2017 deposit growth forecast by 0.4pp to 5.4%. In 2018, we expect further modest deposit collection deceleration to 4.8% on the back of low passive interest rates and high base. Ahead of the NBS 2Q banking sector data, we can only say that substantially lower provisioning in the aftermath of NPL sales and write-offs bode well for pre-tax profits.

IMF Deal on Hold Over Delays in Reforms

We have downgraded our 2017 and 2018 GDP forecast to 2.7% and 3.1%, respectively as authorities failed to met IMF conditions and secure the second tranche. As politicians focus shift to October 2018 general election, we don't expect the IMF deal to be unlocked at least not until the elections end. Meanwhile, we expect C/A deficit to re-widen to 5.3% of GDP in 2017 due to higher trade deficit, while inflation is set to increase 1.6% yoy on average before accelerating to 2.2% in 2018.

Consumption on strong footing

After 2.7% yoy GDP growth in Q1, high frequency data suggests steady to modest trends in economic activity in April-July, driven by buoyant private consumption. Strong retail sales growth continued in April-July (+5.2% yoy) amid job creation, wage growth and household re-leveraging. Foreign trade continued its upside momentum as export surged 16.5% yoy on the back of stronger EU demand, while import rose 11.2% yoy in April-July, leading to 4.2% yoy higher trade gap. Industrial output growth of 3.0% yoy in April-July was below our expectation, mainly due to maintenance in thermal power plants. Construction fell 1.0% yoy in Q2 in the absence of public capex.

GDP growth revised downward for 2017 and 2018

B-H authorities haven't yet met required IMF conditions, leaving the second IMF tranche locked along with public capex, and forcing us to cut GDP growth forecast for 2017 and 2018 by 0.4pp to 2.7% and 3.1%, respectively. This year's growth will be driven by 2.6% stronger private consumption amid further employment and wage growth, record tourist season, higher remittances and re-leveraging. Strong rise in corporate loans indicates intensifying private investments that will partly offset weak public capex. Industrial production is set to accelerate in 2H as power plant maintenance is over. Despite further upgrade of exports outlook given ever brighter external demand, stronger domestic demand will push imports further and result in negative net trade contribution to growth. Complicated political system, high youth and long-term unemployment, and emigration remain downside risks. On the other hand, buoyant euro zone growth creates upside risk to external demand and even higher remittances. As stated, we expect growth to accelerate in 2018 on the heels of pre-election spending and private consumption amid higher remittances and improved labor market.

IMF deal locked until the end of elections

Against our expectations, the authorities failed to adopt Law on Excise in order to unlock second IMF tranche. As October 2018 general elections are approaching, politicians are now turning focus to pre-election populistic promises. Even if excise duties were adopted, series of other conditions need to be met including SOE privatization that will be likely blocked in order to prevent political scandals in a sensitive pre-election period. Therefore, the IMF program is clinically dead, and we don't expect any revival at least until after elections, but more likely only in 2019.

We expect the budget surplus at 1.0% of GDP in 2017

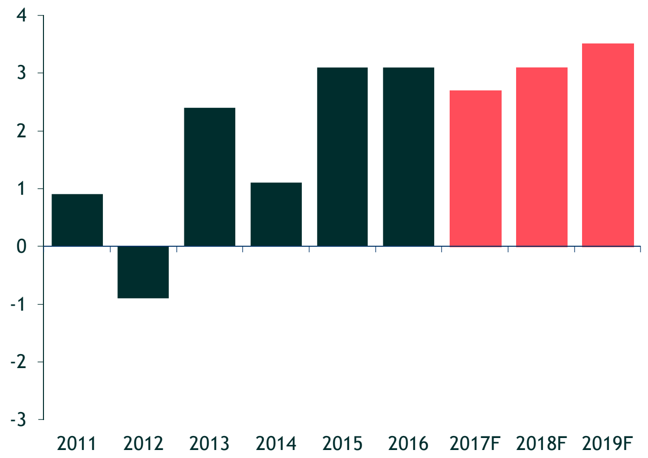
According to belated 2016 fiscal accounts, consolidated budget entered into a surplus of 1.2% of GDP, against broadly expected 0.7% deficit, providing the much needed flexibility in the IMF's tranche absence. Another cushion for entities' budgets is EUR116m repayment of old USSR debt. Federation B-H's budget is in slightly better position given better tax collection (+9.3% yoy in H1), ongoing access to local bank loans and the planned EUR5m in war claim bonds. Having secured liquidity, FB-H cancelled three expensive T-bills auctions in Q3. Meanwhile, RS is covering budget gap via longer-term local debt issuance. To date, RS sold EUR110m in T-bills and EUR172m in bonds yielding 3.6%. Both budgets should remain stable in 2017-2018 given stable interbank liquidity and debt issuance, although B-H' public finance are unsustainable without the IMF funds. Given public capex under-execution and solid tax revenues, we expect the budget surplus at 1.0% of GDP in 2017, followed by a 0.5% deficit amid pre-election campaigns.

Inflation to accelerate in the medium term

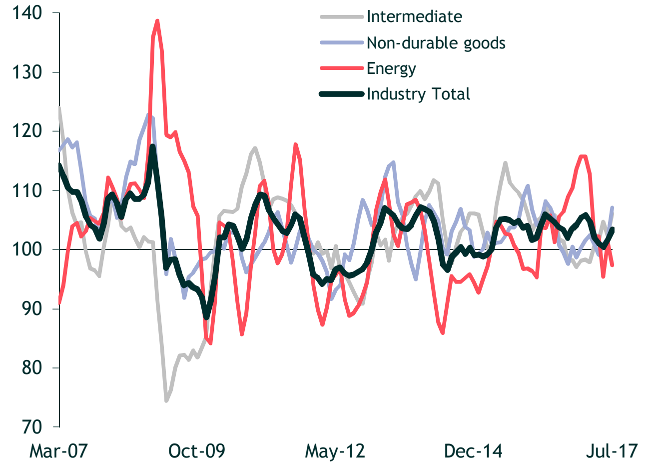
We keep 5.3%/GDP C/A deficit forecast for 2017 due to goods trade deficit re-widening on stronger domestic demand, outpacing record tourist FC revenues and remittances. Inflationary pressures increased this year, as headline CPI hit multi-year high of 2.2% in May on the back of higher energy and utility prices. However, CPI eased since then to 1.0% yoy on average in June-July on fading fuel price hikes. With inflation largely in line with our expectations, we keep 1.6% average inflation growth forecast for 2017, while we see inflation at 2.2% and 2.5% in 2018 and 2019, respectively on stronger domestic demand.

Bosnia and Herzegovina's data trends

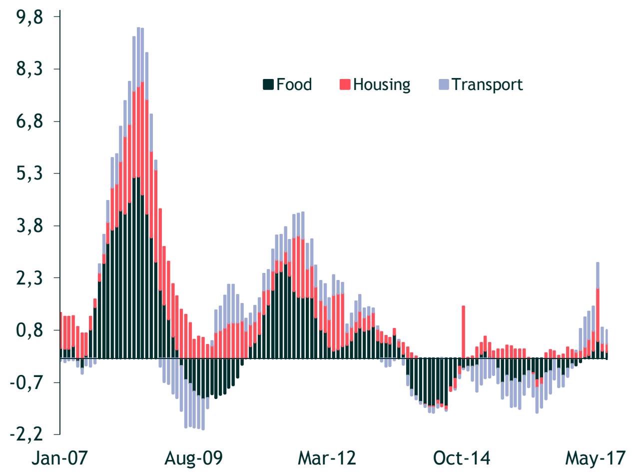
Real GDP growth (% YoY)



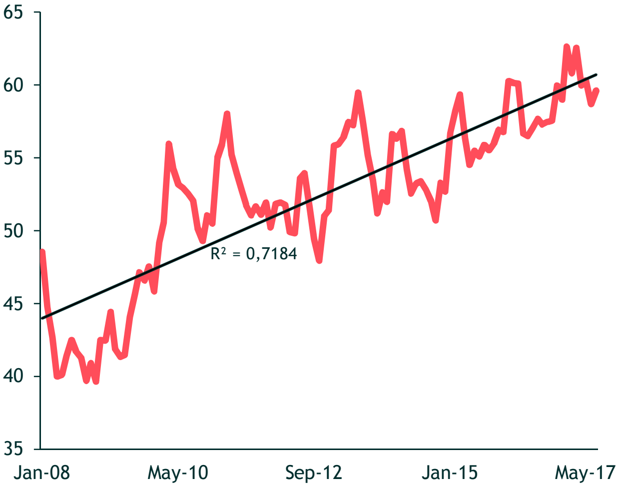
Industrial production (%, yoy, s-a, 3mma)



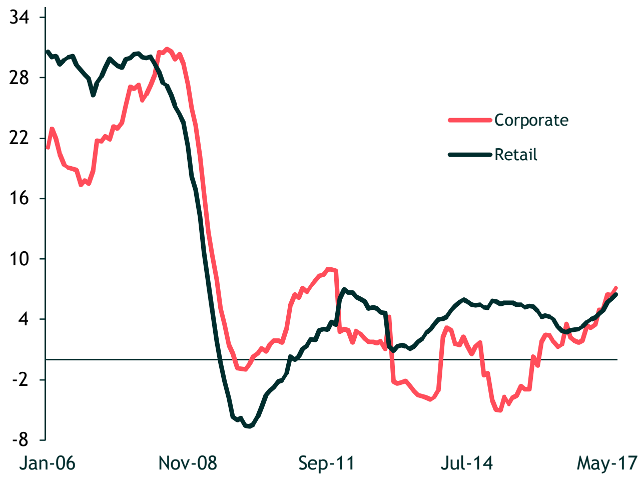
Key CPI contributions (pp)



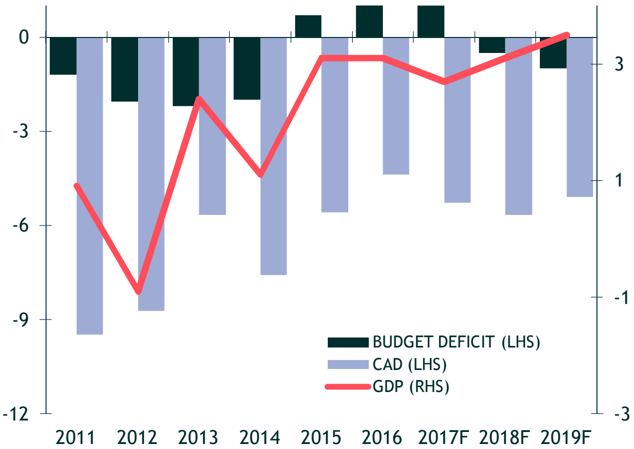
Merchandise import cover (%, 3mma)



Private credit dynamics (%, YoY)



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



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Activity									
Nominal GDP (BAMbn, current prices)	26,2	26,2	26,7	27,3	28,2	29,9	31,2	32,9	34,9
Nominal GDP (EURbn)	13,4	13,4	13,7	14,0	14,4	15,3	16,0	16,8	17,8
Nominal GDP (USDbn)	18,7	17,2	18,2	18,5	16,0	16,9	17,8	18,9	20,5
GDP per capita (EUR)	3.488,1	3.485,8	3.872,5	3.953,7	4.099,7	4.345,5	4.534,5	4.777,9	5.068,8
GDP per capita (USD)	4.857,5	4.482,7	5.143,0	5.252,5	4.547,0	4.812,1	5.061,0	5.363,2	5.829,1
Real GDP (constant prices YoY, %)	0,9	-0,9	2,4	1,1	3,1	3,1	2,7	3,1	3,5
Private consumption (YoY, %)	1,6	2,3	2,7	2,7	1,2	2,4	2,6	3,0	3,2
Fixed investment (YoY, %)	7,9	6,3	-2,4	11,1	-4,1	4,8	4,3	6,5	7,1
Industrial production (YoY, %)	5,9	-5,3	6,6	0,3	3,1	4,5	4,1	4,8	5,2
Unemployment rate (ILO, average, %)	27,6	28,0	27,4	27,5	27,7	25,4	19,4	17,9	16,4
Prices									
CPI inflation (average % YoY)	3,7	2,1	0,1	-0,9	-1,0	-1,1	1,6	2,2	2,5
CPI inflation (end-year % YoY)	3,1	1,8	-1,2	-0,4	-1,3	-0,2	2,1	1,9	2,7
PPI inflation (average % YoY)	3,8	1,5	-2,2	-0,5	0,6	-2,1	2,2	2,4	2,6
Net wage rates (% YoY, nominal)	2,0	1,2	0,1	0,4	0,0	0,9	1,9	2,5	2,9
Fiscal balance (% of GDP)									
State budget balance	-1,2	-2,0	-2,2	-2,0	0,7	1,2	1,0	-0,5	-1,0
Public debt	43,1	43,4	44,5	45,0	45,4	47,6	47,1	46,8	46,3
External balance									
Export of goods and services (EURbn)	4,297	4,312	4,597	4,733	5,054	5,413	5,975	6,213	6,524
Import of goods and services (EURbn)	-7,484	-7,483	-7,414	-7,943	-7,780	-7,994	-8,826	-9,207	-9,483
Merchandise trade balance (EURbn)	-4,131	-4,091	-3,741	-4,142	-3,810	-3,681	-4,024	-4,218	-4,159
Merchandise trade balance (% of GDP)	-30,8	-30,5	-27,4	-29,7	-26,4	-24,1	-25,2	-25,1	-23,3
Remittances (EURbn)	1,027	1,070	1,097	1,163	1,216	1,247	1,348	1,372	1,386
Current account balance (EURbn)	-1,270	-1,168	-0,773	-1,057	-0,806	-0,670	-0,840	-0,952	-0,909
Current account balance (% of GDP)	-9,5	-8,7	-5,7	-7,6	-5,6	-4,4	-5,3	-5,7	-5,1
Net FDI (EURbn)	0,3	0,3	0,2	0,4	0,2	0,2	0,4	0,5	0,4
FDI (% of GDP)	2,6	1,9	1,6	3,0	1,5	1,6	2,5	2,9	2,2
FDI cover (%)	27,1	22,3	29,1	40,0	27,4	36,9	47,6	51,7	44,0
Gross international reserves (EURbn)	3,285	3,328	3,614	4,001	4,400	4,873	4,763	4,313	4,094
Import cover (months of imports)	5,3	5,3	5,8	6,0	6,8	7,3	6,5	5,6	5,2
Debt indicators									
Gross external debt (EURbn)	10,163	11,330	11,443	10,638	11,479	11,601	11,631	11,341	11,331
Government (EURbn)	3,407	3,687	3,867	4,316	4,444	4,536	4,506	4,206	4,186
Private (EURbn)	6,756	7,642	7,576	6,321	7,035	7,065	7,125	7,135	7,145
Gross external debt (% of GDP)	75,8	84,6	83,7	76,2	79,6	75,9	72,9	67,5	63,5
Gross external debt (% of exports)	236,5	262,7	248,9	224,8	227,1	214,3	194,7	182,5	173,7
Exchange rates and money growth									
USD/BAM (end-year)	1,51	1,48	1,42	1,61	1,79	1,87	1,70	1,72	1,67
USD/BAM (average)	1,40	1,52	1,47	1,47	1,76	1,77	1,75	1,74	1,70
EUR/BAM (end-year)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
EUR/BAM (average)	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96	1,96
Money supply M1 (% YoY)	4,8	-0,7	9,0	9,2	11,9	13,7	10,7	9,1	7,7
Broad money M2 (% YoY)	5,8	3,4	7,9	7,3	8,0	8,3	7,8	7,2	6,7
Domestic credit (% YoY)	5,3	4,1	0,5	2,8	2,4	2,0	5,8	6,0	6,6
EURIBOR 3M interest rate (average %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,25

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	11.196	11.414	11.794	12.299	12.756	13.279	13.998	14.536	15.185
Assets (%, YoY)	3,4	1,9	3,3	4,3	3,7	4,1	5,4	3,8	4,5
Assets (% of GDP)	83,5	85,2	86,3	88,1	88,4	86,9	87,7	86,5	85,2
Gross loans (EURm)	7.828	8.151	8.194	8.423	8.624	8.795	9.307	9.863	10.514
Gross loans (%, YoY)	5,3	4,1	0,5	2,8	2,4	2,0	5,8	6,0	6,6
Gross loans (% of GDP)	58,4	60,9	59,9	60,3	59,8	57,5	58,3	58,7	59,0
Deposits (EURm)	6.643	6.814	7.285	7.861	8.452	9.077	9.763	10.405	10.994
Deposits (%, YoY)	3,7	2,6	6,9	7,9	7,5	7,4	7,6	6,6	5,7
Deposits (% of GDP)	49,6	50,9	53,3	56,3	58,6	59,4	61,2	61,9	61,7
Loan-to-deposit ratio (%)	117,8	119,6	112,5	107,1	102,0	96,9	95,3	94,8	95,6
Capital adequacy ratio (%)	17,1	17,0	17,8	16,3	14,9	15,8	16,5	16,8	17,0
Performance									
Net interest income (EURm)	396	389	385	383	398	411	432	457	495
Net interest income (%, YoY)	8,2	-1,8	-1,0	-0,5	3,9	3,3	5,2	5,6	8,4
Total operating income (EURm)	620	610	618	623	642	680	721	763	814
Total operating income (%, YoY)	1,8	-1,5	1,2	0,8	3,1	6,0	6,0	5,8	6,7
Pre-provision profit (EURm)	209	207	184	213	206	222	250	276	310
Pre-provision profit (%, YoY)	-5,1	-0,8	-11,1	15,8	-3,6	8,1	12,3	10,7	12,3
Provision charges (EURm)	125	130	192	117	171	91	100	101	99
Profitability and efficiency									
Net interest margin (%)	3,6	3,4	3,3	3,2	3,2	3,2	3,2	3,2	3,3
Pre-tax ROAA (%)	0,8	0,7	-0,1	0,8	0,3	1,0	1,1	1,2	1,4
Pre-tax ROAE (%)	5,9	4,8	-0,5	5,6	1,9	6,9	7,5	8,1	9,1
Cost-to-income ratio (%)	66,3	66,0	70,2	65,7	67,9	67,3	65,4	63,8	61,9
Operating expense (% of assets)	-3,7	-3,6	-3,7	-3,4	-3,5	-3,5	-3,5	-3,4	-3,4
Credit quality and provisioning									
NPL ratio (%)	11,8	13,5	15,1	14,2	13,7	11,8	10,5	9,9	9,1
NPL coverage (%)	66,3	65,9	66,7	69,7	71,2	74,4	94,9	112,3	120,3
Provision charges (% of loans)	1,6	1,6	2,3	1,4	2,0	1,0	1,1	1,1	1,0
Provision charges (% of PPP)	-60,0	-62,8	-104,1	-55,1	-83,1	-41,1	-39,9	-36,4	-31,8

Source: CBBH, banking agencies, Addiko research

Private sector support credit growth

Credit growth accelerated to 4.0% in the year to June after 2.0% in 2016, driven by private credit. Namely, corporate lending accelerated to 4.1% ytd (vs 3.3% in 2016) on better business sentiment and stronger investments. Retail lending rose 3.9% ytd (vs 3.8% in 2016) thanks to employment and wage growth, lower interest rates and strong consumer credit. Public lending contributed positively as well (2.8% ytd vs -17.2% in 2016) in oreder to compensate for non-existent IMF funding. With better-than-expected private and notably corporate lending, we upgraded credit growth forecast by 1.0pp to 5.8% yoy on the back of improving labor market, firmer private capex, record tourist season and easing credit standards (including lower interest rates). We see 6.0%-alike credit growth in 2018 given stronger private consumption and business optimism. NPL ratio fell to 11.1% in Q2, and we see it around 10.5% at YE17 before declining further to 9.9% in 2018 amid write-offs and better debt collection in the corporate sector. Better bankruptcy laws and tax incentives for NPL write-offs could further accelerate NPL decline, in our view.

Deposit collection continues at an unexpectedly strong pace…

Deposit collection recorded further growth of 4.0% ytd (vs 7.4% yoy in 2016), driven by 2.7% ytd (vs 8.1% yoy in 2016) higher household deposits on employment and wage growth and strong remittances, despite lower interest rates. Corporate contributed positively as well with 3.9% ytd (vs. 5.6% yoy in 2016) deposit growth amid improved liquidity, while public deposits soared 11.2% ytd (vs. 8.8% yoy in 2016). That said, ytd numbers outshone our expectation, and we upgraded deposit collection forecast by 1.4pp to 7.6% ytd thanks to improved labor market, record tourist season, remittances growth and generally improving economic outlook, while in 2018 we expect deposits growth to slow to 6.6% yoy. In Q1, B-H banking sector saw 12.7% yoy higher operating income, which alongside stagnating opex led to 30.7% surge in pre-tax profit. Given better credit growth outlook, we expect solid rise in net interest income, which will lead to 15.0%-alike pre-tax growth this year.

Stellar Tourist Season Boosts Growth

As 1H17 data came largely in line with our expectations, we keep our view of a 3.2% GDP growth this year driven with private consumptions and investments, and followed by acceleration to 3.4% in 2018. Upside risks to growth stem from increased tourism value added in economy after the completion of several big projects. At the same time, highway construction will boost both budget and current account deficit in this year and next. We see average CPI inflation of 2.4% this year and next, as diminishing of one-off effects in 2018 will be offset with VAT and excise duties increase.

Hard data suggest mixed performance in Q2 and beyond

After 3.2% yoy GDP growth in 1Q17, the latest data suggest a mixed performance in Q2 and beyond. Namely, after 3.5% yoy increase in Q1, retail sales growth slowed slightly to 3.3% yoy (on average) in April-July. After soaring 41.4% yoy in Q1, exports growth fell to just 0.5% yoy in April-July. However, import growth eased sharply from 20.3% yoy in Q1 to just 2.4% yoy in April-July, leading to slightly higher trade deficit (+4.7% yoy) of EUR186m in the year to July. After a 9.8% yoy drop in Q1, industrial output slump decelerated to -6.2% yoy in April-July. Construction activity accelerated to 51.5% yoy in Q2 after 37.5% yoy in Q1, reflecting energetic highway construction and plethora of other projects in tourism and energy. Due to methodological changes, this year's tourist activity data are not comparable with 2016, but 18.5% yoy jump in tourist income in Q2 suggests another record tourist season. In all, we'd expect Q2 GDP growth in the 3% yoy region, driven by tourism and construction.

2017 GDP growth seen at 3.2%

With 1H17 data largely in line with our expectations, we keep 2017 GDP growth forecast at 3.2%. Private consumption at 3% yoy pace is set to be the main growth driver on the back of stellar tourist season, moderate wage growth, private employment and resurgent retail lending. Investments continue to be driven by infrastructure capex, but also private investments in tourism and energy projects. Net exports will contribute negatively on the back of strong import-intensive domestic demand notably given energetic highway construction. In 2018, we expect GDP growth acceleration to 3.4%, driven by personal consumption supported with the aforementioned drivers and investments. Investment activity will be mainly driven by highway construction intensification and a number of projects in tourism and energy sector. Completion of Luštica bay and Porto Montenegro projects this year will increase the tourism value-added in the economy and further spur consumption. Certain downside risks to personal consumption stem from 2pp VAT hike and a plethora excise taxes hikes.

Highway related expenditures will keep deficit at elevated levels

1H17 budget data show 7.2% yoy lower deficit (EUR105m or 2.7% of 2017e GDP) on the back of 20.0% yoy surge in tax intake (3.7% above plan) thanks to better tax compliance, cyclical upswing and higher excise tax receipts (+21.5% yoy). Meanwhile, expenditures rose 5.4% yoy in 1H17 on the back of both higher current spending (+7.8% yoy) and capex that roughly tripled. In spite of strong growth, only half of the planned capex for 1H17 was realized. For now, we keep budget deficit forecast at 6.1% of GDP since the ongoing highway construction will boost capital outlays in 2H17. While highway construction will keep budget outlays elevated in 2018 as well, we see slightly lower budget deficit at 5.3% of GDP thanks to 2pp VAT hike, various excise tax hikes and wage containment. Some risks stem from flourishing grey economy when prices of inelastic goods (such as tobacco) increase. That said, public debt will keep its upward trajectory well above 70% of GDP.

Inflation pressures accelerated recently

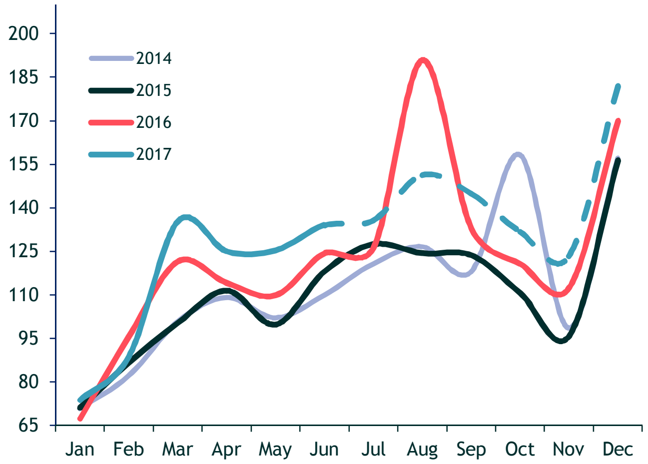
Inflationary pressures accelerated in July (3.2% yoy vs.2.5% yoy in 1H17) driven by food prices, which added 0.8pp in the course of this year, in line with general regional trends and caused by higher import prices of food and harsh weather. Strong positive contribution (+0.7pp) came from higher accommodation and restaurant prices, in line with increased investment activity in tourism. Higher oil prices and tobacco price hike in July added to the picture. We keep 2.4% average CPI inflation forecast for this year. We have also upgraded our 2018 inflation forecast slightly to 2.4% as diminishing of (food-related) one-off effects will be offset by 2pp VAT hike as well as higher tobacco, alcohol and coal excises since the beginning of 2018.

Current account set to widen further

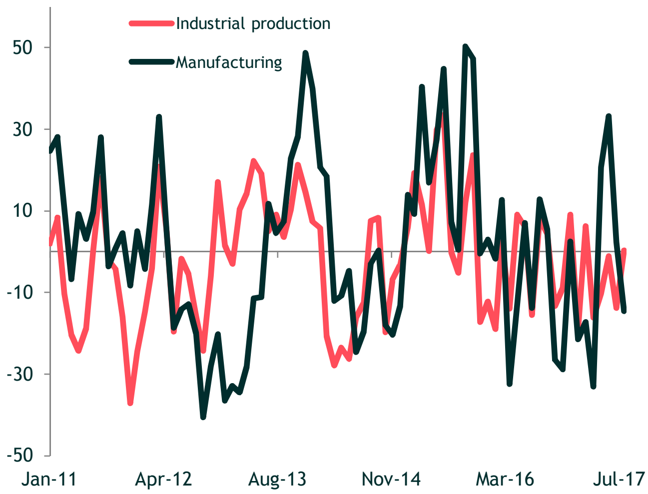
After hitting 19.5% of GDP in 2016, the C/A deficit fell 4.4% yoy in 1H17 as soaring services surplus more than offset further goods trade deficit widening. Goods trade gap rose 8.8% yoy in 1H17, while services surplus jumped 48.4% yoy on the back of 20.5% higher tourist income and 15.1% increase in transport services. Net FDI surged 41.7% yoy in 1H17 to EUR0.2bn, while portfolio investments faced a small net capital inflow after facing outflows in the past four years. Despite ongoing highway construction and domestic demand import dependence that will boost imports, we lower 2017 C/A gap forecast to 18.6% of GDP on the back of double-digit tourist income growth. In 2019, we see slightly higher C/A deficit of 19.4% of GDP as we expect that further investment acceleration will additionally boost imports.

Montenegrin data trends

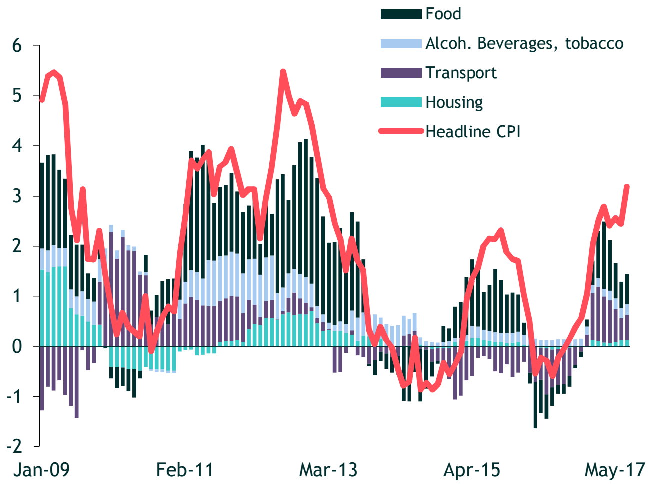
Budget revenue movements (EURm)



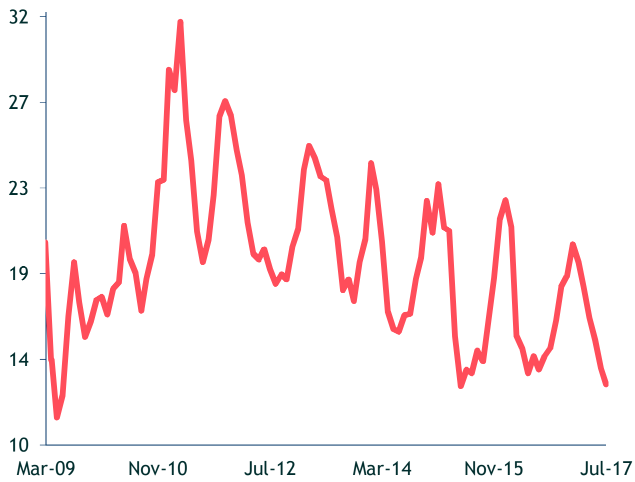
Industrial production (%, yoy)



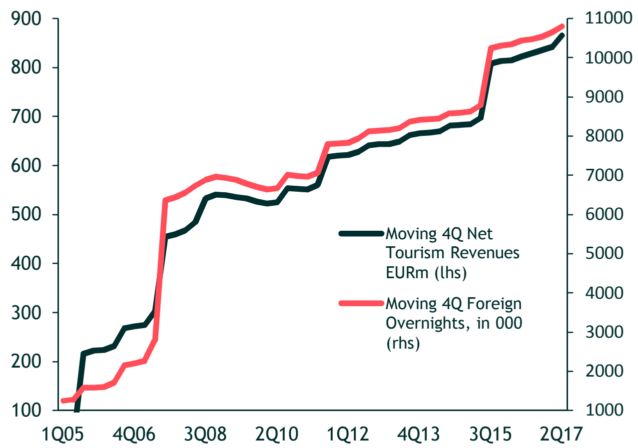
CPI by key contributions (pps)



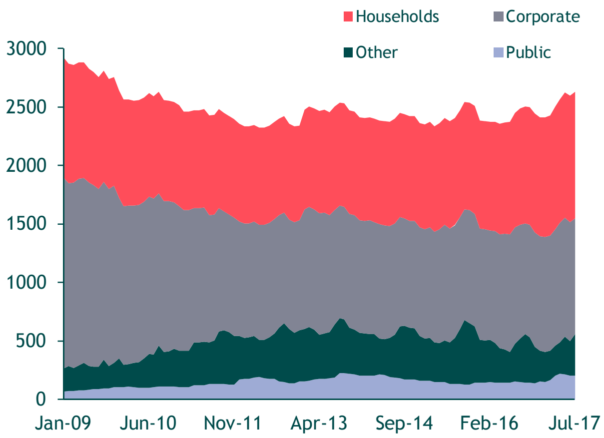
Merchandise import cover (%, 3mma)



Tourism



Gross loans by sector in EURm



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

SELECTED ECONOMIC FORECASTS

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Activity									
Nominal GDP (EURbn,current prices)	3,2	3,1	3,3	3,4	3,6	3,6	3,9	4,1	4,3
Nominal GDP (USDbn)	4,5	4,0	4,4	4,5	3,9	4,0	4,3	4,6	5,0
GDP per capita (EUR)	5.211	5.062	5.359	5.460	5.710	5.860	6.194	6.558	6.917
GDP per capita (USD)	7.257	6.510	7.117	7.253	6.333	6.490	6.913	7.362	7.955
Real GDP (constant prices YoY, %)	3,2	-2,7	3,5	1,5	3,2	2,5	3,2	3,4	2,9
Private consumption (YoY, %)	7,0	-0,7	1,6	2,9	2,2	2,6	3,1	3,3	3,0
Fixed investment (YoY, %)	-9,6	-1,8	10,7	-2,5	11,9	26,4	29,5	27,1	15,5
Industrial production (YoY, %)	-8,7	-6,2	10,7	-10,5	9,2	-3,3	-5,5	3,5	3,2
Unemployment rate (ILO, average %)	18,1	20,6	19,5	18,0	17,6	17,8	16,3	15,9	15,6
Prices									
CPI inflation (average % YoY)	3,3	4,0	1,8	-0,5	1,4	0,1	2,4	2,4	2,5
CPI inflation (end-year % YoY)	3,0	4,4	0,4	-0,6	1,7	1,0	1,9	2,3	2,2
PPI inflation (average % YoY)	3,2	1,8	1,7	0,2	0,3	-0,1	0,8	1,2	1,5
Net wage rates (% YoY, nominal)	1,0	0,7	-1,7	0,1	0,7	3,8	2,1	1,3	2,5
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	-6,7	-5,8	-6,3	-3,1	-8,0	-3,5	-6,1	-5,3	-3,5
Public debt	45,6	53,4	55,2	59,9	66,4	69,9	73,6	76,2	75,6
Gross public funding needs	n/a	n/a	9,5	5,1	17,8	19,1	13,5	7,5	9,3
External balance									
Export of goods and services (EURbn)	1,383	1,389	1,390	1,388	1,539	1,593	1,786	1,951	2,097
Import of goods and services (EURbn)	-2,100	-2,166	-2,066	-2,074	-2,214	-2,479	-2,680	-2,923	-3,062
Merchandise trade balance (EURbn)	-1,306	-1,389	-1,329	-1,376	-1,464	-1,661	-1,818	-2,012	-2,112
Merchandise trade balance (% of GDP)	-40,4	-44,1	-39,9	-40,6	-41,2	-45,6	-47,2	-49,3	-49,1
Tourism receipts (EURbn)	0,619	0,643	0,666	0,682	0,813	0,836	0,986	1,104	1,215
Current account balance (EURbn)	-0,573	-0,588	-0,487	-0,526	-0,483	-0,712	-0,718	-0,793	-0,783
Current account balance (% of GDP)	-17,7	-18,7	-14,6	-15,5	-13,6	-19,5	-18,6	-19,4	-18,2
Net FDI (EURbn)	0,4	0,5	0,3	0,4	0,6	0,4	0,5	0,5	0,5
FDI (% of GDP)	12,0	14,7	9,7	10,4	17,4	10,2	11,9	12,9	11,6
FDI cover (%)	67,9	78,5	66,6	67,3	128,3	52,2	63,7	66,3	63,9
Gross international reserves (EURbn)	0,273	0,318	0,395	0,514	0,641	0,780	0,916	1,102	1,265
Import cover (months of imports)	1,6	1,8	2,3	3,0	3,5	3,8	4,1	4,5	5,0
Debt indicators									
Gross external debt (EURbn)	4,689	4,909	5,041	5,253	5,403	5,645	6,041	6,494	6,940
Government (EURbn)	1,415	1,477	1,433	1,562	1,975	2,003	2,179	2,341	2,454
Private (EURbn)	3,275	3,432	3,687	3,857	3,962	3,642	3,862	4,153	4,486
Gross external debt (% of GDP)	145,0	155,9	151,5	154,8	152,1	154,8	156,7	159,1	161,2
Gross external debt (% of exports)	339,2	353,3	362,6	378,4	351,0	354,3	338,3	332,8	330,9
Exchange rates and money growth									
EUR/USD (end-year)	1,30	1,32	1,38	1,21	1,09	1,05	1,15	1,14	1,17
EUR/USD (average)	1,39	1,29	1,33	1,33	1,11	1,11	1,12	1,12	1,15
Money supply M1 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Broad money M3 (% YoY)*	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Domestic credit (% YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	6,3	6,4	5,2
ECB reference rate (end-year %)	1,00	0,75	0,25	0,05	0,05	0,00	0,00	0,00	0,17
EURIBOR 3M interest rate (average, %)	1,39	0,58	0,22	0,21	-0,02	-0,18	-0,33	-0,33	-0,25

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

SELECTED BANKING SECTOR DATA

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Balance sheet									
Assets (EURm)	2.810	2.808	2.959	3.136	3.472	3.791	4.207	4.648	4.992
Assets (%, YoY)	-4,5	-0,1	5,4	6,0	10,7	9,2	11,0	10,5	7,4
Assets (% of GDP)	86,9	89,2	88,9	92,4	97,3	100,6	105,4	113,9	116,0
Gross loans (EURm)	2.359	2.342	2.414	2.367	2.386	2.416	2.592	2.777	2.922
Gross loans (%, YoY)	-6,3	-0,7	3,1	-1,9	0,8	1,3	7,3	7,1	5,2
Gross loans (% of GDP)	72,9	74,4	72,6	69,8	66,8	64,1	65,0	68,0	67,9
Deposits (EURm)	1.817	1.981	2.098	2.308	2.625	2.871	3.071	3.229	3.370
Deposits (%, YoY)	1,5	9,0	5,9	10,0	13,7	9,4	6,9	5,1	4,4
Deposits (% of GDP)	56,2	62,9	63,0	68,0	73,5	76,2	77,0	79,1	78,3
Loan-to-deposit ratio (%)	129,8	118,2	115,1	102,6	90,9	84,1	84,4	86,0	86,7
Capital adequacy ratio (%)	16,5	14,7	14,4	16,2	15,5	16,1	15,5	13,2	12,4
Performance									
Net interest income (EURm)	106	106	104	111	117	122	127	131	137
Net interest income (%, YoY)	-4,8	-0,1	-1,6	6,6	5,3	4,2	4,3	2,7	4,8
Total operating income (EURm)	221	178	156	158	171	175	181	188	197
Total operating income (%, YoY)	42,6	-19,5	-12,0	1,2	8,3	1,9	3,8	3,9	4,8
Pre-provision profit (EURm)	114	65	48	46	52	53	57	63	72
Pre-provision profit (%, YoY)	114,7	-43,2	-26,7	-2,6	11,5	2,6	7,6	9,9	14,3
Provision charges (EURm)	124	121	44	21	53	44	45	44	43
Profitability and efficiency									
Net interest margin (%)	3,7	3,8	3,6	3,6	3,5	3,4	3,2	3,0	2,8
Pre-tax ROAA (%)	-0,3	-2,0	0,1	0,8	-0,1	0,3	0,3	0,4	0,6
Pre-tax ROAE (%)	-3,2	-18,7	1,0	6,0	-0,4	2,0	2,4	3,7	5,6
Cost-to-income ratio (%)	48,2	63,5	69,6	70,7	69,8	69,6	68,5	66,7	63,6
Operating expense (% of assets)	3,7	4,0	3,8	3,7	3,6	3,3	3,1	2,8	2,6
Credit quality and provisioning									
NPL ratio (%)	15,5	17,6	17,5	15,9	12,5	10,3	8,0	7,5	7,3
NPL coverage (%)	27,6	32,7	44,7	46,0	49,6	56,9	65,4	74,4	84,2
Provision charges (% of loans)	5,1	5,1	1,9	0,9	2,2	1,8	1,8	1,7	1,5
Provision charges (% of PPP)	108,5	185,7	92,5	45,6	103,2	82,2	79,0	70,6	60,4

Source: CBCG, Addiko research

Strong credit growth expected in 2017 and 2018

Credit growth accelerated to 9.0% in the year to July (vs 1.3% yoy in 2016), with the strongest positive contribution from the volatile credit growth of ‘other’ sectors (+35.0% ytd vs -28.0% yoy in 2016) and 32.6% stronger public credit amid highway construction (vs 4.9% yoy in 2016). Retail lending rose 6.5% ytd (vs 10.5% yoy in 2016), driven by cash loans amid wages and job growth. Corporate lending rose only 0.9% ytd (vs. 3.0% yoy in 2016), albeit solely due to one-off working capital credit slump in July. That said, we upgraded credit growth forecast for 2017 and 2018 to 7.3% yoy and 7.1% yoy, respectively, given stronger-than-expected public lending. In addition, credit growth in 2017 will be boosted by wage and employment growth, private investments, stronger construction activity and low interest rates. In 2018 the growth will be supported by intensified highway construction and private capex. NPL ratio fell to 8.2% in July (vs. 10.3% in 2016), and we expect it to decline further to 8.0% by end-2017 and 7.5% in 2018 given expansion and time extension of voluntary debt resolution framework known as ‘Podgoricki model’.

Pre-tax profit growth expected in 2017

Deposit collection increased by 5.4% ytd (vs 9.4% yoy in 2016), driven by private sector as corporate deposits rose 9.3% ytd (vs 18.1% yoy in 2016), while household deposits increased 3.9% ytd (vs. 6.6% yoy in 2016) thanks to tourism and improving labor market. Public sector contributed negatively given 1.8% ytd lower deposits (vs +22.5% yoy in FY16). We keep 6.9% yoy deposits growth forecast for 2017 on the back of stellar tourist season, further employment gains and moderate wage hikes, while in 2018 we expect deposits collection to slow given intensified investments and high-base effects. P&L sheet for H1 indicates improved profitability as 5.4% yoy higher TOI led to 18.2% yoy stronger pre-tax income, while opex and provision stayed flattish. Looking ahead, despite low interest rates and limited space for interest spread widening, we see solid NII income growth in 2017 given stronger credit growth in the 3.5% region that along with solid fee income growth and steady provisioning leads to EUR13m pre-tax profit. We expect further pre-tax growth in 2018 on rising operating income and stable provisioning and opex.

ABBREVIATIONS

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

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