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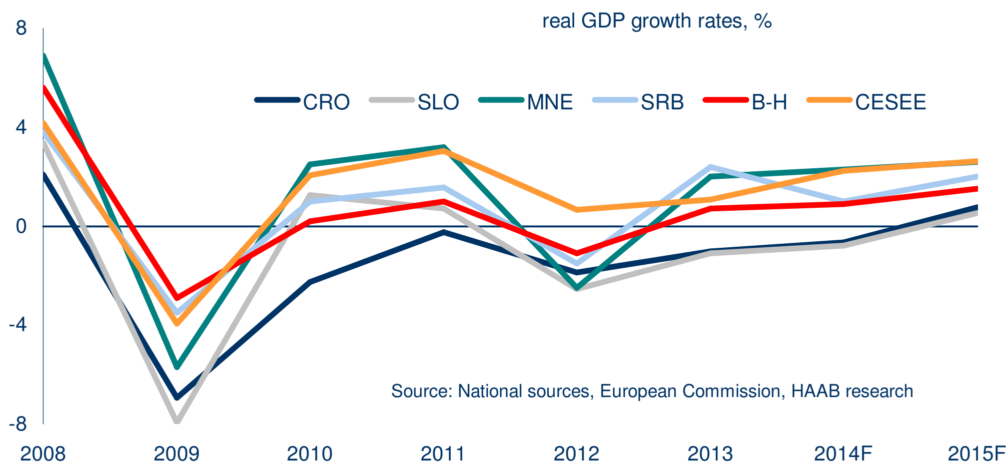
MACROECONOMIC RESEARCH: SEE QUARTERLY

FROM RECESSION TO STAGNATION

SEE GROWTH CONTINUES TO UNDERPERFOM



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EXECUTIVE SUMMARY

BOTTOM LINE: We expect GDP to stagnate in 2014 in the SEE region, with slight upgrades in Slovenia and Montenegro largely offset by GDP downgrades in Serbia and Bosnia and Herzegovina. Private spending stays the key drag on GDP headline, which is largely connected to further deterioration in households' expenditure fundamentals. Net trade will be less positive than in the recent years, with external demand recovery still fragile, and imports lifted by the anticipated investment increase. Risks to our view are mostly on the downside if there is increased risk aversion in the face of global markets volatility and/or structural reforms are further back-loaded. Our inflation forecasts saw the biggest downward revisions given debilitating impact of domestic demand weakness and contained import prices.

KEY POINTS:

1. In Croatia, we expect another year of an 1%-alike GDP contraction as the accelerated, EC imposed fiscal tightening will combine with private de-leveraging and soaring unemployment. Meanwhile, for Slovenia we tempered our GDP forecast to -0.8% from -1.4% on better export outlook, easing financial market tension and replacement capex stabilization. Serbian GDP growth is seen slower than before given downgraded public capex upon deteriorated (quasi)sovereign ability to secure funding and the EU's market competition regulations.

2. Croatian MinFin prolonged the adjustment further, under which it could take six years to meet the EDP criteria. So the next big thing is the future of internal devaluation, which may via higher potential growth either help growing out of fiscal troubles or further aggravate fiscal trends. In Slovenia, bank recapitalizations upon the AQR and stress tests are steps in the right direction, but need to be complemented by firms' restructuring, solutions for distressed assets and privatisations. In Serbia, the recent elections outcome give the new government a strong mandate to embark on harsh reforms, however political leaders still have to walk the walk on painful reforms rather than just talk the talk. In B-H, the key risk event that could affect fiscal policy are the autumn's general elections, and the risk remains that fiscal slippage freezes essential IFI support.

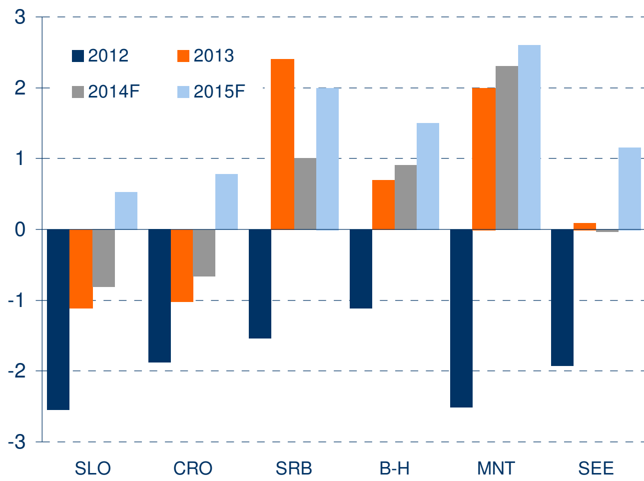
3. We have lowered our inflation forecasts due to subdued outlook for global commodity prices, fiscal tightening, and significant slack in the economy. Path-wise, the unwinding of high base effects and indirect tax hikes will see higher yoy inflation rates later in the year. Risks to our view are mostly on the downside should already subdued commodity outlook prove optimistic, and fiscal austerity bites harder. In Serbia, we do not fully exclude upside CPI inflation surprises in case there is stronger-than-expected dinar depreciation.

4. Central banks remained on hold recently, with the ECB still not worried about deflationary risks. That said, we think that the ECB's baseline assumption must be substantially challenged to see any big easing action by the ECB in the near term, but this does not fully exclude additional unorthodox measures to prevent funding cost spikes as 3Y LTRO roll-offs loom large ahead. Meanwhile, given already bearish growth/weak credit backdrop, we think the CNB will act against an unwarranted funding cost concerns amid bank deleveraging, and a worsening of the medium-term demand outlook in the event of austerity trap. The NBS must continue to play it safe against volatile capital flows, whereas a quick government formation alongside slow inflation recovery provides a potential for rate cuts ahead.

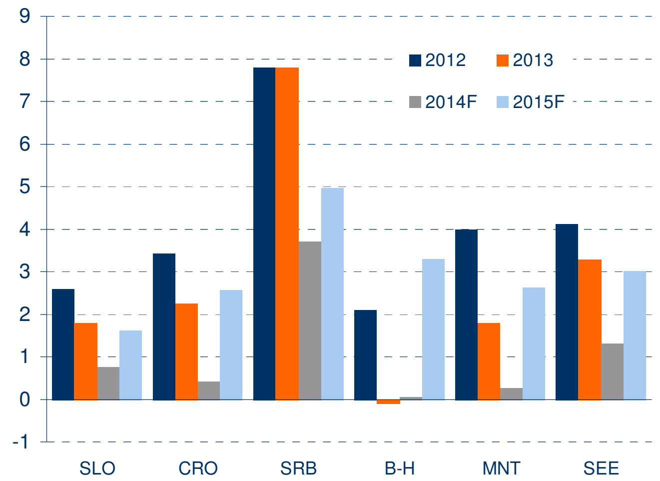
5. After the recent outlook improvements, an upgrade to Slovenian rating would still require broad-based fiscal improvement including a thorough state-owned firms' restructuring/privatization, and further contingency measures to prevent fiscal deficit overshoot. In Croatia, as long as the cabinet prefers revenue-based adjustment, while refraining from less growth-unfriendly taxation of non-tradables, and (labour) reforms are further delayed, we do not rule out downside pressures to the sovereign rating. In Serbia, without more decisive budget cuts, the sovereign rating stays exposed to downgrade risks, which could make deficit covering even more expensive in the coming years. Against shaky global markets and less accommodativeness by the key central banks, investors become more selective in EM asset exposure, which places spreads of structurally weaker SEE issuers under pressure especially in case of fiscal procrastination.

SEE data trends

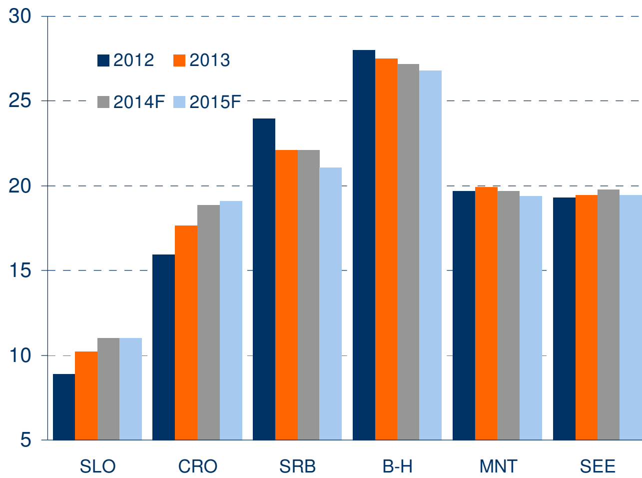
Real GDP growth (%)



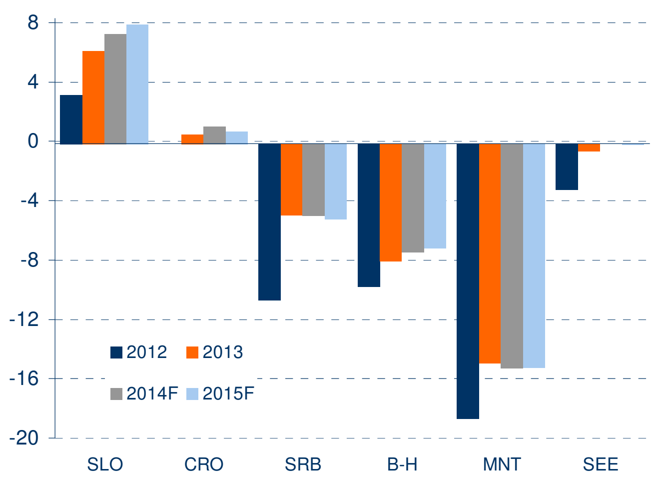
CPI inflation (average, %, YoY)



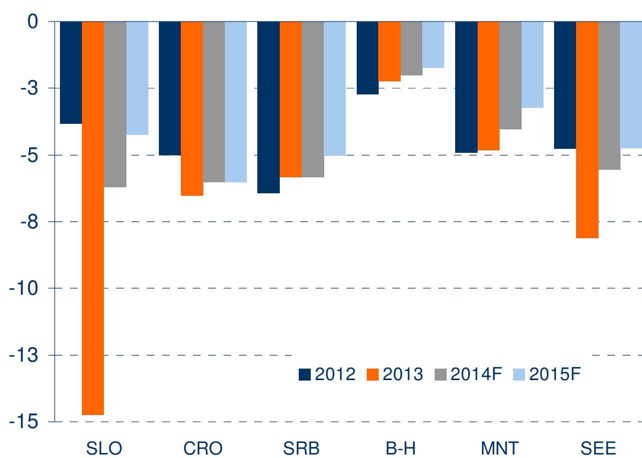
Unemployment rate (ILO, average, %)



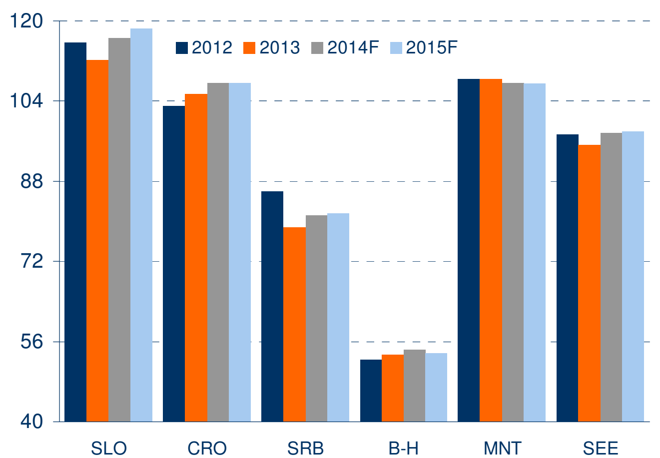
Current account balance (% of GDP)



Government balance (% of GDP)



Gross foreign debt (% of GDP)



Source: national sources, HAAB research

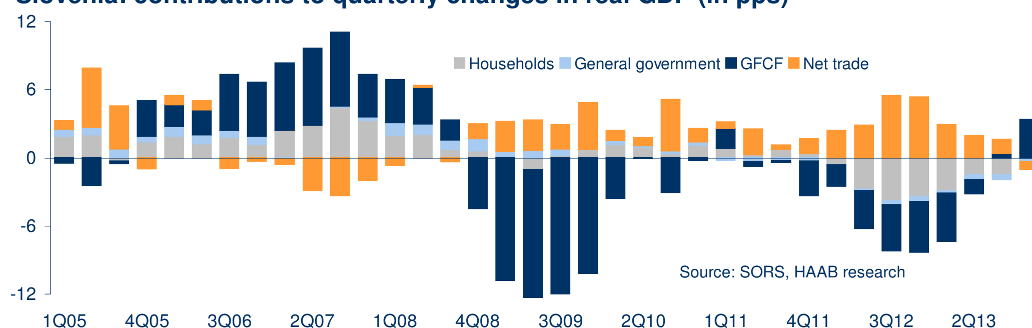
Not Yet Out of the Woods

Bank recapitalizations upon the AQR and stress tests are steps in the right direction, but need to be complemented by firms' restructuring, solutions for distressed assets and privatisations. Meanwhile, contingency measures are needed to prevent fiscal overshoot. We therefore maintain wait-and-see stance on policy developments before reassessing outlook on yields.

2013 ended on a stronger note

The surprisingly firm 4Q13 GDP (+1.2% qoq, among the strongest in CESEE) shows the recession is abating as the economy also grew 1.9% yoy. Three things largely explain this overshoot: i) upward revision in 1-3Q to a cumulative +0.7% from -0.4% previously; ii) a large 1.3pp stocks contribution; iii) another big 0.7pp contribution from net taxes. Private spending and investments were also stronger than expected, with one-offs (EU co-funded coal power plant) aiding the buildings sector. A durable consumption rebound is dubious given the ongoing wage deflation, de-leveraging and consumer pessimism. While net trade subtracted from Q4 growth due to hefty capital goods imports, the EU recovery as depicted by stronger forward-looking E(M)U PMIs bodes well for Slovenian exports. Though adverse weather in 1Q14, de-stocking and subdued consumption hinder near-term prospects, the confidence indicator (notably for export orders) points to a continuing recovery, though at lower pace.

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



Upgrading 2014 on a resumption of EU demand

After an 1.1% drop in 2013, we tempered our GDP recession forecast to -0.8% from -1.4% on better export outlook, easing financial market tension and replacement capex stabilization. Funding conditions nevertheless remain tight, which alongside firms' needs to restore financial position and very low aggregate profitability is not a conducive environment for investments. The key signpost to watch here is massive corporate restructuring by banks that release useful equity and help viable businesses to survive. Slovenia must also reverse the low appeal as FDI destination, with FDI a key funding option in view of EUR5bn-alike recap needs and state asset sales. Consumption is facing headwinds from further decline in employment and wages, de-leveraging and rising tax burden. The main downside risks stem from faster bank de-leveraging under the ECB's Asset Quality Review, faltering EMU growth momentum and also declining appetite for structural reforms. On the upside, private capex acceleration hinges on speedier firms' restructuring, solutions for distressed assets, timely privatisations and confidence spillover effects from continued short-term exports recovery. In 2015, GDP growth should resume amid a gradual stabilization in domestic demand, some electioneering and accelerating external demand.

Inflation coming down below EMU average

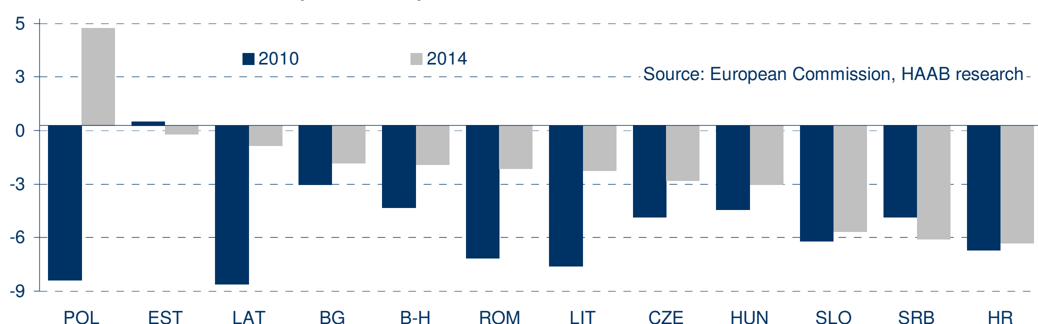
As elsewhere in Europe, CPI inflation surprised to the downside due to lower commodity prices, generally weak domestic demand, persistent labour market slack and the stronger EUR impact. Further pro-competitiveness disposable income adjustment and the fading out of the July 2013 VAT hikes will keep headline and core inflation low for several years. It is also important that Slovenia will see inflation below the EMU average for the first time in three years, which effectively boosts competitiveness vis-à-vis the main trading partners. Although not our base case, deflationary scenario would, however, hurt company's sales prospects and debt-servicing ability. While the ECB is open to rate cuts in Q2 if tensions in the money market increase and/or the inflation outlook worsens, we think they may try unconventional measures (including forms of QE, credit easing or funding for lending schemes) thereafter, should the situation warrant it.

Current account hitting new record highs, portfolio inflows keep coming

While the current account surplus doubled to a record 6.5% of GDP in 2013 and is heading still higher, such rebalancing is mainly cyclical and driven by import compression and de-leveraging, rather than intrinsic improvement. Although it has to be said that competitiveness has also improved somewhat in that unit labour costs are down 6% from the year-ago peak. A further increase in the trade surplus will be to some extent offset by higher income deficit on elevated debt servicing costs and negative net valuation changes in offshore investment.

With the C/A surplus and the latest USD3.5bn bond issuance, the economy's (re)financing requirement is on a extremely comfortable footing, and although further issuance is coming soon, the government may afford to wait for positive market volatility. Beyond the global risk appetite, portfolio flows will nevertheless depend on the pace of fiscal adjustment and ongoing bank and corporate restructuring. While privatization is been very slow, with only two small-ticket sales out of 15 names first put forward in 1H13, extremely favourable external liquidity and the absence of market pressure of late makes the political opposition to 'strategic' asset sales all the more likely. Meanwhile, Slovenian corporate is generally poorly capitalized and attracting FDI through M&A activity is key to help solving this problem.

Slovenia: fiscal deficits (% of GDP)



Budget deficit and public debt on upward trajectory, contingency measures are needed

Despite fiscal measures implemented, the budget deficit ex. bank recaps was 4.0% as VAT hikes, public wage and social transfer cuts were largely offset by soaring interest and pension outlays. Adding the two biggest banks successful recapitalizations, the overall deficit hit 14.3% of GDP. In 2014-2015, we see a flattish core deficit performance as the budget has shifted away from spending adjustment of last years towards revenue measures. Namely, a great deal of consolidation hinges on a real estate tax (1.1pp/GDP), followed by de-indexation of income tax allowances, but legal obstacles over real estate tax and demand-inflicted tax underperformance will see revenues off target this year. Spending overruns are also likely as the bad weather caused EUR0.5bn in sanation costs, the court annulled a retroactive wage freeze from 2012, and Slovenia has to compensate residents who were declined Slovenian citizenship in 1991. Taken together with the third biggest Abanka recap (0.8pp/GDP), state participation in two 'private' bank recaps, total deficit will top 6%, with upside risks to that from further NPL growth and the ECB's AQR for the involved banks. Contingency measures of ca. 1.5pp may partly compensate in the event of cuts in subsidies, transfers and public employment, but ahead of 2015 elections (or earlier) there is a risk of doing too little, too late.

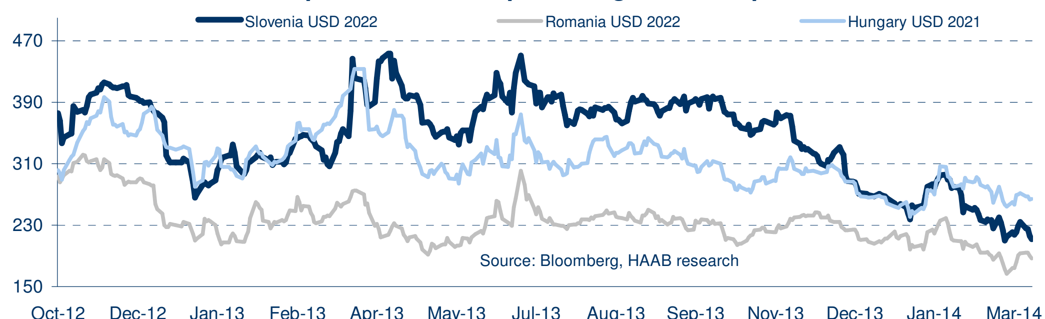
In need of credible medium-term restructuring and adjustment strategy

Following a spike past 73% of GDP in 2013 on bank rescue costs (EUR4.8bn), public debt will hit 83% of GDP in 2015 due to primary deficits, smaller-scale bank recaps, weaker-than-expected GDP and higher interest expenditure. While Slovenia entered 2014 with one of the CESEE-highest gross funding requirement, the latest bonds, lifting the MinFin's cash reserve to EUR5bn, covered basically all 2014 needs, plus 38% of those for 2015-2016, which substantially reduces the risk of unattainable access to market financing. Also, BAMC bonds on bank books are eligible collateral with the ECB and could be used to purchase state bonds from liquidity against this collateral. The flip side of this, however, is that a successful fund raising has the downside of allowing further inaction on policy, eg on the long-awaited health, pension and labour reforms. Although finally the banking system capital problems appear to have been warded off for the time being, in the medium term we are sceptical over Slovenia's credible restructuring and adjustment strategy. This is because of the genuine unions' and politicians' opposition to structural reforms, indicating to us that the drive to improve state banks' risk-management practices and raise restructuring efforts could be well insufficient. Should these problems resurface in the future and banks are faced with another round of hefty recaps, Slovenia may have to re-consider an ESM program with the EU/IMF oversight.

Slovenian bonds have outperformed...

Slovenian bonds saw the strongest total returns CEE-wise in Q1 in the afterglow of relatively successful bank recaps and the recent hefty fiscal reserve build-up, which have diminished chances of requiring external financial assistance as the key source of uncertainty. Moreover, Moody's outlook upgrade added to the bullish tone, citing greater clarity on banks' capital needs, reduced uncertainty about funding prospects and balancing of risks to fiscal outlook. The rally stopped at levels considered to be roughly fair against CESEE peers as investors continue to be sceptical about policy implementation risks, expect fresh supply, and do not yet consider Slovenia as a candidate to participate in the rally in EMU peripherals.

Slovenia USD bonds outperformed as z-spreads tightened vs peers

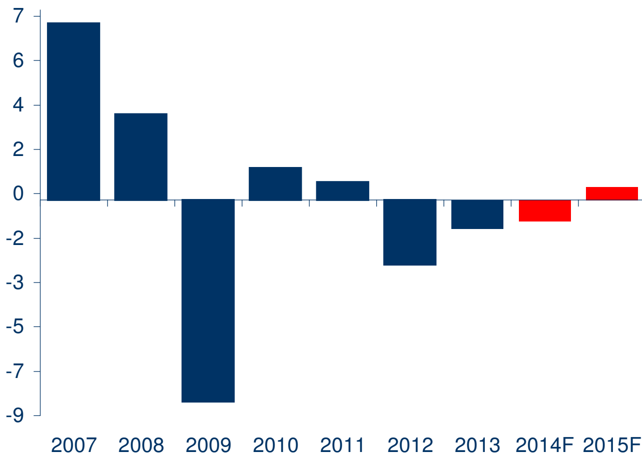


Watching policy developments for yields outlook

We maintain wait-and-see stance on Slovenian bonds and think investors should follow policy developments as the current challenging environment within EM strengthens the case for even more differentiation. Our concern is that in the absence of such market pressure that forced the country to implement the bad bank plan and corporate insolvency procedures, complacency has set in. Our bear case assumes renewed weakness in the banking sector exacerbated by delays in corporate restructuring, and inactive government with slow reforms and privatization being clearly obstructed by politicians, which may lead to renewed pressure on ratings. In the baseline, Slovenia comes up with contingency measures half-heartedly, and political procrastination ahead of 2015 elections yields very little in the entitlements area. In the first case, we would expect the markets to price-in further bank recaps and yields soar amid increased uncertainty about banks' health and the overall sovereign's funding prospects. The latter scenario would mean Slovenian bonds underperformance vis-à-vis peers albeit lower dependence on portfolio inflows provides some comfort. A bull case of a smooth execution on the reform front coupled with a meaningful easing in the eurozone financial conditions would comfort investors and help Slovenian spreads to converge to that of EMU peripherals.

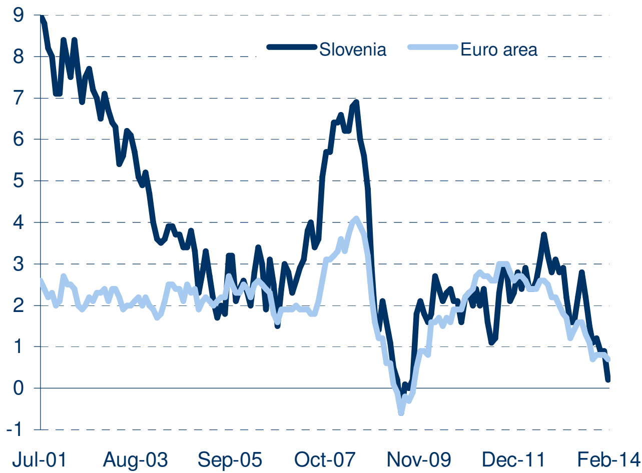
Slovenia's data trends

Real GDP growth (% YoY)



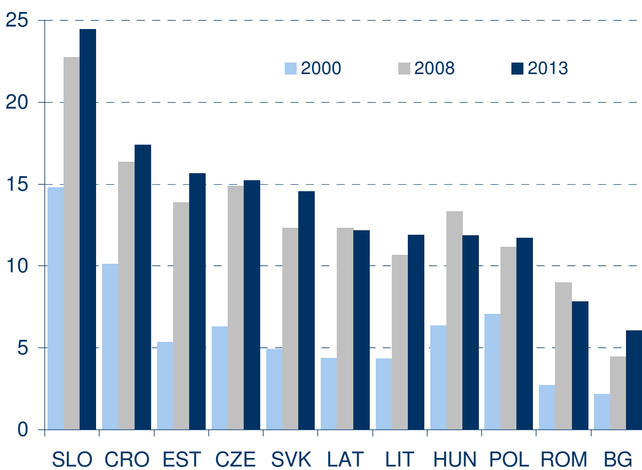
Economic confidence vs. GDP growth

CPI inflation dynamics (% YoY)

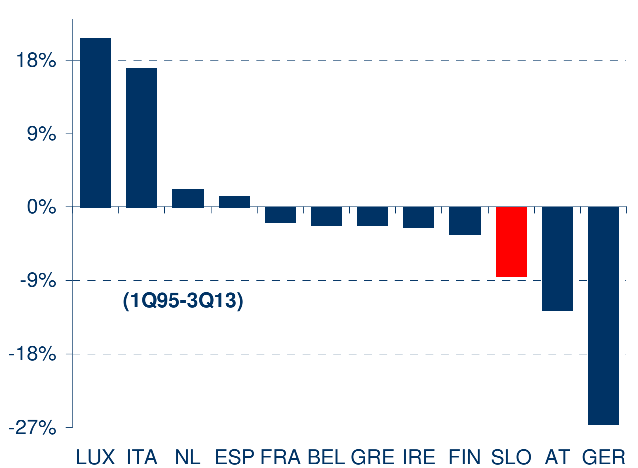


Business sentiment in manufacturing

Compensation per employee, p.a., EURk



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, HAAB research

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Activity									
Nominal GDP (EURbn, current prices)	34,6	37,2	35,4	35,5	36,2	35,3	35,3	34,9	35,3
Nominal GDP (USDbn)	47,4	54,8	49,4	47,1	50,3	45,4	46,9	46,9	46,6
GDP per capita (EUR)	17.208	18.527	17.428	17.335	17.633	17.183	17.134	16.932	17.147
GDP per capita (USD)	23.590	27.257	24.309	22.997	24.555	22.097	22.768	22.807	22.641
Real GDP (constant prices YoY, %)	7,0	3,4	-7,9	1,3	0,7	-2,5	-1,1	-0,8	0,5
Private consumption (YoY, %)	6,2	2,5	-0,1	1,5	1,0	-4,8	-2,7	-2,4	-0,4
Fixed investment (YoY, %)	13,3	7,1	-23,8	-15,2	-5,5	-8,2	0,2	-3,4	1,0
Industrial production (YoY, %)	7,2	2,5	-17,3	7,1	1,3	-1,1	-0,7	1,8	2,4
Unemployment rate (ILO, average %)	4,9	4,4	5,9	7,3	8,2	8,9	10,2	11,0	11,0
Prices									
CPI inflation (average % YoY)	3,6	5,7	0,9	1,8	1,8	2,6	1,8	0,8	1,6
CPI inflation (end-year % YoY)	5,7	3,1	1,6	1,4	2,7	2,7	0,7	1,5	1,6
PPI inflation (average % YoY)	4,2	3,9	-1,3	2,1	4,5	0,9	0,3	2,0	1,5
Net wage rates (% YoY, nominal)	5,9	7,9	3,4	3,9	2,1	0,4	0,6	0,8	0,5
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	0,0	-1,9	-6,2	-5,9	-6,3	-3,8	-14,7	-6,2	-4,2
Public debt	23,1	22,0	35,0	38,7	47,1	54,4	71,9	78,1	83,4
Gross public funding needs	n/a	n/a	n/a	7,1	10,8	8,4	19,9	15,8	11,8
External balance									
Export of goods and services (EURbn)	24,167	25,480	20,919	23,566	26,292	26,798	27,527	28,297	29,053
Import of goods and services (EURbn)	-24,576	-26,197	-20,194	-23,116	-25,772	-25,104	-24,891	-25,329	-25,894
Merchandise trade balance (EURbn)	-1,456	-2,144	-0,441	-0,830	-0,957	-0,110	0,632	1,248	1,439
Merchandise trade balance (% of GDP)	-4,2	-5,8	-1,2	-2,3	-2,6	-0,3	1,8	3,6	4,1
Tourism receipts (EURbn)	1,666	1,827	1,804	1,925	1,975	2,090	2,101	2,143	2,182
Current account balance (EURbn)	-1,441	-2,028	-0,173	-0,050	0,146	1,159	2,224	2,584	2,850
Current account balance (% of GDP)	-4,2	-5,4	-0,5	-0,1	0,4	3,3	6,3	7,4	8,1
Net FDI (EURbn)	-0,3	0,3	-0,7	0,4	0,6	0,2	-0,6	0,3	0,5
FDI (% of GDP)	-0,7	0,9	-1,9	1,2	1,8	0,5	-1,6	0,9	1,4
FDI cover (%)	n/a	16,1	n/a	858,5	n/a	n/a	25,0	n/a	n/a
Gross international reserves (EURbn)	0,724	0,687	0,749	0,803	0,767	0,722	0,680	0,750	0,750
Import cover (months of imports)	0,4	0,3	0,4	0,4	0,4	0,3	0,3	0,4	0,3
Debt indicators									
Gross external debt (EURbn)	34,783	39,234	40,318	40,723	40,100	40,849	39,566	40,636	41,836
Government (EURbn)	3,036	3,736	6,559	8,167	8,715	11,063	15,432	17,832	20,282
Private (EURbn)	28,159	31,866	30,163	30,182	28,375	25,083	19,134	17,804	16,554
Gross external debt (% of GDP)	100,5	105,3	113,8	114,8	110,9	115,7	112,2	116,6	118,5
Gross external debt (% of exports)	143,9	154,0	192,7	172,8	152,5	152,4	143,7	143,6	144,0
Exchange rates and money									
EUR/USD (end-year)	1,46	1,40	1,43	1,34	1,30	1,32	1,37	1,32	1,31
EUR/USD (average)	1,37	1,47	1,39	1,33	1,39	1,29	1,33	1,35	1,32
Money supply M1 (% YoY)*	-6,6	-3,7	7,7	13,5	1,5	4,4	0,1	0,5	2,0
Broad money M3 (% YoY)*	5,0	8,9	2,6	2,4	3,5	-1,4	-1,3	-1,0	0,5
Domestic credit (% YoY)	n/a	n/a	1,1	1,6	-4,6	-5,8	-21,1	-9,8	1,5
ECB reference rate (end-year %)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,25	0,25
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,22	0,30	0,38
SLO 5Y yield (average %)	-	-	-	3,03	3,96	4,55	4,35	4,00	3,90
SLO 10Y yield (average %)	-	4,49	4,35	3,84	4,98	6,01	5,87	5,60	5,40

* Since 2007 ECB data

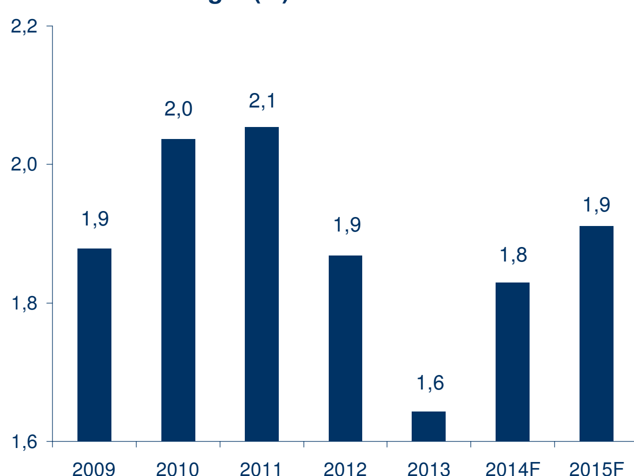
Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, IMF, HAAB research

SELECTED BANKING SECTOR DATA

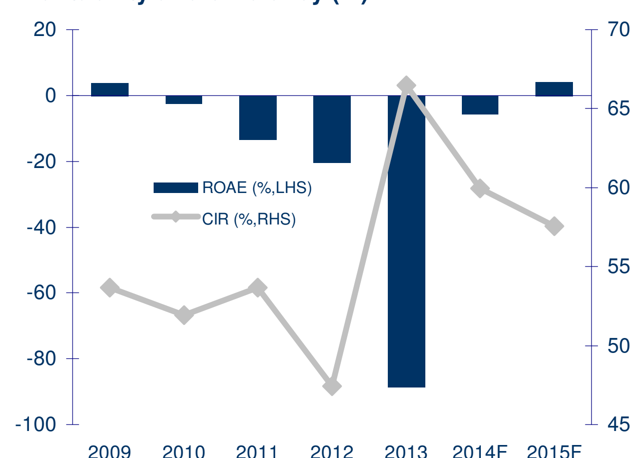
	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Balance sheet figures and ratios									
Assets (EURm)	n/a	47.628	51.612	50.319	48.748	46.119	40.467	38.444	38.636
Loans (EURm)	n/a	33.530	33.910	34.450	32.875	30.962	24.428	22.034	22.365
Loans (% YoY)	n/a	n/a	1,1	1,6	-4,6	-5,8	-21,1	-9,8	1,5
Loans (% of GDP)	n/a	90,0	95,7	97,1	90,9	87,7	69,3	63,2	63,3
Deposits (EURm)	n/a	20.612	23.570	23.507	24.170	23.856	22.550	21.828	22.156
Deposits (% YoY)	n/a	n/a	14,4	-0,3	2,8	-1,3	-5,5	-3,2	1,5
Deposits (% of GDP)	n/a	55,3	66,5	66,2	66,9	67,5	63,9	62,6	62,8
Loans-to-deposit ratio (%)	n/a	162,7	143,9	146,6	136,0	129,8	108,3	100,9	100,9
Capital adequacy ratio (%)	n/a	11,7	11,6	11,3	11,6	12,1	16,5	17,0	17,0
P&L figures and ratios									
Net interest income (EURm)	n/a	945	932	1.038	1.018	886	711	722	736
Total operating income (EURm)	n/a	1.360	1.425	1.474	1.447	1.566	1.083	1.104	1.132
Net provisions (EURm)	n/a	278	500	810	1.207	1.599	3.696	658	313
Pre-tax profit (EBT, EURm)	n/a	306	161	-101	-537	-776	-3.334	-216	167
Net interest margin (%)	n/a	n/a	1,9	2,0	2,1	1,9	1,6	1,8	1,9
Cost-to-income ratio (%)	n/a	57,1	53,7	51,9	53,7	47,4	66,5	60,0	57,6
ROAE (pre-tax income/avg. equity, %)	n/a	n/a	3,9	-2,4	-13,3	-20,3	-88,5	-5,5	4,1
ROAA (pre-tax income/avg. assets, %)	n/a	n/a	0,3	-0,2	-1,1	-1,6	-7,7	-0,5	0,4
Non-performing loans (%)	n/a	3,2	5,2	7,3	11,5	16,5	13,4	12,0	11,0
Cost of risk (% of avg. loans)	n/a	n/a	1,5	2,4	3,6	5,0	13,3	2,8	1,4

Highlights: Asset transfer to BAMC has strongly reduced loan stock in 2013, while private sector de-leveraging also helped as subdued macro prospects, persistent payment arrears, poor profitability, real net wage deflation and rising unemployment affect risk appetite. Further increase in capital adequacy is expected after the realization of all restructuring measures and capital increases at remaining banks. Wholesale funding dependence has moderated given continuation of debt repayments to foreign banks and the Euro system. On the other side, deposit collection started to show recovery in January 2014 (+2.2% mom), primarily thanks to household and public segments. NIM has deteriorated 3pp to 1.6% in 2013 on the wings of net interest income slump by 19.7% yoy, which was partially offset by falling deposit interest rates. To prevent larger erosion of profitability, banks are cutting operating expenses, primarily that of personnel and admin costs. Nevertheless, Slovenian banking sector will likely be loss making in 2014, the fifth year in row.

Net interest margin (%)



Profitability and efficiency (%)



All sources: Slovenian National Bank, IMF, central banks, Eurostat, HAAB research

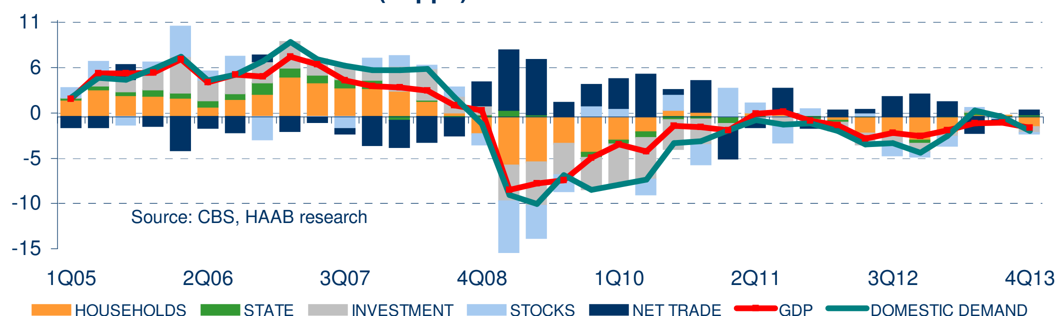
Fiscal Challenges Prevent Recovery

Croatia remains in recession in 2014 largely due to ongoing domestic demand adjustment. The first steps to reshuffle the government budget towards the EC-proposed targets are still largely driven by revenue increases. There is no rapid recovery in investments largely due to public capex cuts. CPI will most likely border with deflation until autumn.

Domestic demand weakness pulls GDP deeper into contraction in late 2013

The 4Q13 GDP fell by 1.2% yoy (for a -1.0% FY13 print), with resumed personal spending contraction the weakest link therein. The latter reflected higher joblessness, real net wage decline, citizens' de-leveraging and a smaller impact of fiscal cash registers aka fiscalization after the Q3 peak of tourist season. Investments also weighed on the GDP headline largely on public capex reduction and further corporate balance sheet restructuring. Net trade contributed positively to the headline figure, however this was mostly due to imports weakness as a function of the general domestic demand slimness. Exports were lower given the EU-required shipyards restructuring and off-shoring a part of SEE-directed food processing after CEFTA exit. January's upside surprises in industrial output, goods trade balance and retail trade do not make a big change for underlying trends. Besides, there are no signs of investment improvement, and with households' expenditure likely in still in contraction we expect the 1Q14 GDP decline at 1.5%-alike pace.

Croatia: contributions to GDP (in pps)



Recession continues in 2014

Another year of an 1%-alike GDP contraction lies ahead as the accelerated, EC-imposed fiscal tightening will combine with private de-leveraging and soaring unemployment. The long overdue fiscal actions with entitlement cuts' knock-on effect on real disposable income, ongoing state firms' restructuring partly through job shedding, and citizens' de-leveraging are headwinds to households demand. Too lengthy pre-bankruptcy process, funding cost spikes amid rating pressures, regulatory uncertainty and the turmoil in emerging markets could only constrain bank lending. Any recovery in investment will certainly not be rapid given the looming EDP-demanded public capex cuts, but once it starts to materialize it will be initially accompanied by higher imports given extremely high intensity of investments for imports. Exports should recover a little with another good tourist season and a gradual EU recovery, but the CEFTA knock-on impact on SEE exports and fragile outlook for the key trading partners make any gains limited. In a bear case, extra EC-imposed austerity, prebankruptcy proceedings (with reported claims 18% of GDP) morphing into a systemic risk, and interest rate spike amid destabilizing domestic policy decisions may trigger further GDP downgrades.

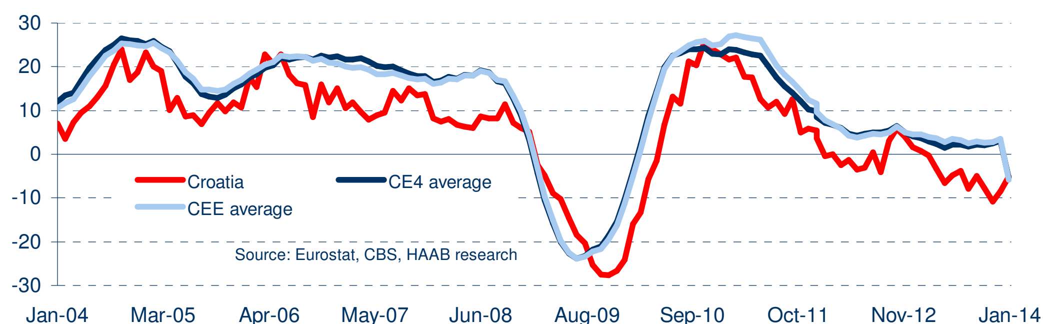
Inflation backdrop stays benign

We see four factors explaining the recent deflation: 1) there is significant slack in the economy as shown by high unemployment and a sizeable output gap; 2) imported inflation is very low due to moderate inflation globally, strong euro, and weak energy prices; 3) price wars between retailers upon the EU entry; 4) fading off administered price hikes. The main drivers of 2014 inflation are the lower VAT rate hikes and the EU-required, energy, water and tobacco excise adjustments. CPI inflation will most likely border with deflation until autumn, followed by a slight recovery to around 2% by year-end as administered price hikes combine with low base effects. On the average, we see CPI inflation slowing in 2014 towards 0.4% after 2.2% in 2013. Risks to our view are mostly on the downside in case of downside surprises to global commodity prices and/or there is a bigger impact of fiscal austerity.

Trade deficit rises slightly, the C/A surplus increases further

Regardless of gradually recovering external demand, we forecast a tepid exports growth ahead due to more production offshoring into CEFTA countries and enrooted competitiveness issues of Croatian producers. Despite persistent domestic demand weakness, we still expect imports to grow slightly as investments stabilize and there is more influence of stronger import EU competition. Goods trade gap is seen slightly higher, but we nonetheless forecast the 2014 C/A surplus at around 1%/GDP given higher tourism intake, lower dividend outflows, higher transfers and less interest payments abroad. The BoP funding mix stays poor due to FDI weakness, external de-leveraging and dependence on portfolio investments. The basic (C/A+FDI) surplus at 4% removes the need for new debt, but the short-term debt roll-over need (30%/GDP) bears watching even if its lower than in the recent years. We don't see FX reserves under pressure as the sovereign may be eyeing a new USD bond after the summer.

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



CNB maintains easing bias, but private sector de-leveraging goes on

In light of the uncertainty over the economic outlook, it is no surprise that the CNB will keep a clear easing bias. The Governor Vujcic said expansive monetary policy will be maintained to ensure the most conducive conditions for credit growth. The contingencies that will force the CNB to act again remain the same an unwarranted funding cost concerns amid bank de-leveraging and a worsening of the mid-term demand outlook in the event of austerity trap. That said, firmer CNB language is an indication the baseline (gradual recovery, ample liquidity for the government's borrowing) is exposed to downside risks. In our view, given still bearish growth/credit backdrop, the CNB will act as soon as they see any deterioration, however, considering the risk backdrop and the looming prolonged period of fiscal uncertainty under the EDP, a more cautious approach is more likely. We see corporate credit to finish 2014 slightly above water, while households will continue to reduce indebtedness at a similar pace. Indeed, subdued macro environment, tedious pre-bankruptcy settlements and collateral-quality issues will continue to pressure credit demand, while banks will stay reluctant to ease lending condition and originate more in spite of CNB’s new corporate credit support scheme.

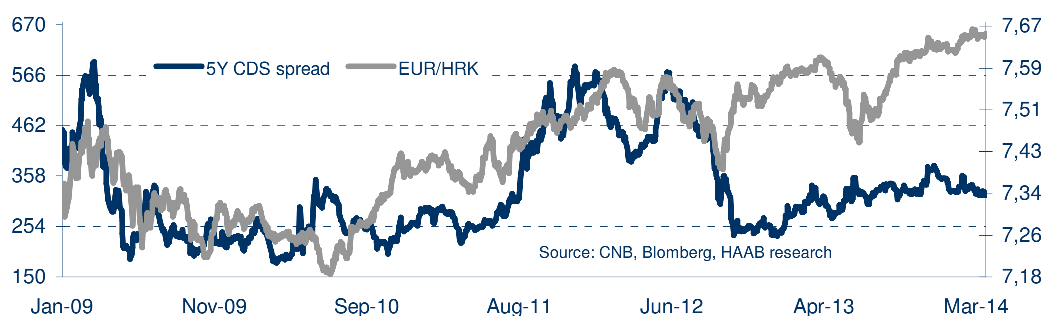
Fiscal risks weaken kuna

The kuna fell victim to the goods trade deterioration, banks' provisioning and external de-leveraging, and fiscal concerns. The kuna weakness was afterwards partly reversed by the above-planned EUR1.15bn 5Y&10Y local bond issuance, and the CNB's readiness to stave off depreciation pressures by selling EUR240m to date. The CNB's determinism to maintain ultra-easy interbank liquidity (HRK8.5bn+ surplus), plus a multi-billion liquidity creation potential via gradual conversions of mid-November USD bonds, has helped short-end kuna rates to remain around their record lows. The rating downgrade, heavy debt amortization schedule in the year to April and unfavourable fiscal and growth differentials in the CESEE context combined by perceived domestic policy weakness have seen Croatian z-spreads underperform peers like Serbia and Slovenia, as investors have shortened duration.

Supportive seasonal patterns aside, the causes of (on average) higher EUR/HRK outlook through 2014 are multi-faceted, from ongoing goods trade weakness, bank provisioning and fiscal slippages. The CNB's easing cycle would first involve hefty, non-sterilized USD bond conversions and then mandatory reserve rate cuts. One important signpost to watch is whether the MinFin converts USD proceeds on the market or directly with the CNB since the latter option would suggest the CNB's tolerance of a weaker exchange rate. The CNB's accommodativeness would be also necessary to prevent persistent disinflation. However, above 7.70-7.75, we expect the CNB to take steps to limit the kuna weakness first by verbal intervention, then intervention, and as a last resort, mandatory reserve hikes, tighter risk provisioning rules or soft capital controls. Until, however, the fiscal story remains a dampener on Croatian assets, 7.60 should be a solid floor in the short term.

Bonds outlook: any spread compression potential in the near term is limited by structural issues

Croatia: 5Y CDS spreads and EUR/HRK



With more monetary easing, weak lending activity, and contained FX development, we see short-end rates near the record lows. Volatility is possible if stronger HRK depreciation pressures force the CNB to take away liquidity. With the latest local bond issues lifting the MinFin's cash reserve to about 6% of GDP, or more than a half of the remaining 2014 gross funding needs, and the coming EUR redemptions fully pre-funded by the last USD bonds, Croatian spreads may find reprieve due to lack of supply at least until Q3, and the outlook for improving current account. As hitherto pull factors for capital flows to EM (EM-DM growth differential, ratings) deteriorate further, and risk appetite (from falling USTs) is behind us, we see renewed pressures on EM assets and Croatia underperforming as the country lags on structural issues and growth outlook. Political risks only compound risk aversion to EM, while a stronger US economy with higher USTs would only support the notion of fading the recent stabilization in EM assets. Most positives for EM are medium term in nature as confirmed by a solid demand for EM debt from crossover investors with buy-hold strategies, which would support Croatian debt if the country makes the use of a credible EDP anchor.

Austerity ambitions weaken

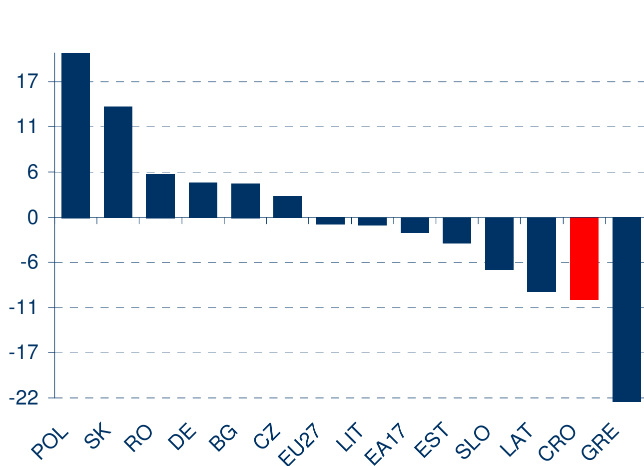
The 2014 budget rebalance that targets 1pp-alike adjustment to the EC-proposed 4.6% of GDP is again largely revenue-driven (up 3.5% yoy). The 2pp hike in health contributions combined by public capex cuts has undermined competitiveness and potential growth. Symbolic cuts in material costs, inefficient subsidies and public wage surcharges are offset by another HRK3.2bn clearance of healthcare arrears. The MinFin has finally opted for a HRK5.85bn transfer of beneficiary pensions from the fully-funded pension scheme into pay-as you-go system in 2014-2015 (~1pp/GDP p.a.), plus HRK650m public firms' profit transfer, HRK300m lottery taxes and HRK200m concession fees. The 2014 GDP forecast downgrade (0.2% from 1.3%) hints at a more sober view on the economy, however even 1.4% downwardly-revised VAT intake doesn't fully capture a poor state of domestic demand. The budget reshuffle clearly lacks a reform bias when it comes to entitlements' rationalization and the IMF-advocated internal devaluation, which gives a sense the adjustment plans are driven by the coming 2015 elections. Given our 1pp lower GDP forecast, soaring interest costs, healthcare spending overruns, and yet-to-be seen state railways restructuring charge, we expect the budget deficit to hit 6% of GDP this year (from 6.5% in 2013).

The cabinet takes a step but needs to run

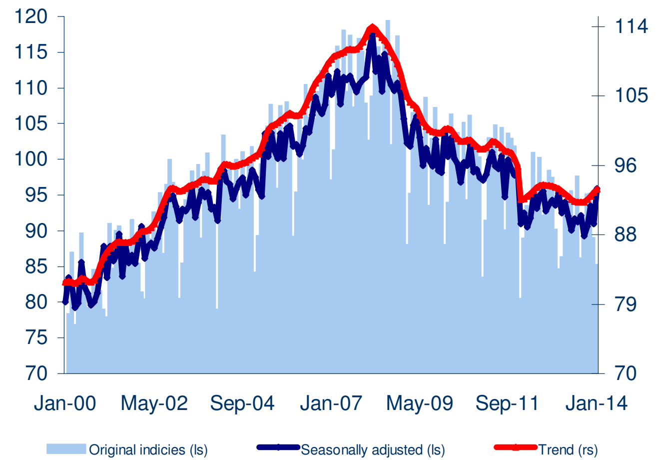
The resulting 1.5pp-alike fiscal overshoot alongside elevated risk premia courtesy of ongoing nonchalance about structural reforms, leaves the public debt (including guarantees and CBRD) on an unsustainable path above 80% of GDP in 2014. The resulting 0.5pp of GDP p.a. interest spending increments mark the fastest pace in the EU terms. Rather than a dramatic change in policy stance, what the MinFin continued is prolongation of adjustment given high fiscal multipliers in a lengthy recession, procyclicality of bank credit and political costs ahead of 2015 polls. While it could take six years at the current pace of fiscal adjustment to meet the EDP criteria, the next big thing is the future of internal devaluation, which may via higher potential growth either help growing out of fiscal troubles or further aggravate fiscal trends. It is neither a surprise that the lack of significant policy action prompted the EC launched the Macro Imbalance Procedure to raise pressure on the cabinet to redouble structural adjustment at the EC-enshrined 0.7pp p.a. pace. Two topics deserve a special attention in terms of policy commitment: one is the ultra-generous entitlements, the other is flexibility of the labour market. That said, one must go more beyond reducing abuse in social transfers, and after modulating working time and pay, labour reforms must also close the distance between well protected open-end contracts and short term contracts. Refocusing on a reduction in the tax wedge on labour and parafiscal fees within a context of de facto fixed FX rate regime should be taken as the main tools for devaluation.

Croatia's data trends

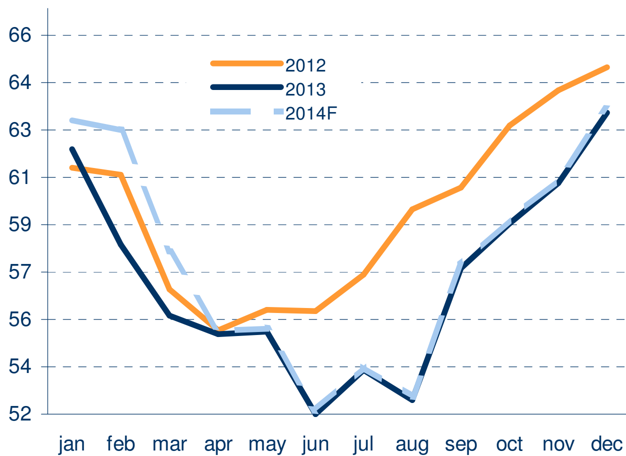
Real GDP growth change (2007-2013)



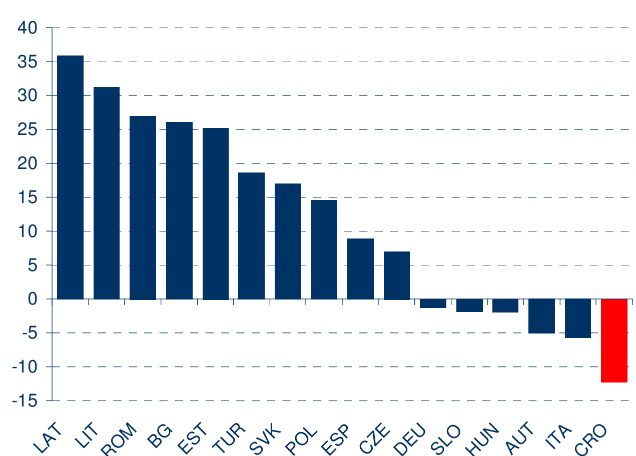
Industrial production, 2010=100



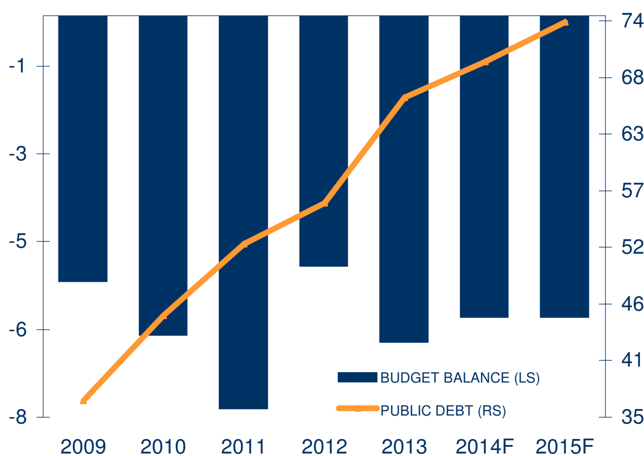
Merchandise import cover (% 3mma)



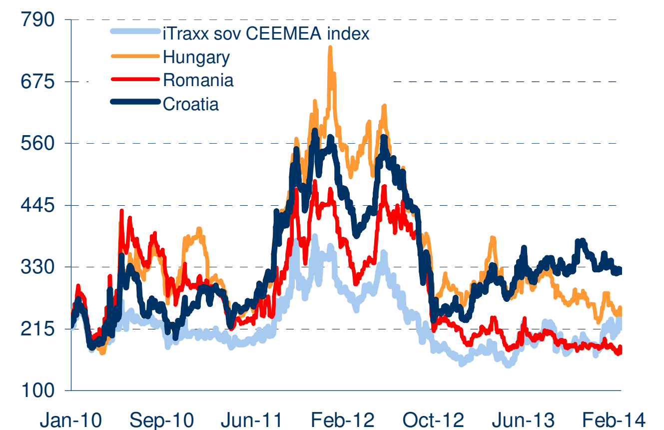
Change in export shares vs EU28, 2013-2008, (%)



Budget balance and public debt (%/GDP)



5Y CDS spreads (bps)



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

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Activity									
Nominal GDP (HRKbn, current prices)	318,3	343,4	328,7	323,8	328,7	328,6	328,3	325,9	335,2
Nominal GDP (EURbn)	43,4	47,5	44,8	44,4	44,2	43,7	43,3	42,7	43,8
Nominal GDP (USDbn)	59,3	69,6	62,2	58,9	61,5	56,2	57,5	57,6	57,8
GDP per capita (EUR)	9.781	10.722	10.111	10.059	10.332	10.243	10.174	10.059	10.322
GDP per capita (USD)	13.372	15.696	14.054	13.326	14.374	13.161	13.504	13.545	13.625
Real GDP (constant prices YoY, %)	5,1	2,1	-6,9	-2,3	-0,2	-1,9	-1,0	-0,7	0,8
Private consumption (YoY, %)	6,3	1,3	-7,6	-1,3	0,3	-3,0	-1,0	-1,2	0,2
Fixed investment (YoY, %)	7,1	8,7	-14,2	-15,0	-3,4	-4,7	-1,0	0,7	3,6
Industrial production (YoY, %)	5,7	1,8	-9,2	-1,4	-1,2	-5,5	-1,4	1,6	1,8
Unemployment rate (ILO, average %)	9,6	8,4	9,1	11,8	13,5	16,0	17,7	18,9	19,1
Prices									
CPI inflation (average % YoY)	2,9	6,1	2,4	1,1	2,3	3,4	2,2	0,4	2,6
CPI inflation (end-year % YoY)	5,7	2,9	2,0	1,8	2,1	4,7	0,3	2,1	1,7
PPI inflation (average % YoY)	3,4	9,7	-0,4	4,3	6,4	7,0	0,5	0,2	3,6
Net wage rates (% YoY, nominal, euros)	5,0	8,6	0,9	1,3	-0,2	-0,4	-0,1	-0,4	0,4
Fiscal balance (% of GDP)									
State budget balance	n/a	n/a	-5,3	-6,4	-7,8	-5,0	-6,5	-6,0	-6,0
Public debt	n/a	n/a	36,6	44,9	51,9	55,8	66,1	69,5	73,4
Gross public funding needs	n/a	n/a	n/a	n/a	n/a	n/a	17,5	19,6	20,2
External balance									
Export of goods and services (EURbn)	18,299	19,884	16,370	17,715	18,766	19,128	18,774	19,106	19,568
Import of goods and services (EURbn)	-21,388	-23,664	-17,927	-17,685	-18,715	-18,712	-18,263	-18,580	-19,261
Merchandise trade balance (EURbn)	-9,829	-11,232	-7,691	-6,232	-6,699	-6,587	-6,822	-6,851	-7,176
Merchandise trade balance (% of GDP)	-22,7	-23,6	-17,2	-14,0	-15,1	-15,1	-15,7	-16,0	-16,4
Tourism receipts (EURbn)	6,753	7,459	6,380	6,230	6,617	6,859	7,160	7,304	7,450
Current account balance (EURbn)	-3,136	-4,256	-2,334	-0,523	-0,392	-0,013	0,258	0,493	0,345
Current account balance (% of GDP)	-7,2	-9,0	-5,2	-1,2	-0,9	0,0	0,6	1,2	0,8
Net FDI (EURbn)	3,5	3,3	1,5	0,4	1,1	1,1	1,0	1,2	1,4
FDI (% of GDP)	8,0	6,9	3,4	1,0	2,4	2,6	2,3	2,7	3,3
FDI cover (%)	110,6	77,0	65,0	82,4	276,0	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	9,307	9,121	10,376	10,660	11,195	11,236	11,744	12,432	12,930
Import cover (months of imports)	5,2	4,6	6,9	7,2	7,2	7,2	7,7	8,0	8,1
Debt indicators									
Gross external debt (EURbn)	34,086	40,956	45,427	46,685	46,059	45,019	45,715	46,002	47,105
Government (EURbn)	6,280	4,817	5,795	6,622	7,190	8,573	10,377	10,577	11,962
Private (EURbn)	27,806	36,139	39,632	40,063	38,869	36,446	35,338	35,425	35,143
Gross external debt (% of GDP)	78,6	86,1	101,4	105,0	104,2	103,0	105,5	107,6	107,6
Gross external debt (% of exports)	186,3	206,0	277,5	263,5	245,4	235,4	243,5	240,8	240,7
Exchange rates and money									
USD/HRK (end-year)	4,99	5,16	5,09	5,57	5,82	5,72	5,55	5,80	5,89
USD/HRK (average)	5,37	4,93	5,28	5,50	5,34	5,85	5,71	5,66	5,80
EUR/HRK (end-year)	7,33	7,32	7,31	7,39	7,52	7,55	7,64	7,65	7,68
EUR/HRK (average)	7,34	7,22	7,34	7,29	7,43	7,52	7,57	7,62	7,66
Money supply M1 (% YoY)	19,3	-4,6	-14,6	4,2	7,5	1,6	10,9	6,0	5,5
Broad money M4 (% YoY)	18,3	4,3	-0,9	4,4	1,6	3,2	2,9	2,2	2,8
Domestic credit (% YoY, euros)	14,5	14,5	2,5	6,1	4,2	-2,8	-0,3	-0,3	1,0
ZIBOR 3M interest rate (average %)	5,70	7,20	8,90	2,40	3,30	3,19	1,26	0,79	1,50
HRK 1Y yield (average %)	4,09	5,96	7,39	4,19	3,72	3,93	2,54	2,05	2,40
HRK 10Y yield (average %)	-	-	-	6,34	6,68	6,67	5,78	6,03	5,90

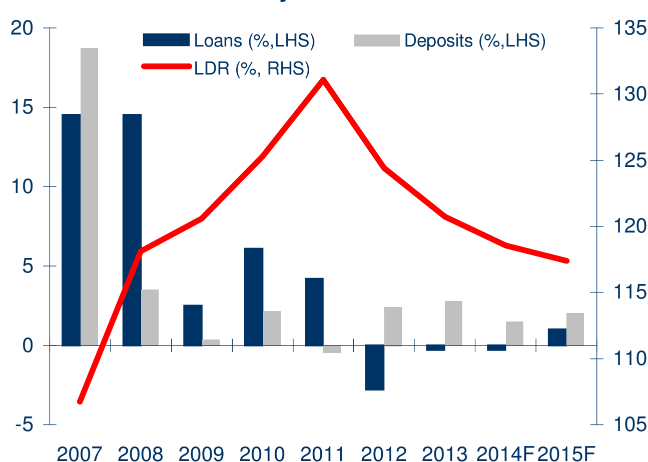
Source: Croatian National Bank, Central Bureau of Statistics, Ministry of Finance, HAAB research

SELECTED BANKING SECTOR DATA

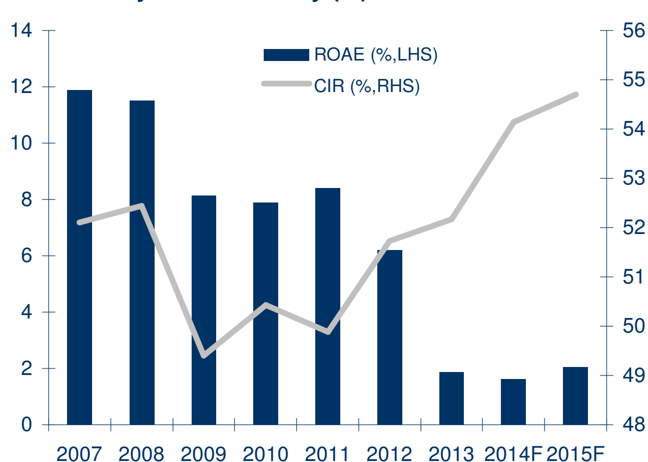
	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Balance sheet figures and ratios									
Assets (EURm)	46.772	50.233	51.650	53.660	55.038	54.021	53.786	52.979	53.509
Loans (EURm)	29.852	34.184	35.040	37.173	38.726	37.646	37.539	37.426	37.801
Loans (% YoY)	14,5	14,5	2,5	6,1	4,2	-2,8	-0,3	-0,3	1,0
Loans (% of GDP)	68,8	71,9	78,2	83,6	87,6	86,1	86,6	87,5	86,4
Deposits (EURm)	27.962	28.945	29.055	29.673	29.546	30.262	31.100	31.566	32.198
Deposits (% YoY)	18,7	3,5	0,4	2,1	-0,4	2,4	2,8	1,5	2,0
Deposits (% of GDP)	64,4	60,9	64,9	66,8	66,8	69,2	71,8	73,8	73,6
Loans-to-deposit ratio (%)	106,8	118,1	120,6	125,3	131,1	124,4	120,7	118,6	117,4
Capital adequacy ratio (%)	16,4	15,2	16,4	18,5	19,2	20,6	20,9	19,7	19,7
P&L figures and ratios									
Net interest income (EURm)	1.168	1.360	1.307	1.485	1.540	1.449	1.360	1.228	1.204
Total operating income (EURm)	1.731	1.962	2.094	2.204	2.249	2.015	1.923	1.749	1.696
Net provisions (EURm)	128	150	473	510	500	501	780	682	615
Pre-tax profit (EBT, EURm)	701	783	586	583	627	471	140	120	154
Net interest margin (%)	2,5	2,8	2,6	2,8	2,8	2,7	2,5	2,3	2,3
Cost-to-income ratio (%)	52,1	52,4	49,4	50,4	49,9	51,7	52,2	54,1	54,7
ROAE (pre-tax income/avg. equity, %)	11,9	11,5	8,1	7,9	8,4	6,2	1,9	1,6	2,1
ROAA (pre-tax income/avg. assets, %)	1,5	1,6	1,2	1,1	1,2	0,9	0,3	0,2	0,3
Non-performing loans (%)	4,8	4,9	7,8	11,2	12,4	13,9	15,6	18,7	19,0
Cost of risk (% of avg. loans)	0,4	0,5	1,4	1,4	1,3	1,3	2,1	1,8	1,6

Highlights: Croatian banking sector's pre-tax profit plummeted 70.3% yoy in 2013 to EUR140m, hurt by deteriorated net interest income (-6.1% yoy) and CNB's tightening risk provisioning requirements. Signs of corporate deleveraging slowdown are emerging: after adjusting for one-off effects in 2013, loans to corporate grew at low-single digit pace sixth month in a row as of January. That said, we see corporate credit to finish 2014 slightly above water, while households will continue to reduce indebtedness at a similar pace. Deposit collection remains stable driven mostly by household's savings growth and fiscalization-related previously unregistered cash inflows. In order to decrease interest expenses further, banks started to shift term to a-vista deposits. We are also mindful that diminishing banks' ROE will see parent banks to re-consider funding resources provided to subsidiaries. Going forward, subdued macro environment, tedious pre-bankruptcy settlements and collateral-quality issues will continue to pressure credit demand, while banks will stay risk averse.

Balance sheet industry trends



Profitability and efficiency (%)



All sources: Croatian National Bank, HAAB research

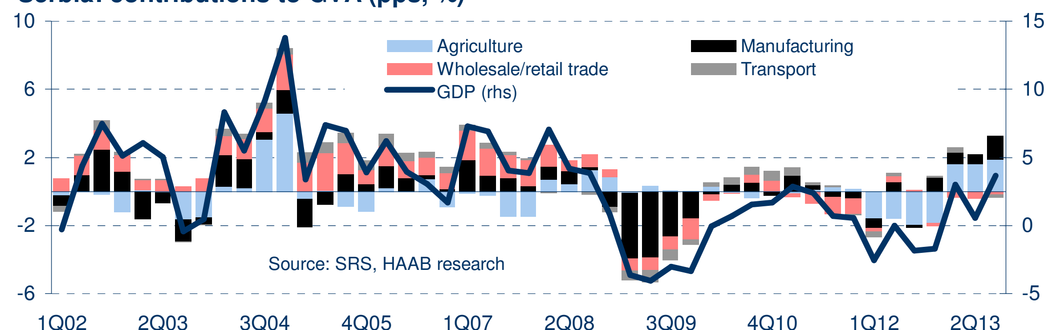
Goodbye Elections, Hello Reforms?

We have downgraded our 2014 GDP forecast on less public capex, whereas private spending remains the weakest link. Budget reforms are the key, with the new government gaining a strong mandate for adjustment. Inflation will remain low in historical terms, and the NBS could ease policy in case fiscal risks are mitigated. The government has a lot more borrowing to do going forth.

Net trade losing traction, private spending shows less negative signs

The 4Q13 GDP (2.6% yoy) shaped a stronger-than-expected 2.4% GDP increase for the FY13. Despite stronger agri-exports after a strong harvest season, the Q4 saw smaller net trade contribution than in Q3 as car&oil exports growth slowed on high base effects. Private spending stabilized, with rising real net wages, lower unemployment and increased retail borrowing offset by consumer rationing on fiscal austerity announcements and lower workers' remittances. While private sector investments rose (albeit from low base) as suggested by stronger capital goods imports, public capex was even weaker as large infrastructure projects in energy/transportation were back-loaded. In 1Q14, we expect GDP growth to slow towards 1% on further moderation in net trade gains, deteriorated confidence courtesy of electoral-related policy uncertainty, and delays to sizeable public investments.

Serbia: contributions to GVA (pps, %)



GDP prospects less favourable due to downgraded public capex outlook; reforms remain the key to improve the mid-term outlook

We have tweaked our 2014 GDP forecast to 1.0% (prev 1.25%), given downgraded public capex outlook (eg South Stream gas pipeline) upon deteriorated (quasi)sovereign ability to secure funding and the EU's market competition regulations. Weak prospects for private investment reflect firms' de-leveraging, expensive funding and policy uncertainty. We haven't changed our exports forecast as demand recovery at the key trade partners remains fragile, but we still expect a positive net trade contribution as downgraded investment outlook will slow imports growth. Personal spending stays the weakest link mostly on fiscal tightening, real net wage deflation and the underlying economic trends still unable to materially reduce unemployment. Although the elections outcome gives the new government a strong mandate for adjustment, it doesn't affect our view on the near-term developments as political leaders still have to walk the walk on painful reforms rather than just talk the talk. This is also why we see only a one-in-two chance that the country regains the IMF back-up this year, with the talks on a new deal set to start in June/July. Before the government strengthens fiscal consolidation resolve and the resulting competitiveness improvements lift investments into tradables, GDP growth will remain sub-potential in the mid-term with downside risks emanating from expensive (re)financing, rating risks and stronger de-leveraging pressures.

C/A gap seen around 5% of GDP against slower exports growth

The FY13 C/A deficit halved to just below 5% of GDP mostly on lower merchandise trade gap (12%/GDP vs 18% in 2012), with import cover rising by 12pp to record-highest 71.4% largely on the back of car&energy exports supported by increased production capacity. The C/A improvement was also driven by higher workers' remittances, offsetting higher foreigners' profit repatriation and interest payments abroad. In 2014, production capacity changes will be far less influential than in the recent years, so we forecast exports growth at slower pace than in 2013 ie more in line with a gradual foreign demand recovery. Imports will continue to underperform exports as a reflection of ongoing weak state of domestic demand outside (quasi)sovereign capex. With also some transfers in the EU pre-accession funds, we forecast the 2014 C/A deficit just around the last year's 5%/GDP.

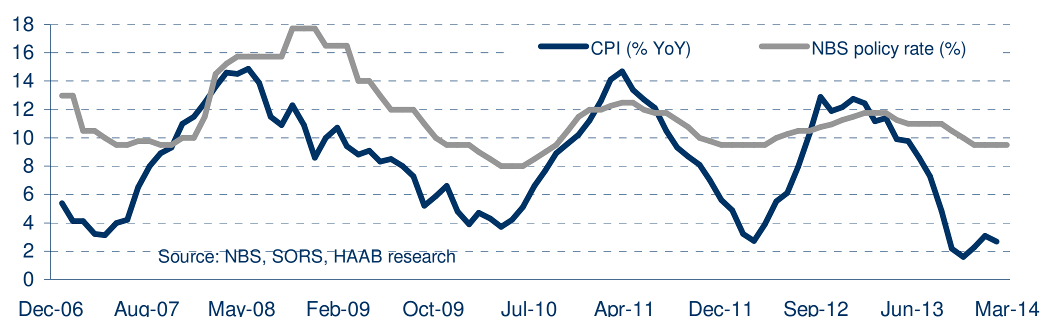
C/A financing mix remains weak, with low FDI and high reliance on fickle portfolio inflows

Policy unpredictability alongside the IMF uncertainty leaves the current account funding mix weak going forth as investors do not know the structure nor the length of the upcoming fiscal tightening, which negatively influences FDI and portfolio inflows. The best evidence of such development is that Serbia failed to attract much more FDI (outside automotive sector) than CESEE peers in the recent years despite competitiveness gains delivered via REER-based dinar depreciation. Furthermore, it is also too early to expect that the EU-related institutional framework improvement could overcome the mentioned policy risks. Also, reform delays keep portfolio inflows volatile as the global markets instability fuels investors' selectiveness against risky assets. Everything mentioned suggests that the NBS FX reserves remain under pressure, however they are still suitable to counter near-term market instability especially since gross external (re)financing needs (17%/GDP) are not so big in CESEE terms.

Inflation expected lower this year

The recent CPI inflation rise back into the NBS 4±1.5% targeted corridor was driven by 2pp hike to reduced VAT rate, excise tax hikes and the dinar depreciation. Defying weak households' expenditure fundamentals, retailers apparently managed to pass over a big portion of tax increases onto end customers as Serbian retail market is highly consolidated. The 2H13 CPI trends have shaped the smallest statistical carry-over in almost ten years, which alongside further unwinding of high base effects, more dinar weakness and stable global commodity prices suggests only a gradual inflation rise towards 5% yoy (on average) in 4Q14 for the FY14 CPI average around 4%. Risks to our view are mostly on the upside in case that additional fiscal tightening is delivered via further indirect tax hikes and/or there is stronger-than-expected dinar depreciation.

Serbia: CPI inflation and NBS policy rate



NBS policy stays highly dependent on capital flows in the economy - fiscal risks mitigation would allow for further rate cuts

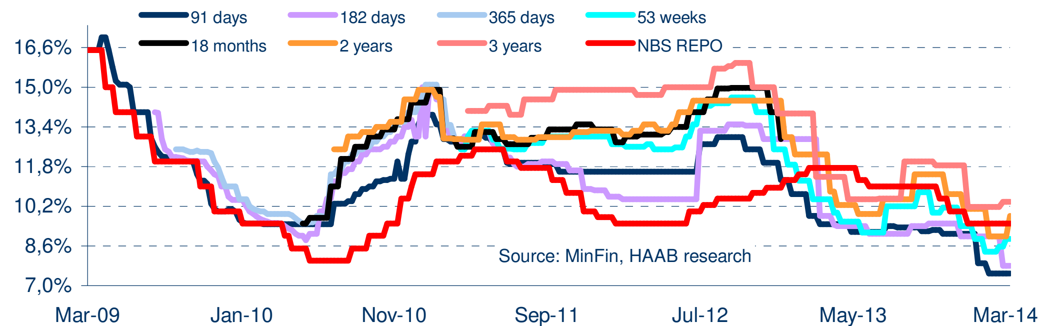
Resurgent dinar downside pressures to date largely owe to risk sentiment deterioration amid heightened global markets volatility, but also increased policy uncertainty around early elections, and back-loaded IMF prospects. Besides the related decline in carry trades, the RSD underperformance vs CEE FX peers also reflected private sector's external de-leveraging and falling net trade gains. The NBS apparently defended the EUR/RSD 116 level, having squeezed RSD65bn out of system in combined action of EUR820m FX reserve sales and RSD30bn liquidity injections via the weekly REPO auctions. Curbing the dinar slide also required leaving the policy rate unchanged at 9.50% despite wide differential against CPI inflation. Meanwhile, the RSD curve bear-steepened as increased fiscal uncertainty prompted investors to reduce duration risk, while private sector de-leveraging left investors with too few alternatives. Bigger yield changes were still prevented by the MinFin's cash reserve (8%/GDP) allowing it to reject the most expensive bids at T-bills/bonds auctions.

A quick government formation alongside slow inflation recovery give room to the NBS to cut policy rate by 75bp in Q2-Q3. However, the NBS policy stays highly dependent on capital flows in the economy, which means that delays to define fiscal contingency measures and the resultant IMF deal uncertainty could see the NBS remaining on hold for some time. Needless to mention that the NBS rate cuts would also strongly depend on the global risk sentiment as renewed risk aversion could force the NBS to act even more cautiously. Bottom line is that many details are linked to the dinar movements as FC sales become increasingly more expensive following three months of heavy interventions. In a bear case, however, extra measures that the NBS might thus consider do not necessarily need to involve rate hikes as we think that lifting the dinar part of FC component of banks' mandatory reserves could also do the trick to curb the dinar downside pressures.

More dinar downside looms ahead

With no more big changes in Serbian economy's supply/demand set-up, and one of CESEE-highest twin-deficits thus still in place, the dinar downside is mostly linked to the economy's structural weaknesses. Aside from falling net trade gains, our assumption rests on less carry trades, the IMF uncertainties and private sector's external de-leveraging. Another important point is non-residents' willingness to keep exposure in RSD assets, with anecdotal evidence that they hold around a half of USD2bn T-bills that mature by end-2014. We think that the dinar slide will be slowed down by the NBS active liquidity management as the NBS targets to contain inflation expectations. In a bull case based on a quick contingency definition and better risk sentiment globally, we would assume sporadic RSD appreciation episodes, however only more economy rebalancing could lead to sustainable dinar stability.

Serbia: T-bills/notes yields



Fiscal risks remain in place

The MinFin's 2M14 budget data show 12% yoy wider gap largely on higher interest payments and pension outlays insufficiently offset by hikes to reduced VAT rate and excise taxes. After elections, there are still no details on the examined consolidation measures, and we maintain a cautious approach as consolidation might still be largely driven by small-sized fixes. Namely, real gains of better fiscal discipline would still require enhanced IT infrastructure. Restructuring of SOEs reduces structural deficit, however this process is already delayed and its real benefits may be visible only in a few years time. Before tax targets are recalibrated to the recent outlook downgrades, and settlements of sizeable public sector arrears loom large, we expect the fiscal gap above 5%/GDP in 2014-2015. That said, structural budget improvements need a comprehensive spending adjustment eg via public wage and pension reforms (eg lifting retirement age, targeting sustainable pension indexation), subsidy rationalization and means-tested entitlement rights reform.

Sovereign funding more dependent on the market borrowing than initial plans

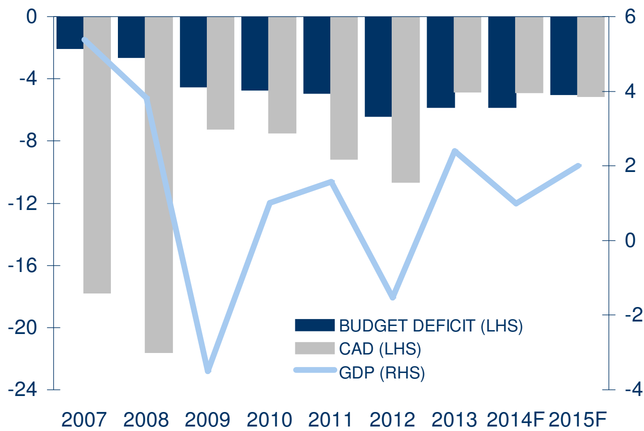
Although the Q1 saw weaker investors' appetite for RSD T-bills/bonds and resultantly much smaller local debt stock increase (RSD24bn) than in Q4 (RSD53bn), the MinFin was not in a rush to borrow money thanks to the existing cash reserve (7%/GDP). However, that the newest USD1bn loan from UAE is a way below USD3bn that the government budgeted for 2014 corroborates our earlier view that the sovereign may be eyeing a new USD1bn-alike bond in the coming months. With renewed supply concerns, investors may want to see more than just talking up consolidation ideas, especially since structural reform delays have seen the public debt more than double in just six years. Without more decisive budget cuts, the sovereign rating stays exposed to downgrade risks, which could make deficit covering even more expensive and the size of the required fiscal tightening even bigger in the coming years. Besides, one should not ignore that the sovereign's failures to secure enough funds from abroad could lead to increased local borrowing, which could then further aggravate GDP prospects as too few funds would remain for the private sector locally.

RSD curve could see more bear-steepening and USD bonds cannot materially outperform as long as fiscal risks remain in place

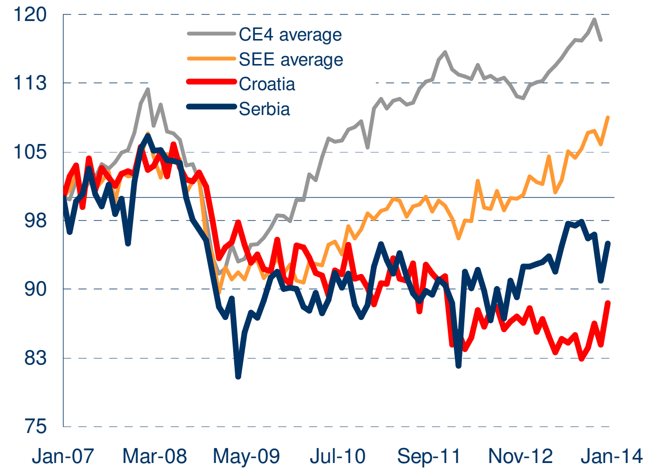
In the near term, we expect more bear-steepening of RSD curve as investors continue to reduce duration risk amid policy uncertainties, and there are much less carry trades that go directly into ≥53W RSD instruments. With sizeable USD2bn T-bills redemptions in the rest of 2014, interest rate volatility could be mitigated by the NBS' active liquidity management and private sector's de-leveraging leaving investors with less alternatives. Meanwhile, that the elections outcome signals a strong mandate for reforms does not only provide some support to Serbian USDs, but has also created some expectations over the coming policy decisions. Namely, a failure to mitigate fiscal risks and the IMF uncertainties would keep rating pressures in place, which alongside renewed bond supply concerns could see Serbian USDs underperform. Even in case the government ramps up consolidation efforts, we would still expect rising core rates to prevent any large spread compression.

Serbia's data trends

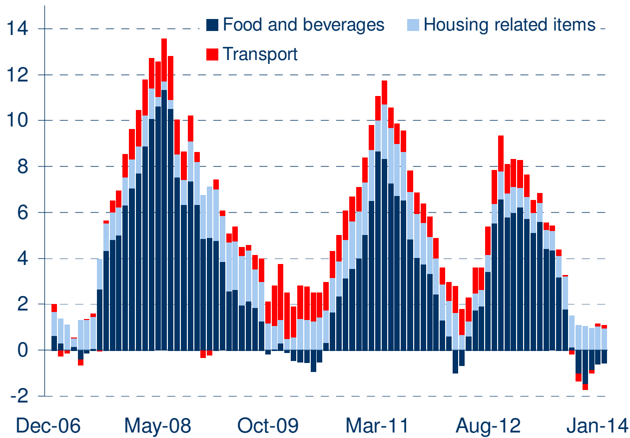
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



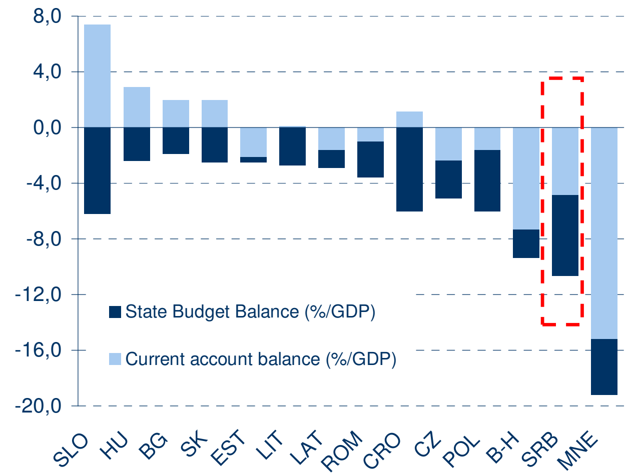
Industrial production Jan-2007=100



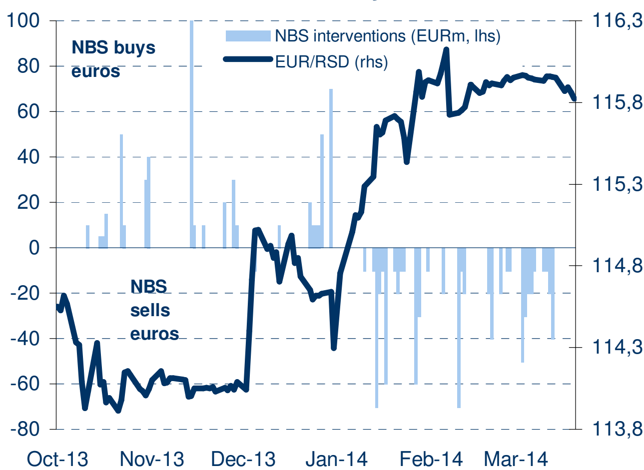
CPI contribution - key categories (pps)



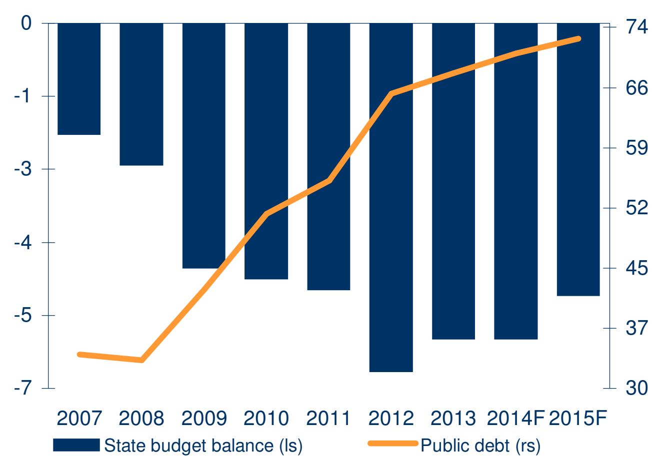
Twin deficits (2014F, % of GDP)



NBS increased EUR sales lately



Public finances (% of GDP)



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

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Activity									
Nominal GDP (RSDbn, current prices)	2.277	2.661	2.720	2.882	3.209	3.386	3.709	3.881	4.162
Nominal GDP (EURbn)	28,5	32,7	29,0	28,0	31,5	29,9	32,8	32,9	34,5
Nominal GDP (USDbn)	39,0	47,7	40,3	37,0	43,8	38,4	43,5	44,3	45,5
GDP per capita (EUR)	3.857	4.446	3.955	3.836	4.336	4.158	4.604	4.618	4.838
GDP per capita (USD)	5.282	6.493	5.507	5.073	6.027	5.338	6.116	6.219	6.386
Real GDP (constant prices YoY, %)	5,4	3,8	-3,5	1,0	1,6	-1,5	2,4	1,0	2,0
Private consumption (YoY, %)	7,8	6,8	-2,7	-1,0	-1,2	-1,9	-1,3	-0,4	0,7
Fixed investment (YoY, %)	29,7	8,5	-22,1	-5,5	8,4	14,4	-3,9	3,0	8,6
Industrial production (YoY, %)	4,1	1,4	-12,6	2,5	2,1	-2,9	5,5	4,1	4,5
Unemployment rate (ILO, average %)	18,1	13,8	16,1	19,2	23,0	24,0	22,1	22,1	21,1
Prices									
CPI inflation (average % YoY)	6,5	11,7	8,4	6,5	11,0	7,8	7,8	3,7	5,0
CPI inflation (end-year % YoY)	11,0	8,6	6,6	10,2	7,0	12,2	2,2	5,3	5,3
PPI inflation (average % YoY)	5,9	12,4	5,6	12,7	14,2	5,6	3,6	3,3	5,8
Net wage rates (% YoY, nominal, euros	33,9	15,8	-16,0	-1,8	12,3	-1,8	6,1	0,8	1,2
Fiscal balance (% of GDP)									
State budget balance	-2,0	-2,6	-4,5	-4,7	-4,9	-6,4	-5,8	-5,8	-5,0
Public debt	34,1	33,4	41,9	51,1	55,0	65,5	68,0	70,4	72,1
Gross public funding needs	n/a	n/a	19,2	13,2	14,0	15,5	18,2	19,3	17,9
External balance									
Export of goods and services (EURbn)	8,687	10,157	8,478	10,070	11,472	11,829	14,378	15,217	16,167
Import of goods and services (EURbn)	-16,016	-18,843	-13,578	-14,838	-16,627	-17,153	-18,023	-19,042	-20,231
Merchandise trade balance (EURbn)	-7,069	-8,501	-5,118	-4,774	-5,318	-5,480	-3,979	-4,327	-4,698
Merchandise trade balance (% of GDP)	-24,8	-26,0	-17,7	-17,1	-16,9	-18,3	-12,1	-13,2	-13,6
Remittances, net (EURbn)	2,134	1,770	2,668	2,422	2,110	1,989	2,217	2,439	2,536
Current account balance (EURbn)	-5,053	-7,054	-2,084	-2,082	-2,870	-3,176	-1,585	-1,603	-1,761
Current account balance (% of GDP)	-17,7	-21,6	-7,2	-7,4	-9,1	-10,6	-4,8	-4,9	-5,1
Net FDI (EURbn)	1,8	1,8	1,4	0,9	1,8	0,2	0,7	0,8	0,9
FDI (% of GDP)	6,4	5,6	4,7	3,1	5,8	0,8	2,1	2,4	2,5
FDI cover (%)	36,0	25,9	65,8	41,3	63,7	7,6	44,2	49,9	48,3
Gross international reserves (EURbn)	9,634	8,162	10,602	10,002	12,058	10,914	11,189	11,546	12,350
Import cover (months of imports)	7,2	5,2	9,4	8,1	8,7	7,6	7,4	7,3	7,3
Debt indicators									
Gross external debt (EURbn)	17,139	21,088	22,487	23,786	24,125	25,721	25,842	26,701	28,116
Government (EURbn)	6,285	6,521	7,764	9,076	10,773	12,187	13,173	14,478	15,773
Private (EURbn)	10,854	14,568	14,724	14,710	13,352	13,534	12,669	12,224	12,344
Gross external debt (% of GDP)	60,2	64,5	77,7	85,0	76,7	85,9	78,8	81,2	81,6
Gross external debt (% of exports)	197,3	207,6	265,3	236,2	210,3	217,4	179,7	175,5	173,9
Exchange rates and money									
USD/RSD (end-year)	53,73	62,90	66,73	79,28	80,87	86,18	83,42	91,36	94,56
USD/RSD (average)	58,39	55,76	67,47	77,91	73,34	88,12	85,16	87,65	91,52
EUR/RSD (end-year)	79,24	88,60	95,89	105,50	104,64	113,72	114,64	120,60	123,40
EUR/RSD (average)	79,96	81,44	93,95	103,04	101,95	113,13	113,14	118,03	120,81
Money supply M1 (% YoY)	24,0	-13,5	-0,8	-10,9	16,9	-3,3	20,6	6,0	3,4
Broad money M3 (% YoY)	42,0	-1,8	12,3	2,6	11,2	0,7	3,9	2,6	4,1
Domestic credit (% YoY, euros)	40,0	20,8	7,4	15,3	8,9	0,9	-5,3	-3,9	2,6
NBS policy rate (average %)	10,38	14,67	13,08	9,13	11,54	10,14	11,00	9,21	9,56
NBS policy rate (end-year %)	10,00	17,75	9,50	11,50	9,75	11,25	9,50	9,75	9,25
6M BELIBOR interest rate (average %)	11,34	15,68	14,52	11,00	13,13	11,96	10,44	9,90	10,25

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

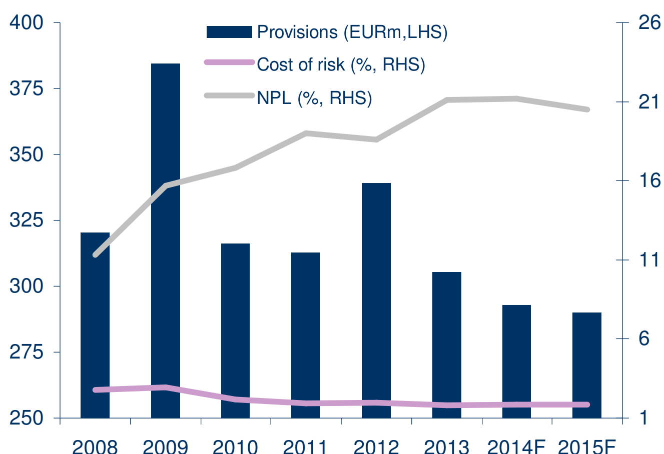
SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Balance sheet figures and ratios									
Assets (EURm)	16.072	20.055	22.530	24.015	25.324	25.093	25.093	24.842	25.687
Loans (EURm)	10.442	12.609	13.544	15.621	17.013	17.162	16.253	15.619	16.025
Loans (% YoY)	40,0	20,8	7,4	15,3	8,9	0,9	-5,3	-3,9	2,6
Loans (% of GDP)	36,7	38,6	46,8	55,9	54,1	57,3	49,6	47,5	46,5
Deposits (EURm)	10.299	10.019	11.440	11.897	13.099	13.310	13.655	13.890	14.334
Deposits (% YoY)	50,3	-2,7	14,2	4,0	10,1	1,6	2,6	1,7	3,2
Deposits (% of GDP)	36,2	30,7	39,5	42,5	41,6	44,5	41,7	42,2	41,6
Loans-to-deposit ratio (%)	101,4	125,9	118,4	131,3	129,9	128,9	119,0	112,4	111,8
Capital adequacy ratio (%)	27,9	21,9	21,4	20,0	19,1	19,9	19,9	20,0	20,0
P&L figures and ratios*									
Net interest income (EURm)	793	1.178	1.070	1.052	1.131	1.025	1.032	1.022	1.032
Total operating income (EURm)	1.986	1.820	1.598	1.541	1.590	1.484	1.402	1.360	1.374
Net provisions (EURm)	n/a	320	384	316	313	339	305	293	290
Pre-tax profit (EBT, EURm)	294	429	213	246	304	231	239	252	276
Net interest margin (%)	4,9	6,5	5,0	4,5	4,6	4,1	4,1	4,1	4,1
Cost-to-income ratio (%)	n/a	58,8	62,6	63,5	61,2	61,5	61,2	60,0	58,8
ROAE (pre-tax income/avg. equity, %)	8,6	9,7	4,5	5,3	6,3	4,6	4,6	4,8	5,2
ROAA (pre-tax income/avg. assets, %)	1,8	2,4	1,0	1,1	1,2	0,9	1,0	1,0	1,1
Non-performing loans (%)	5,1	11,3	15,7	16,8	19,0	18,6	21,1	21,2	20,5
Cost of risk (% of avg. loans)	n/a	2,8	2,9	2,2	1,9	2,0	1,8	1,8	1,8

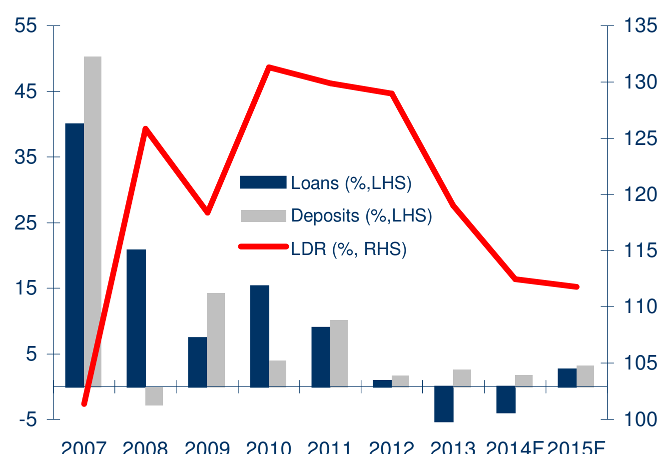
* HAAB forecasts for 2013

Highlights: Private sector de-leveraging in Serbia continues as loan stock fell 5.5% yoy in 2013 led by accelerated de-leveraging in corporate sector (-10.3% yoy) and closure of three banks. Process of consolidation within the banking sector continues, which is depicted in latest Univerzal banka liquidation in January 2014. Deposit collection was weaker than we expected, since banks in November campaign offered lower deposit interest rates, which has not attracted stronger collection like in years before. Despite the highest NPL ratio among SEE banking sector (20.7% at 2013-end according to pre-final entries), CAR at around 20% indicates stability of Serbian banking sector. Going forth, we expect further decrease of credit stock in 2014 due to (i) an absence of new business in corporate sector and suspension of subsidized lending, (ii) continuation of banking consolidation and (iii) households staying risk-averse. Thanks to liquidation of problematic banks and strong opex optimization, we see improvements in profitability of banking sector, especially in terms of CIR and ROAE.

Provisions, cost of risk & NPL



Balance sheet industry trends



All sources: National Bank of Serbia, HAAB research

Tepid Recovery Continues

We have tweaked our 2014 GDP forecast on assumption of slower public capex increase. Households' expenditure is expected to claw back into the positive territory on stabilizing real disposable income. Securing IFI back-up remains the key priority. The current account will improve slightly further, whereas inflation stays just above zero.

Economic activity growth slowed down recently

High frequency data indicated slowdown in 2H13 activity. Namely, industrial production growth moderated to 6.4% yoy in 2H13 (vs 6.9% in 1H13) as stronger intermediate goods output was offset by slowing production of consumer non-durables. The latter were also the key item that pulled exports growth rate lower to 5% yoy in 2H13 (vs 9% yoy in 1H13). Imports stabilized on stronger imports of energy and capital goods that signalled domestic investment demand increase. On balance, import cover was still higher at yoy level (+60bp at 52% in 4Q13), but the pace of improvement slowed from the 1H13's 530bp yoy increase. Finally, the increase in net household deposits (9.3% yoy at end-2013) suggests that citizens continue to amend their spending habits to weak income prospects in the medium term.

Our 2014 GDP growth forecast is slightly downgraded on the assumption of smaller public capex increase

We have cut our 2014 GDP forecast to 0.9% (prev 1.3%) on reduced public capex assumption as too few projects are shovel-ready and there are also delays to South Stream gas pipeline construction. Besides, we cannot expect private investment recovery given costly funding, policy risks and too few reforms to boost the economy's growth potential. Although less investments will see slower imports growth than assumed before, we still expect a non-existent net trade contribution to GDP headline as exports growth maintain the last year's pace mostly fuelled by more capacity reallocations of CEFTA-oriented production out of Croatia. Private consumption will inch back into positive territory on stabilizing real disposable income. October's general elections are the key risk event as political wrangling could freeze IFI money and sentiment deterioration would lead to more corporate de-leveraging.

Fiscal consolidation slows down

The electionary budget deficit target (1.8%/GDP) remains, in our view, overreliant on revenue increases that are strongly linked to pretty optimistic macro assumption as well as improved tax discipline. The overall 3% budget spending increase is mostly channelled into increased social payments (eg pension hike), but also 5% public wages hike in RS, which offsets the last year's 10% cut. Not only that we see potential underperformance in tax intake as GDP undershoot looms, but also we can see fiscal slippage emanating from pre-electionary overspending. Finally, the IMF demanded that TRANSCO dividend payout (0.4pp/GDP) is used to cover pre-2014 public sector payment arrears, which only partly mitigates risks of fiscal slippages as these funds cannot be used for election-related expenditure.

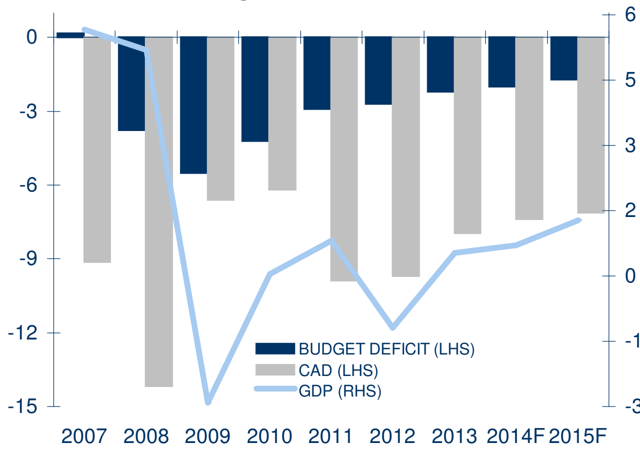
This year's gross public (re)financing needs at around 5.5%/GDP are rather small in CESEE terms as are also public interest payments (~0.9%/GDP), however avoiding bigger (re)financing issues has still required the IMF's EUR150m expansion to the existing Stand-By deal which is now extended until June-2015. On top of the current EUR200m cash reserve, the government is likely to receive about EUR130m from IFIs this year (net of IMF repayments) if we assume no major delays to the IMF lending, which largely covers the 2014 budget deficit. That said, as long as IFI funds are not frozen, we do not see big challenges to T-bills roll-overs, with RS and FB-H facing EUR48m/EUR41m T-bills maturities (respectively). Besides, credit activity remains lacklustre, so banks do not have many alternatives. However, any stronger spread compression is not likely against increased EM woes coupled with rising core rates, the E(M)U de-leveraging pressures and B-H's fiscal risks.

CAD falls further in 2014; inflation expected to recover only gradually

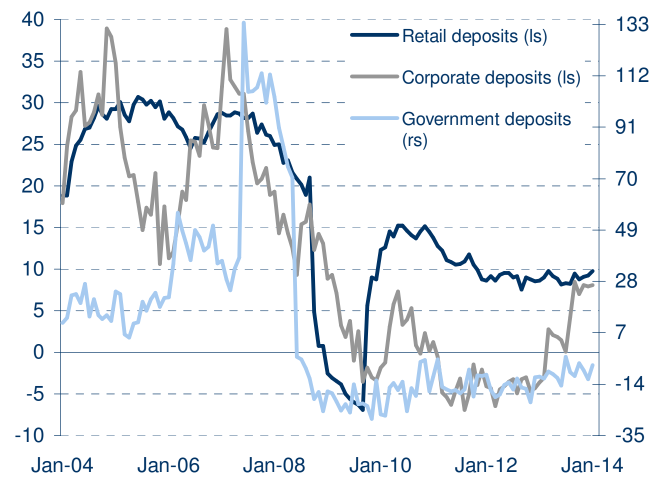
In 2014, the combination of stagnant goods trade gap (30% of GDP) and higher remittances will see the CAD falling to just above 7% of GDP. The absence of broader structural reforms and costlier funding will keep FDI cover at about 30% of CAD, which re-accentuates the need to keep IFI back-up in place. Meanwhile, decline in global commodity prices, domestic demand weakness and high base effects have shaped the FY13 CPI inflation average at -0.1%. We expect CPI to rise towards 3.0% yoy be year-end amid further unwinding of high base effects, excise tax hikes on tobacco and a gradual domestic demand stabilization. This alongside stable global commodity prices will shape the 2014 CPI average at around 0%.

Bosnia and Herzegovina's data trends

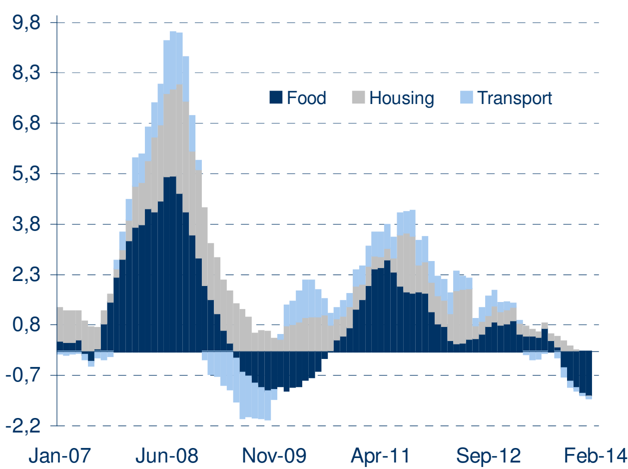
Budget and current account gaps (% of GDP) vs. real GDP growth



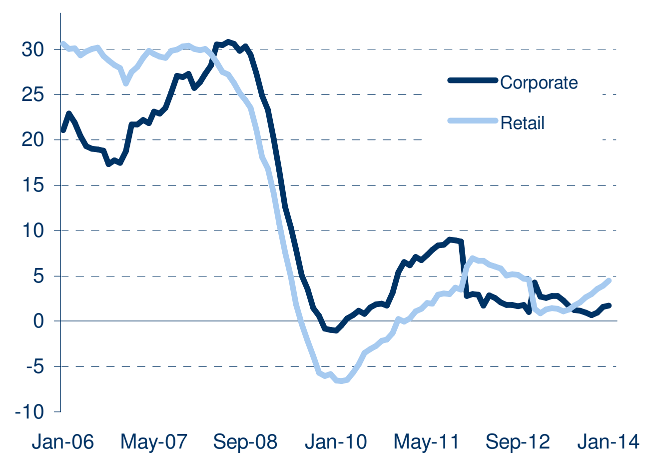
Deposits growth (%, YoY)



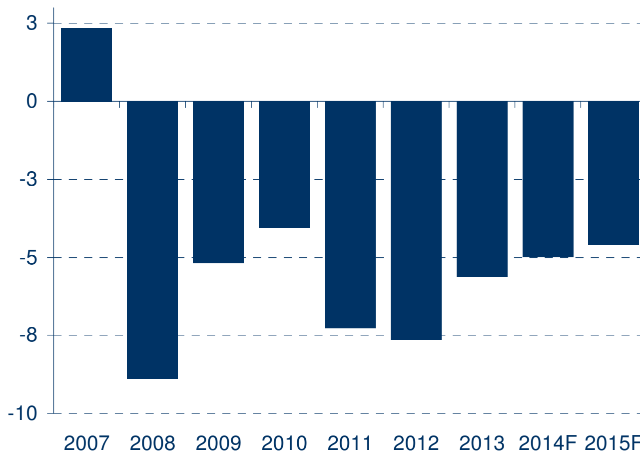
Key CPI contributions (pp)



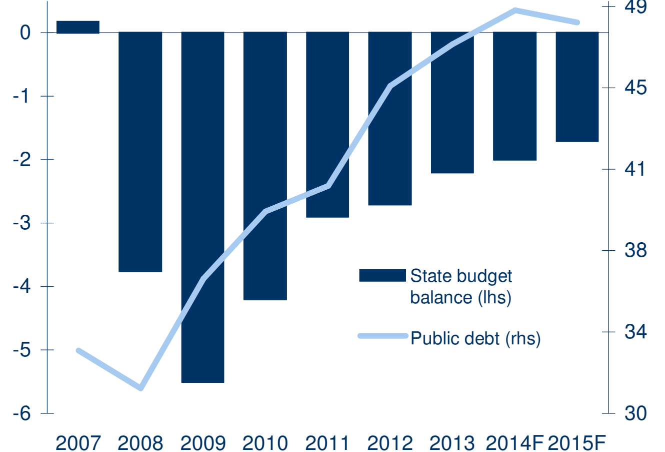
Private credit dynamics (%, YoY)



Basic balance (C/A+net FDI as % of GDP)



Public finances (% of GDP)



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

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Activity									
Nominal GDP (BAMbn, current prices)	21,8	24,8	24,1	24,8	25,7	25,7	25,8	26,1	27,3
Nominal GDP (EURbn)	11,2	12,7	12,3	12,7	13,1	13,1	13,2	13,3	14,0
Nominal GDP (USDbn)	15,3	18,6	17,2	16,8	18,3	16,9	17,5	17,9	18,4
GDP per capita (EUR)	2.906	3.295	3.200	3.296	3.417	3.414	3.435	3.467	3.636
GDP per capita (USD)	3.976	4.821	4.449	4.365	4.753	4.390	4.563	4.669	4.799
Real GDP (constant prices YoY, %)	6,1	5,6	-2,9	0,2	1,0	-1,1	0,7	0,9	1,5
Private consumption (YoY, %)	n/a	n/a	-2,4	-0,8	2,9	-2,6	-2,0	1,0	2,0
Fixed investment (YoY, %)	n/a	n/a	-21,4	-15,9	-8,5	-0,6	4,7	1,9	5,5
Industrial production (YoY, %)	8,6	7,9	-3,3	1,6	5,6	-5,2	6,7	3,9	4,0
Unemployment rate (ILO, average, %)	29,0	23,4	24,1	27,2	27,6	28,0	27,5	27,2	26,8
Prices									
CPI inflation (average % YoY)	1,5	7,5	-0,4	2,1	3,7	2,1	-0,1	0,1	3,3
CPI inflation (end-year % YoY)	5,0	3,8	0,0	3,1	3,1	1,8	-1,2	3,0	2,3
PPI inflation (average % YoY)	n/a	8,6	-3,2	0,9	3,7	1,5	-2,2	0,6	2,0
Net wage rates (% YoY, nominal)	10,1	16,6	5,2	1,3	2,0	1,2	0,1	1,3	1,5
Fiscal balance (% of GDP)									
State budget balance	0,2	-3,8	-5,5	-4,2	-2,9	-2,7	-2,2	-2,0	-1,7
Public debt	32,9	31,2	36,2	39,3	40,5	45,1	47,0	48,6	48,0
External balance									
Export of goods and services (EURbn)	2,980	3,353	3,071	3,700	4,111	4,061	4,301	4,559	4,923
Import of goods and services (EURbn)	-6,363	-7,586	-6,080	-6,498	-7,307	-7,293	-7,322	-7,541	-7,956
Merchandise trade balance (EURbn)	-4,568	-5,453	-3,981	-3,901	-4,267	-4,318	-4,021	-3,983	-4,033
Merchandise trade balance (% of GDP)	-40,9	-43,1	-32,4	-30,8	-32,5	-32,9	-30,5	-29,9	-28,9
Remittances (EURbn)	1,417	1,289	1,028	1,015	1,027	1,070	1,076	1,105	1,143
Current account balance (EURbn)	-1,019	-1,795	-0,813	-0,782	-1,295	-1,273	-1,050	-0,982	-0,994
Current account balance (% of GDP)	-9,1	-14,2	-6,6	-6,2	-9,9	-9,7	-8,0	-7,4	-7,1
Net FDI (EURbn)	1,3	0,7	0,2	0,3	0,3	0,3	0,3	0,3	0,4
FDI (% of GDP)	11,5	5,3	1,4	2,1	2,6	2,1	2,3	2,4	2,5
FDI cover (%)	125,8	37,5	21,7	34,8	26,4	21,5	29,5	32,6	35,7
Gross international reserves (EURbn)	3,425	3,219	3,176	3,302	3,285	3,327	3,104	2,995	2,958
Import cover (months of imports)	6,5	5,1	6,3	6,1	5,4	5,5	5,1	4,8	4,5
Debt indicators									
Gross external debt (EURbn)	5,806	5,823	6,763	6,536	6,447	6,873	7,039	7,242	7,494
Government (EURbn)	2,025	2,168	4,083	3,217	3,401	3,660	3,906	4,177	4,295
Private (EURbn)	3,780	3,655	2,681	3,319	3,046	3,214	3,134	3,066	3,199
Gross external debt (% of GDP)	52,0	46,0	55,0	51,6	49,1	52,4	53,3	54,4	53,6
Gross external debt (% of exports)	194,8	173,7	220,2	176,6	156,8	169,3	163,7	158,9	152,2
Exchange rates and money									
USD/BAM (end-year)	1,34	1,40	1,37	1,46	1,51	1,48	1,42	1,48	1,50
USD/BAM (average)	1,43	1,33	1,40	1,47	1,40	1,52	1,47	1,45	1,48
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)	20,9	-0,7	-2,6	6,4	4,8	-0,7	9,0	2,8	3,0
Broad money M2 (% YoY)	20,7	4,1	2,2	7,2	5,8	3,4	7,9	4,4	3,8
Domestic credit (% YoY)	28,8	22,4	-3,2	3,5	5,3	4,1	2,9	1,6	3,3
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,22	0,30	0,38

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

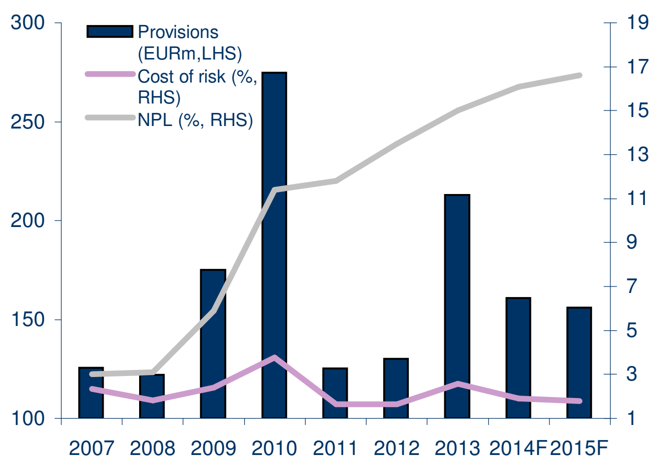
SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Balance sheet figures and ratios									
Assets (EURm)	10.023	10.798	10.742	10.828	11.196	11.414	11.994	12.672	13.089
Loans (EURm)	6.060	7.419	7.184	7.436	7.828	8.151	8.391	8.528	8.809
Loans (% YoY)	28,8	22,4	-3,2	3,5	5,3	4,1	2,9	1,6	3,3
Loans (% of GDP)	54,3	58,6	58,4	58,7	59,6	62,1	63,6	64,0	63,1
Deposits (EURm)	6.180	6.072	6.183	6.407	6.643	6.814	7.286	7.543	7.792
Deposits (% YoY)	37,9	-1,8	1,8	3,6	3,7	2,6	6,9	3,5	3,3
Deposits (% of GDP)	55,4	48,0	50,3	50,6	50,6	51,9	55,2	56,6	55,8
Loans-to-deposit ratio (%)	98,0	122,2	116,2	116,1	117,8	119,6	115,2	113,1	113,1
Capital adequacy ratio (%)	17,1	16,3	16,1	16,2	17,1	17,0	17,0	17,5	17,4
P&L figures and ratios*									
Net interest income (EURm)	334	358	362	366	396	389	385	388	394
Total operating income (EURm)	555	585	581	609	621	611	615	620	627
Net provisions (EURm)	126	122	175	275	125	130	213	161	156
Pre-tax profit (EBT, EURm)	84	56	15	-55	84	78	-14	50	68
Net interest margin (%)	3,8	3,4	3,4	3,4	3,6	3,4	3,3	3,1	3,1
Cost-to-income ratio (%)	62,1	69,5	67,3	63,9	66,2	65,9	67,6	66,0	64,3
ROAE (pre-tax income/avg. equity, %)	8,9	4,3	0,8	-5,5	5,8	5,0	6,0	2,9	3,7
ROAA (pre-tax income/avg. assets, %)	1,0	0,5	0,1	-0,5	0,8	0,7	-0,1	0,4	0,5
Non-performing loans (%)	3,0	3,1	5,9	11,4	11,8	13,5	15,0	16,1	16,6
Cost of risk (% of avg. loans)	2,3	1,8	2,4	3,8	1,6	1,6	2,6	1,9	1,8

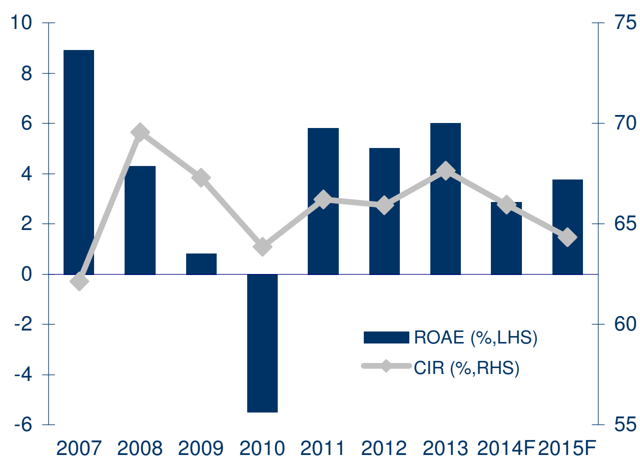
* HAAB forecasts for 2013 (except pre-tax profit)

Highlights: After two years above the water, B-H banks posted pre-tax loss at EUR13.6m in FY13 thanks to higher provisioning and balance sheet restructuring. That said, sharp deterioration in loan book quality (NPLs up 1.5pp yoy to 15.0% in FY13) also added to deceleration of credit growth to the slowest pace (2.9% yoy) since 2009. On the other hand, deposit collection impressed (6.9% yoy) mostly thanks to strong contribution from households as workers' remittances continued to pour in and weak income prospects curbed citizens' propensity to spend. Deposit abundance skewed banks' funding profile towards domestic sources, that is, brought LTD down by 4.5pp to 115.2% in 2013. Going forth, credit supply will stay curbed by further asset quality deterioration and tightening of credit standards, whereas IFI-supported credit program could induce some origination. Limited credit demand will find support in higher GDP growth, public capex and stronger personal spending.

Provisions, cost of risk & NPL



Profitability and efficiency (%)



All sources: CBBH, Banking agency RS&FBiH, HAAB research

Economic Growth Gains Momentum

Personal spending is expected to recover gradually amid better disposable income dynamics. Investments are another strong link ahead, however these are also exposed to big downside risks. Budget revenue performance continues to strongly influence fiscal developments. The C/A gap stays in mid-teens on higher goods trade gap.

GDP surprised on the upside in 2013

Stronger 2013 GDP outcome than assumed before is largely suggested by higher foreign tourist receipts and industrial production remaining in low double-digit yoy growth. The latter mostly reflected output capacity increases in pharmaceuticals and non-metalic minerals, which has offset the impact of loss-making aluminum producer KAP capacity shrinkage. Furthermore, GDP growth was also fuelled by goods trade trends improvement as imports fell due to cheaper food and sizeable capex projects back-loading into 2014. Although a good tourist season pushed unemployment rate lower on yoy basis, this was not really translated into better households' expenditure figures as real net wage decline and consumer pessimism still weighed.

We expect domestic demand to lead stronger GDP growth momentum in 2014

In 2014, we expect GDP growth to gain further momentum on recovering personal spending. Besides positive spillover from another prospective tourist season, households' fundamentals will be also improved by real net wage growth and slightly lower unemployment. Investments in several big-ticket projects in tourism, energy and transport infrastructure also form stronger GDP profile, but these are simultaneously the key downside risks if further delays arise. Since stronger domestic demand will lift goods imports, we expect net trade to create a negative contribution on GDP headline even as exports would still rise on tourism receipts. Downside risks to our view are not only linked to big-ticket capex, but also tourist season given anecdotal evidence of lower participation of Russian/Ukrainian tourists as highly important source markets.

Government budget performance in strongly dependent on revenues; more guarantee calls loom ahead

The government budget stays highly reliant on revenue performance, with improving fiscal discipline, the EU-required excise tax hikes, ongoing implementation of crisis taxes in 2014 and frozen pensions as the key pillars of the medium-term budget strategy. The government is also looking at a sort of Croatia-like out-of-court settlements for financial restructuring of overly indebted firms, however we'd take these as viable only when we see the first results given different experiences in the neighbouring countries. The primary sources of fiscal slippage risk are the government's too optimistic macro assumptions alongside no material structural reforms. Guarantees for ailing aluminum producer KAP are now fully covered by the government, however the cabinet has also tagged public guarantees elsewhere to the amount of 2%/GDP as risky ones. All said, we forecast the public debt on the rise above 60%/GDP in 2014, which alongside the doubling of interest expenses (2%/GDP) also raises eyebrows before S&P/Moody's rating reviews in May/June (respectively).

Only a tepid recovery of CPI inflation is seen in the next months

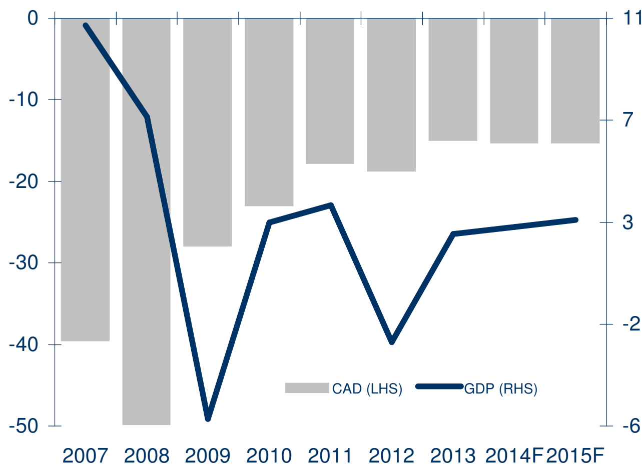
The recent CPI inflation downside surprise largely owed to cheaper food and lower fuels prices. Path-wise, we now see CPI inflation around 0% (on average) in 1H14 and the following-up recovery towards 1.5% (on average) in 4Q14, which would shape the 2014 CPI average of 0.3%. Besides lower base effects, a gradual rise in CPI inflation will be driven by the planned excise tax hike on tobacco in order to comply with the EU requirements, with the general domestic demand stabilization also supporting inflation recovery. However, the expected slight decline of global commodities will prevent stronger CPI rise. Risks to our view are mostly on the downside if domestic demand stabilization is further adjourned.

C/A gap is forecast to rise slightly on higher goods trade deficit driven by stronger capex

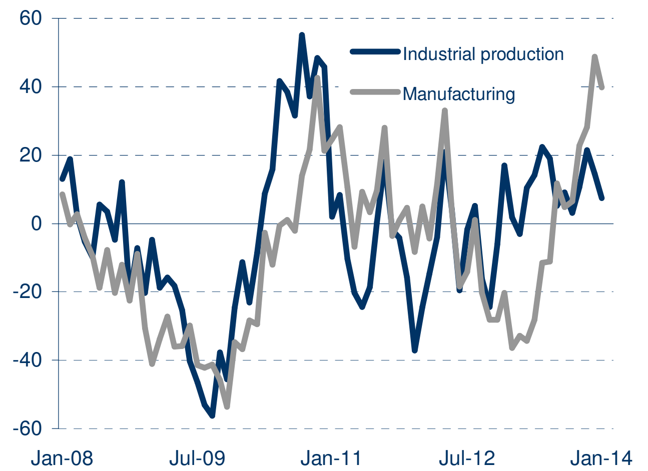
For 2014, we see the C/A gap at around 15% of GDP given higher goods trade gap as sizeable investment projects will increase imports. Higher tourism intake is the key factor preventing an even stronger CAD increase. As for the C/A financing, we expect an ongoing strong coverage by FDI at around 70%, but gross external (re)financing needs remain high at 30%/GDP, which is even more important against the backdrop of rising core rates and higher risk premia for structurally weaker economies amid less accommodativeness by the key central banks. We think that risks that the sovereign would need IFI help have reduced, however in a bear case in which capital flows are clogged again could revive the story of asking for the IMF aid.

Montenegrin data trends

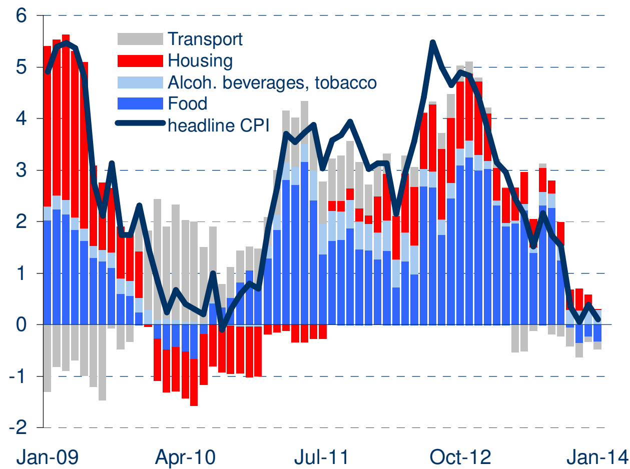
C/A gap (%/GDP) vs. real GDP growth (%)



Industrial production (%, yoy)

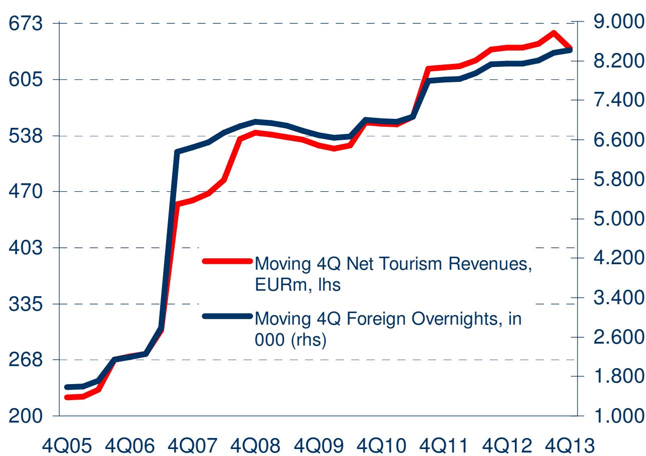


CPI by key contributions (pps)

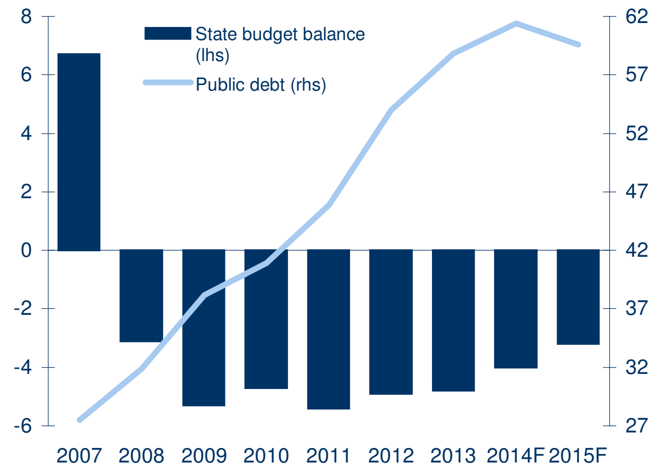


Merchandise import cover (%, 3mma)

Tourism



Public finances (% of GDP)



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

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Activity									
Nominal GDP (EURbn, current prices)	2,7	3,1	3,0	3,1	3,2	3,1	3,3	3,4	3,5
Nominal GDP (USDbn)	3,7	4,5	4,2	4,1	4,5	4,0	4,3	4,5	4,7
GDP per capita (EUR)	4.282	4.907	4.720	5.011	5.211	5.063	5.223	5.357	5.641
GDP per capita (USD)	5.870	7.219	6.584	6.648	7.257	6.469	6.939	7.214	7.446
Real GDP (constant prices YoY, %)	10,7	6,9	-5,7	2,5	3,2	-2,5	2,0	2,3	2,6
Private consumption (YoY, %)	n/a	n/a	n/a	2,0	4,2	-3,2	-1,5	1,8	2,8
Fixed investment (YoY, %)	n/a	n/a	n/a	-18,5	-10,3	-3,3	1,4	5,7	6,0
Industrial production (YoY, %)	0,1	-2,0	-32,2	17,5	-10,3	-7,1	10,6	4,1	4,4
Unemployment rate (ILO, average %)	19,4	16,8	19,1	19,7	19,7	19,7	19,9	19,7	19,4
Prices									
CPI inflation (average % YoY)	4,3	8,6	3,4	0,5	3,3	4,0	1,8	0,3	2,6
CPI inflation (end-year % YoY)	7,7	7,2	1,5	0,7	3,0	4,4	0,4	1,8	2,5
PPI inflation (average % YoY)	8,5	14,0	-3,9	-0,9	3,2	5,7	1,6	0,4	2,6
Net wage rates (% YoY, nominal)	19,9	23,1	11,3	3,5	1,0	0,6	-1,6	1,0	2,6
Fiscal balance (% of GDP)									
State budget balance (ESA-95)	6,7	-3,1	-5,3	-4,7	-5,4	-4,9	-4,8	-4,0	-3,2
Public debt	27,5	31,9	38,2	40,9	45,9	54,0	58,8	61,4	59,6
Gross public funding needs	n/a	n/a	n/a	n/a	n/a	n/a	6,1	8,9	14,2
External balance									
Export of goods and services (EURbn)	1,156	1,226	1,028	1,158	1,383	1,389	1,461	1,513	1,568
Import of goods and services (EURbn)	-2,306	-2,881	-1,949	-1,961	-2,100	-2,166	-2,144	-2,223	-2,310
Merchandise trade balance (EURbn)	-1,544	-2,025	-1,322	-1,267	-1,306	-1,389	-1,330	-1,388	-1,448
Merchandise trade balance (% of GDP)	-57,6	-65,6	-44,3	-40,8	-40,4	-44,1	-40,7	-41,4	-41,0
Tourism receipts (EURbn)	0,460	0,541	0,526	0,552	0,619	0,643	0,666	0,696	0,730
Current account balance (EURbn)	-1,059	-1,535	-0,830	-0,710	-0,573	-0,588	-0,487	-0,510	-0,536
Current account balance (% of GDP)	-39,5	-49,8	-27,9	-22,9	-17,7	-18,7	-14,9	-15,2	-15,2
Net FDI (EURbn)	0,6	0,6	1,1	0,6	0,4	0,5	0,3	0,4	0,3
FDI (% of GDP)	21,2	18,9	35,8	17,8	12,0	14,7	9,9	11,0	8,2
FDI cover (%)	53,6	37,9	128,5	77,7	67,9	78,5	66,5	72,6	54,1
Gross international reserves (EURbn)	0,468	0,313	0,397	0,416	0,303	0,348	0,317	0,239	0,180
Import cover (months of imports)	2,4	1,3	2,4	2,5	1,7	1,9	1,8	1,3	0,9
Debt indicators									
Gross external debt (EURbn)	1,986	2,802	2,787	2,992	3,279	3,414	3,545	3,608	3,794
Government (EURbn)	0,461	0,481	0,701	0,912	1,064	1,156	1,313	1,421	1,522
Private (EURbn)	1,525	2,321	2,087	2,080	2,215	2,257	2,232	2,187	2,272
Gross external debt (% of GDP)	74,1	90,8	93,5	96,4	101,4	108,4	108,4	107,6	107,5
Gross external debt (% of exports)	171,8	228,4	271,2	258,5	237,2	245,7	242,7	238,5	241,9
Exchange rates and money									
EUR/USD (end-year)	1,46	1,40	1,43	1,34	1,30	1,32	1,37	1,32	1,31
EUR/USD (average)	1,37	1,47	1,39	1,33	1,39	1,29	1,33	1,35	1,32
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)	n/a	n/a	n/a	-4,8	-6,3	-0,7	3,0	4,8	5,0
ECB reference rate (end-year %)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,25	0,25
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,22	0,30	0,38

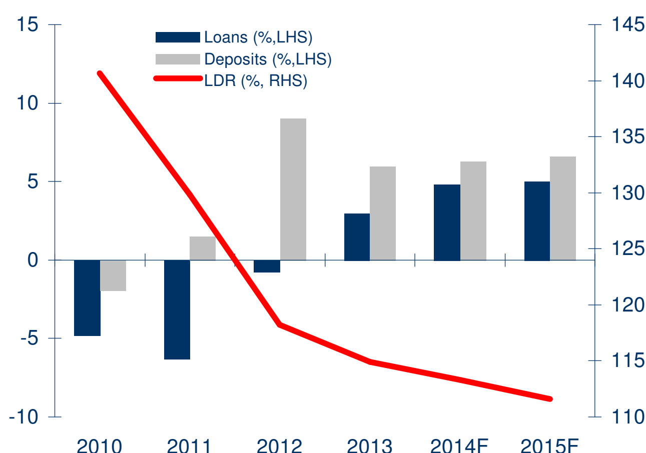
Source: Montenegrin National Bank, MONSTAT, Ministry of Finance, IMF, HAAB research

SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Balance sheet figures and ratios									
Assets (EURm)	n/a	n/a	3.025	2.944	2.810	2.808	2.959	3.074	3.213
Loans (EURm)	n/a	n/a	2.644	2.518	2.359	2.342	2.412	2.528	2.654
Loans (% YoY)	n/a	n/a	n/a	-4,8	-6,3	-0,7	3,0	4,8	5,0
Loans (% of GDP)	n/a	n/a	88,7	81,1	72,9	74,4	73,8	75,4	75,2
Deposits (EURm)	n/a	n/a	1.825	1.790	1.817	1.981	2.099	2.231	2.378
Deposits (% YoY)	n/a	n/a	n/a	-1,9	1,5	9,0	6,0	6,3	6,6
Deposits (% of GDP)	n/a	n/a	61,2	57,7	56,2	62,9	64,2	66,5	67,3
Loans-to-deposit ratio (%)	n/a	n/a	144,9	140,7	129,8	118,2	114,9	113,3	111,6
Capital adequacy ratio (%)	n/a	n/a	15,7	15,9	16,5	14,7	15,5	15,2	15,2
P&L figures and ratios									
Net interest income (EURm)	n/a	n/a	121	111	106	106	104	107	111
Total operating income (EURm)	n/a	n/a	162	155	221	178	156	164	168
Net provisions (EURm)	n/a	n/a	81	148	124	121	44	49	52
Pre-tax profit (EBT, EURm)	n/a	n/a	-20	-94	-10	-56	4	8	11
Net interest margin (%)	n/a	n/a	n/a	3,7	3,7	3,8	3,6	3,5	3,5
Cost-to-income ratio (%)	n/a	n/a	62,2	65,6	48,2	63,5	69,5	64,9	62,7
ROAE (pre-tax income/avg. equity, %)	n/a	n/a	n/a	-30,0	-3,2	-18,7	1,1	2,0	2,6
ROAA (pre-tax income/avg. assets, %)	n/a	n/a	n/a	-3,2	-0,3	-2,0	0,1	0,3	0,3
Non-performing loans (%)	n/a	n/a	13,5	21,0	15,5	17,6	17,5	18,2	19,0
Cost of risk (% of avg. loans)	n/a	n/a	n/a	5,7	5,1	5,1	1,9	2,0	2,0

Highlights: Montenegrin banks returned to profitable territory after five years of balance sheet cleaning and de-leveraging. Pre-tax result came in at EUR3.7m in FY13 as looser IFRS provisioning standards adopted in January knocked down reservations (-63.5% yoy) and offset the absence of hitherto regular revenues from bad loans sale to factoring companies. NII continued to deteriorate (-1.6% yoy) as the effect of interest rate spread widening was nullified by deterioration in loan quality (NPLs at 17.5% at 2013-end). Deposit collection continued strongly (+6.0% yoy), providing banks with cheaper alternative to scarce foreign funding and supporting their newly discovered credit appetite. Notwithstanding IFRS-related re-booking of EUR90m previously written-off loans, credit (3.0% yoy) was supported by new origination in amount of EUR807.6m. While bettering macro fundamentals will support lending going forth, profits will be kept at bay given unresolved loan quality issues.

Balance sheet industry trends



Net interest margin (%)

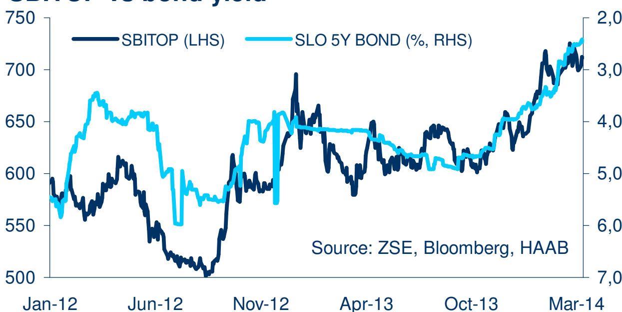
All sources: CBCG, HAAB research

Fundamentals Still the Main Worry

SEE markets recorded mixed performance in 1Q14 with SBITOP and MONEX20 as the biggest gainers, while SASX10, BIRS and Crobex lost on their values. Slovenian blue chip index SBITOP gained 8.6% ytd on the wings of (i) better business results of companies, (ii) reduced risks in banking sector after asset transfer to a bad bank and recapitalization of state banks and (iii) hope that announced privatisation scheme will shake up dormant and illiquid market. The biggest contributors to SBITOP growth were Petrol and Zavarovalnica Triglav, both with solid business results in 2013. On ZSE, Crobex continued to hover in a tight range with no clear direction as growth drivers are still missing in the environment of fiscal tightening, private sector de-leveraging and decreasing household's real net wages, which all together had negative influence on corporate earnings in 2013. Namely, constituents of CROBEX10 index reported deteriorated profitability (EBITDA -34.3% yoy and net profit -71.7% yoy, both aggregated), while downfall was much less severe when INA (with its on-off impairments) is removed from calculation (EBITDA -7.1% yoy and net profit -6.0% yoy). We expect Crobex to remain under pressure in the light of still dismal macroeconomic picture going forth and thus see it under 1.800 points in the short-term. Serbian equity market has seen lot of volatility due to parliamentary elections held on March 16. Market is now waiting for clarification of the new government's steps in regard to public reforms and EU talks, which will determine investor's mood alongside with upcoming business results for 2013.

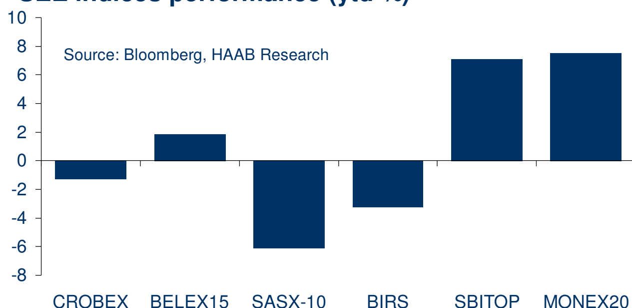
In all, SEE equity markets continue to be weighted by (i) diminished liquidity, (ii) leveraged firms that need restructuring and recapitalization, (iii) private de-leveraging continuation and (iv) bleak macro growth prospects given necessity of economic reforms. On more, growing risk over Ukraine situation, slowing of China economy and uncertainties over monetary policy of Fed, put additional pressure on the performance of regional indices. Short term positive catalysts for SEE equity markets will be privatisations of Croatian companies and Slovenia's government plans to privatize 15 companies as a part of its effort to stabilise the country's finances. This can result in new public offers which can boost so needed liquidity on the equity market. However, privatisation processes are going very slowly and some were cancelled. Lastly, we still keep our defensive stance and recommend focusing on companies with good growth track record, ability to generate free cash flows and export oriented revenues.

SBITOP vs bond yield

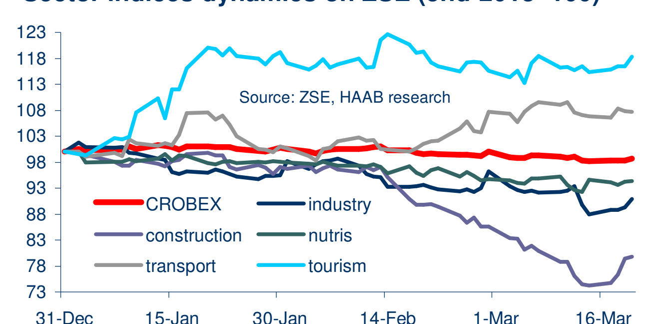


MCap across the region (% GDP)

SEE indices performance (ytd %)



Sector indices dynamics on ZSE (end-2013=100)



ABBREVIATIONS

AUM	Asset Under Management
BRICS	Brazil, Russia, India, China, South Africa
CAD	Current Account Deficit
CARDS	Community Assistance for Resconstruction, Development and Stabilization
CBS	Central Bureau of Statistics
CEE	Central Eastern Europe
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
IMF	International Monetary Fund
IP	Industrial Production
IPO	Initial Public Offering
ISPA	Instrument for Structural Policies for Pre-Accession
LDR	Loan to Deposit Ratio
M1, M4	Monetary aggregates (the narrowest and the broadest, respectively)
M&A	Mergers and Acquisitions
MinFin	Ministry of Finance
MM	Money Market
MoM	month-on-month
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	Public-Private Partnership
REER	Real Effective Exchange Rate
S-D gap	Supply-Demand gap
SAPARD	Special Association Program for Agriculture and Rural Development
SPO	Secondary Public Offering
T-bill	Treasury bill
VAT	Value Added Tax
ZIRP	Zero Interest Rate Policy
YE	year end
yoy	year-on-year
ytd	year-to-date

Disclosures Appendix

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