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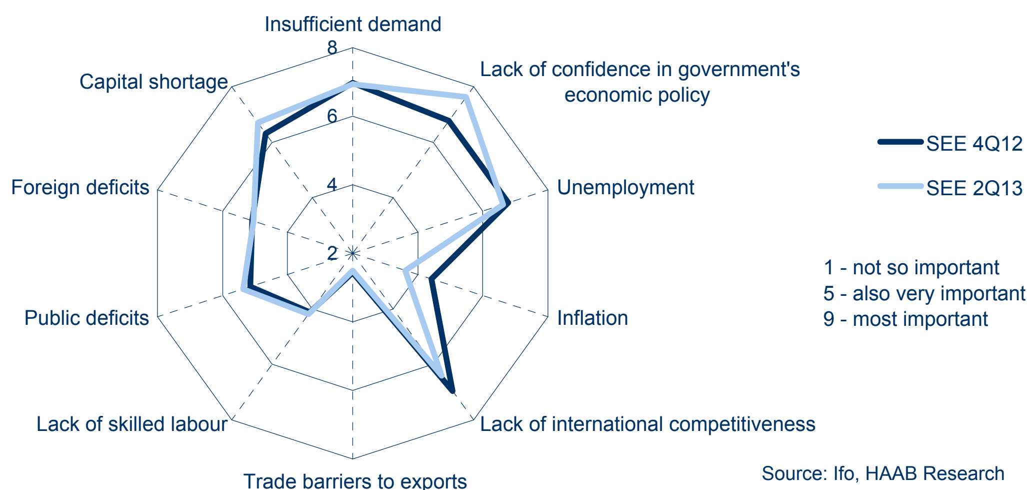
MACROECONOMIC RESEARCH: SEE QUARTERLY

FOR WHOM THE TAPERING BELL TOLLS?

IFO SURVEY - IMPORTANCE OF CURRENT ECONOMIC PROBLEMS



Source: Ifo, HAAB Research

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EXECUTIVE SUMMARY

BOTTOM LINE: While fiscal austerity, worsening external backdrop and de-leveraging have 'only' brought our sub-consensus 2013 figures closer to consensus, we had to downgrade our expectations for the coming year 2014. We, however, did it selectively. On one hand, we see a prolonged recession in Slovenia in Croatia due to prolonged fiscal adjustment, long overdue real sector restructuring and policy uncertainty. While Serbia, Bosnia-Herzegovina and Montenegro can not boast about policy, we keep more constructive figures there on incipient rebound in exports, less fiscal restrictiveness and, in any case, coming from a much lower base. Inflation profiles across SEE are correspondingly revised down. The manoeuvring room for monetary easing has narrowed due to fiscal complacency and fading risk appetite.

KEY POINTS:

1. We have cut forecasts for Croatian 2014 GDP on (i) intensified private de-leveraging, (ii) broadening policy and competitiveness constraints, (iii) rising unemployment, and (iv) dimmed EMU outlook. Meanwhile, Slovenia will succumb to bank repair process and augmented austerity efforts. Finally, Serbian recovery is narrowly-based and policy concerns have arisen, which opens many question marks going forth.

2. Severe structural shortcomings build up over years, fiscal complacency, legal uncertainty and the lagging competitiveness are the biggest downside risks SEE, wherefore Croatia will initially face a competitiveness shocks as the country joins the EU in July. There is hope the EC institutional pressure will help Slovenia and Croatia to put their house in order, accelerate reforms and pursue steadier fiscal consolidation. Our estimates would improve if a few large infrastructure deals on most markets are unfrozen, corporate insolvency models are improved and policy/regulatory uncertainty is reduced.

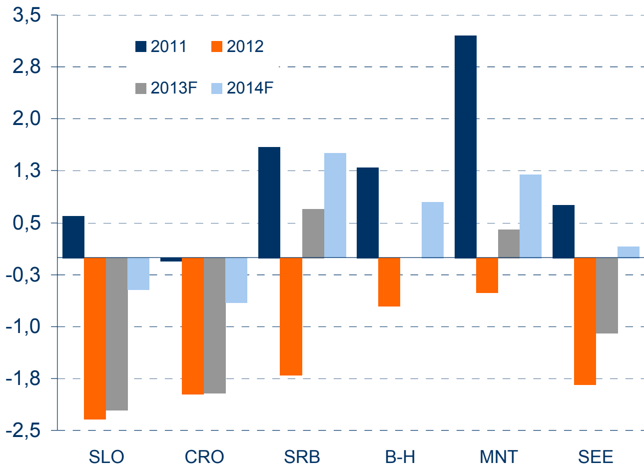
3. We have lowered our inflation forecasts on persistent weakness in consumer demand and the labour market, imported commodity prices disinflation and in some cases adjourned administrative price hikes (Serbia). We continue to spot risks on the upside given fiscally-indispensable administered and indirect tax hikes. In Serbia, the RSD upward volatility could as always influence the near-term price movements, let alone expectations.

4. We think the manoeuvring room for monetary easing has generally narrowed. In Croatia, the CNB stays on hold as the recent data have not been deemed sufficiently weak, and the tightening of risk provisioning rules implies any CNB action is impending on consolidating banks' balance sheets. If the recovery fails to materialize, the CNB will have to re-think its stance as always allowed by the FX stability, fiscal backstop and external risk mitigation. With internal devaluation seemingly out of Serbian authorities' agenda, we think further REPO cuts suggests the NBS is pursuing nominal adjustment by letting the dinar depreciate. We however see the easing cycle slower than before to avoid unwanted FX/interest rate volatility against non-existent IMF back-up.

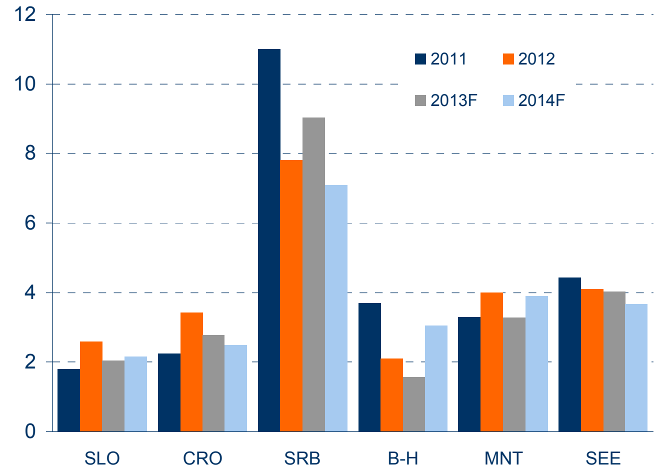
5. Except in the case of Slovenia, rating agencies have apparently taken respite before they see whether the EC/IMF institutional pressures will result in reform acceleration and the subsequent fiscal consolidation. In terms of rating outlook, watering down bank rehabilitation program, austerity and privatisation are all watered down would only captures Slovenian rating in sub-investment territory. Given that EDP's policy anchor, Croatia is facing rating risks 'only' in the medium term given unsustainable public debt development amidst growth concerns. Finally, Serbia looks the most vulnerable to Fed tapering given its over-reliance on portfolio flows in funding one of the highest twin deficits across CESEE. In the absence of fiscal responses, Serbia is also the most exposed to risks of a rating downgrade. Given the lagged fiscal/growth policy respones, we expect all our three sovereign's USD bonds to underperform CESEE peers to the extent determined by relative structural/external vulnerabilities.

SEE data trends

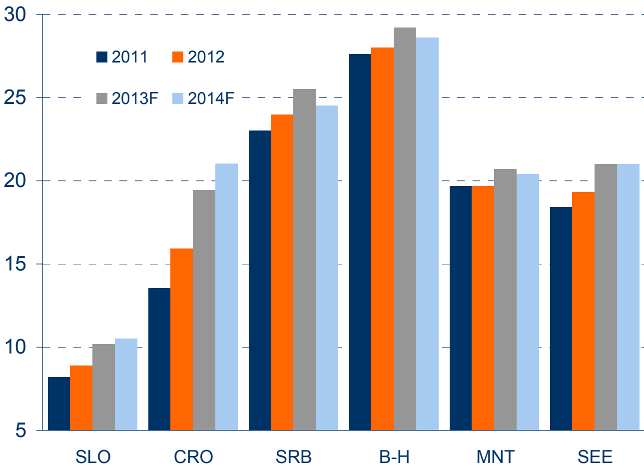
Real GDP growth (%)



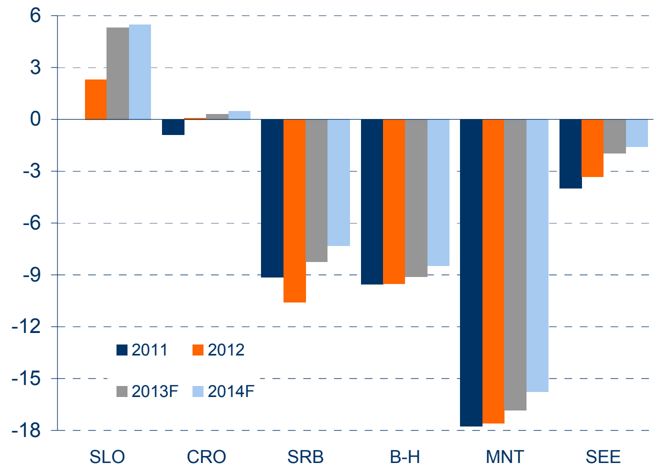
CPI inflation (average, %, YoY)



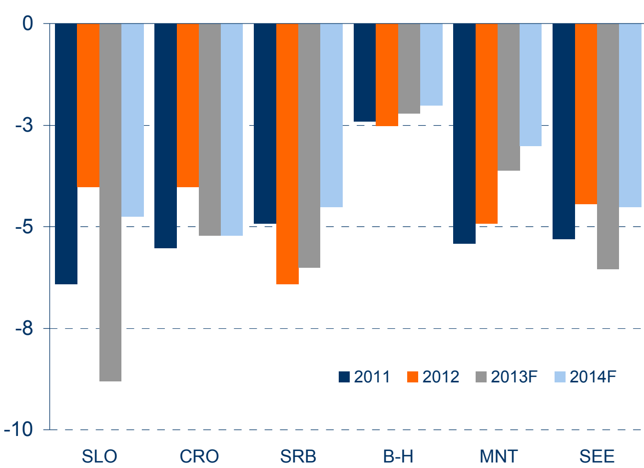
Unemployment rate (ILO, average, %)



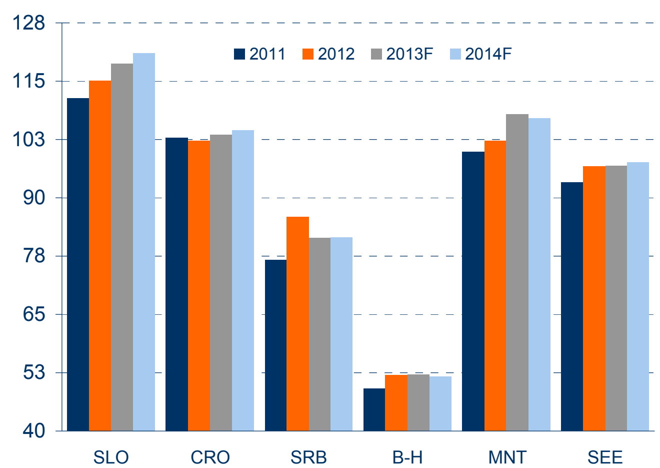
Current account balance (% of GDP)



Government balance (% of GDP)



Gross foreign debt (% of GDP)



Source: national sources, HAAB research

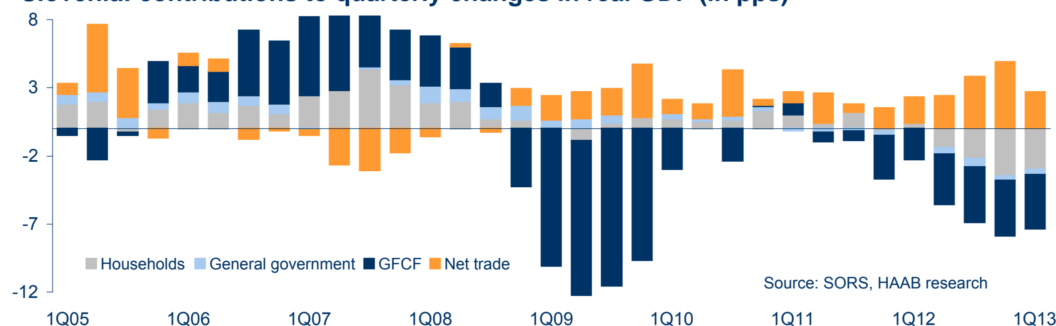
No Easy Fiscal/Banking Fixes

Hefty external borrowing and reforms revival have alleviated investor concerns over the potential EU/IMF bailout, and the EC's firm stance may help turn hope into reality. Double dip recession, however, endangers fiscal consolidation and bank recaps targets. The near-term focus is on meeting the EC's step-by-step guidance for banks restrusturing and privatization that will serve as a a litmus test of credibility.

Recession deepens on demand weakness, de-leveraging, weaker net trade contribution

The disappointing 1Q13 GDP (-0.7% qoq, among the worst in CESEE) shows the economic slump (-4.8% yoy) has deepened. This undershoot echoes all demand components, notably private spending and investment cutbacks, followed by weaker (albeit still substantial) net trade contribution as early Easter and re-stocking prevented an even sharper import slump. Cold weather only added to the downward volatility. While consumers succumb to austerity, wage/job cuts and faster de-leveraging, high policy uncertainty amidst the government change-over and the unresolved banking crisis, leading to further falls in confidence, have dampened capex. Lower industrial output (highly geared to exports) has more or less mirrored trends across CEE4s and Germany. The weaker than expected euro zone Q1 GDP and subdued PMI confidence hint at downside risks to the EMU prospects over Q2 and later, which in turn limits Slovenian export performance and curbs appetite for investment.

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



… leading us to downgrade our 2014 outlook

Our base scenario remains that fiscal consolidation, bank de-levarging and tight funding lead to a -2.2% GDP in 2013, and we lower 2014 GDP forecast by 1.1pp to -0.5% as bank repair process takes time and austerity is augmented. Tough still negative, investments are slightly upgraded as the new power plant triggers machinery capex, and EU funds are better used. Downside risks would be delays in bank restructuring (EUR3.3bn bad loan transfer in Q3) and corporate insolvency procedures, or simply waning appetite for reforms now that hefty external borrowing has bought the cabinet time. In fact, hitherto fiscal moves are skewed to tax hikes rather than spending cuts, let alone material entitlement reforms, which weighs on competitiveness, investor confidence, and potential growth. On the upside, external demand improvement hinges on the EMU internal factors - re-stocking, credit impulse and slowing austerity - and stronger global demand in 2H13. The extension of a deficit-cutting deadline to 2015 is not panacea for Slovenia as the Ecofin ruling actually implies more austerity in the event of fiscal overshoot, and the subsequent years' fiscal multipliers can only be larger.

Inflation continues to slow, administrative hikes keep it above EMU average

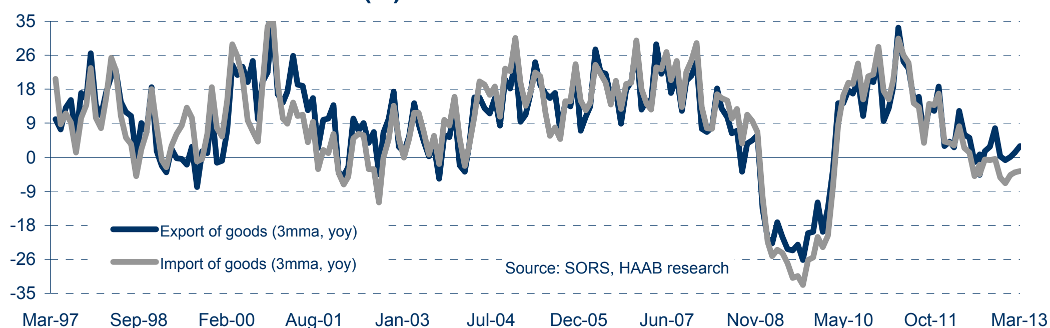
The prolonged weakness of the economy has subdued demand-pull inflation as did lower commodity prices in terms of supply-side pressures. Fiscal austerity and disposable income adjustment required to restore competitiveness in a fixed exchange rate regime will keep core inflation subdued for a while. Notwithstanding the aforementioned factors, we expect relatively higher upside pressures from fiscally-indispensable administered /indirect tax hikes and the removal of utility price controls than in Slovenia's key trading partners will produce the average above-2% CPI, exceeding the respective EMU price gauge. Substantial administered prices pressures may in turn result in further pressure on real disposable income. While the ECB maintains openness to rate cuts in Q3 the back of weaker activity, deflation risks and to preserve low market rates, we think they may consider unconventional policy (liquidity support, credit easing) thereafter, should the situation warrant it.

Current account surplus revised higher, portfolio flows continue to dominate

The seven-fold surge in the C/A surplus to date reflects both export-drive merchandise trade surplus and higher services exports. Meanwhile, lower income deficit on lower debt service costs and net transfers also added to a strong C/A picture. The observed trends are in line with our further upgrades for C/A surplus this year and beyond given the protracted demand adjustment, stably higher exports and better utilization of EU funds. The slowing decline in imports in 2014 owes mainly due to one-off investment in the major energy facility.

The ongoing bank and partly corporate de-leveraging and FDI outflows left C/A funding dependent on portfolio inflows (ie hefty USD bond issuance in May). While the of partly state-owned retailer Mercator could encourage privatization, hence foster FDI, and Fed's tapering talk reduces the attractiveness of external borrowing, we expect the quality of C/A funding to change gradually. Namely, we think the cut-price offers for 15 companies (incl the second biggest bank NKBM) slated to be privatized (one blue chip this year) have yet to test the government's resolve to sell. In either of the cases, multi-billion bond issuances to cover near-term (re)financing needs, and especially sustained progress on FDI front depend on fiscal and policy credibility as well as stronger supply-side reforms.

Slovenia: merchandise trade (%)



No penalty but extra savings?

While Slovenia has not been put into the Macro Imbalance Procedure, the EC is pretty vocal on policy moves ranging from bank/corporate restructuring (incl external asset quality review) to entitlements. Hence, to meet an EDP-compliant sub-3%/GDP deficit in 2015, Slovenia is eyeing fiscal measures incl a 2pp VAT hike, suspension of corporate tax cuts, new property taxes and duty changes, EUR291m public wage cuts in two years, etc. While the 2015 public debt cap and tighter procedures on (anti-reform) referendum notions also bring comfort, the contribution of entitlement reforms to budgetary targets, in particular extra moves to contain pension outlays, is missing. That said, we expect the budget gap ex. bank recaps to remain around 4.5% of GDP in 2013-2014 on demand-inflicted tax shortfall, supreme court's annulment of EUR260m savings and higher pension bill. Combined with our bank recap expectations (HAAB 2013e: ~EUR1.5bn), total fiscal deficit to 8.8% of GDP in 2013, with the main risks to the upside on bank support and slow implementation. Notwithstanding the fiscal agenda now facing in broadly the right direction, our concerns is that prolonged recession, higher deficits and hesitant structural long-run spending reforms, together with privatisation difficulties, may create a difficult nexus of challenges that may necessitate a further package.

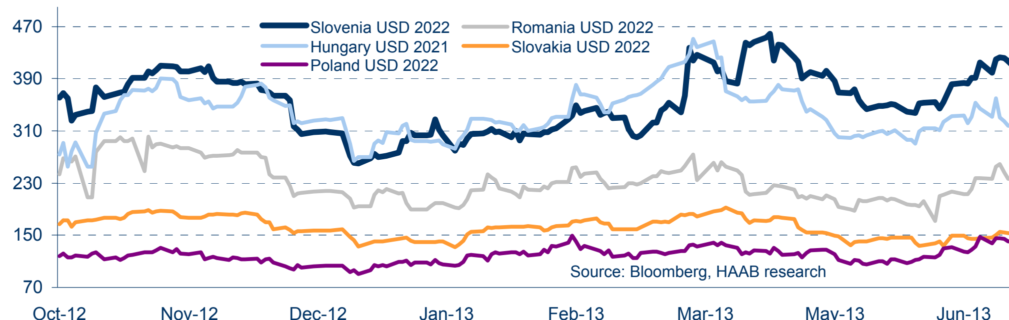
Public debt sustainability rests on swift bank restructuring and primary surplus

The sovereign's guarantees for bad bank bonds (EUR1.1bn in 2013) and bank recaps -on top of 4.5%/GDP budget gap - will see the gross public debt soar to 76% of GDP in 2014. While this is 20pp+ below the EMU average, the figure is also more than double the 'BBB' median (36% of GDP) and still subject to upside risks from bank recaps. The latter is obvious not least due to the weak economy, but ~66% haircut for bad asset transfer alongside ~50% NPL covers implies ~15% of bad asset impairment, and state asset sales may lift capital requirements due to different treatment of Basel III risk weights for loans to state enterprises as opposed to private credit. Accounting for alternative scenarios of fiscal consolidation, we think it could require 1-1.5% of GDP primary fiscal surplus to stabilize public debt, which may prove difficult at the same time as the private sector is deleveraging as well. While the ample funding raised (USD3.5bn in 10Y and 5Y bonds) leaves Slovenia fully funded until 2Q14 (when a EUR1.5bn Eurobond matures), investors should already look at large EUR5.2bn funding challenge in 2014 when the risks of the EU/IMF bailout (EUR11bn over three years, see our previous SEE Outlook Quarterly) in 'complacency' scenario may resurface.

Fiscal and growth concerns remain a drag on ratings and Slovenian credit...

Given the EcoFin's firmer fiscal stance towards Slovenia, Fed tapering prospects have accelerated Slovenian bonds underperformance. The EC's reservation over implementation of the banking and corporate restructuring plans, requiring an external assessment of financial sector and privatisation, leaves investors on tenterhooks. Also, Fitch is the latest agency to downgrade Slovenia on fiscal/growth concerns and higher-than-expected bank recaps, which gradually brings the sovereign to the composite junk status. While outside pressures keep the ruling coalition united, enabling the passage of legislation, politics remain the key risk as the cabinet must follow on the EC deadlines swiftly in a more transparent way.

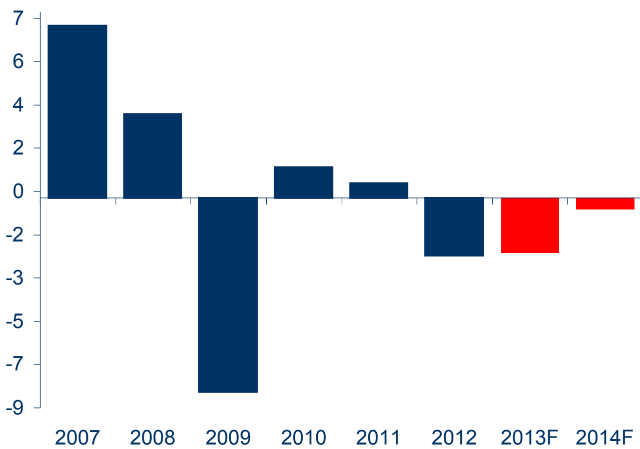
Slovenia USD bonds underperform

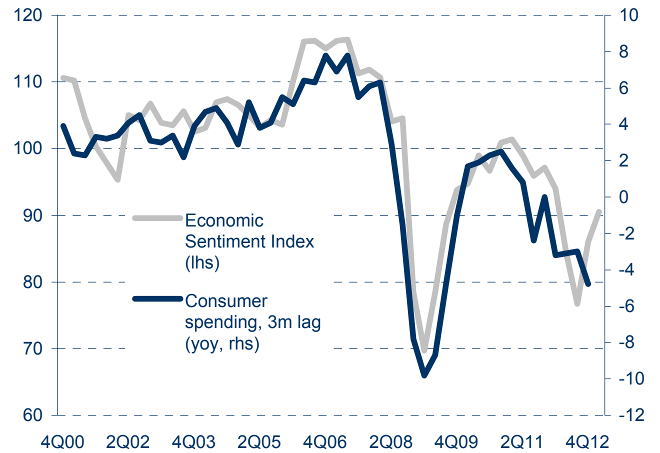


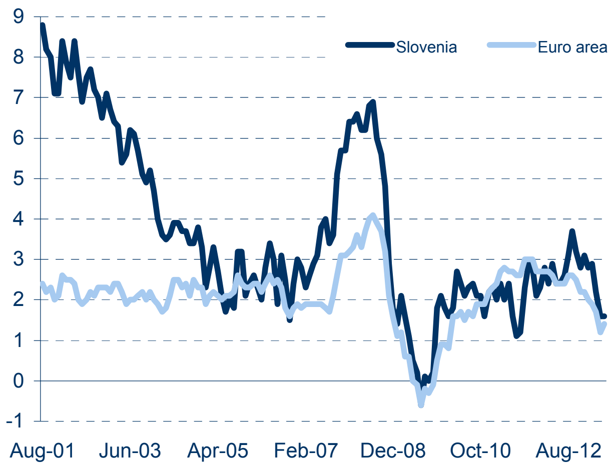
… but the EC pressure and disciplinary markets may anchor expecttions

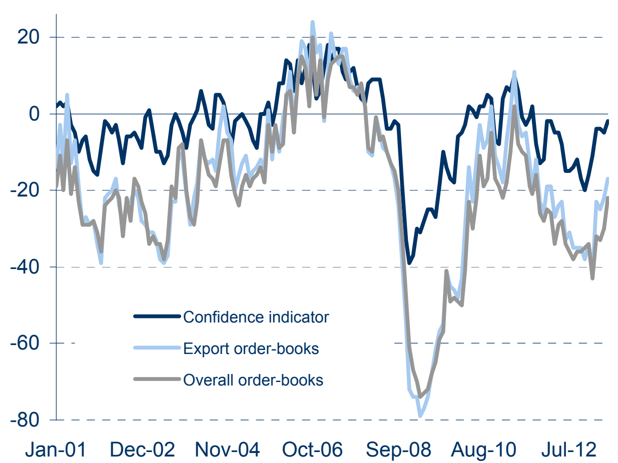
We do not rule out further spreads widening as expectations of more restrictive central banks and risk-averse capital flows forebode discrimination of fiscally weak sovereigns. Until the consolidation strategy due by 1 October, supposed to bring the required clarity on structural items, we would position ourselves for a bumpy ride in Slovenian yields, and light volumes may set the tone for the summer. Indeed, in our bear case, bank rehabilitation program, austerity and privatisation are all watered down, which captures the sovereign's rating in sub-investment territory. In our base scenario, policymakers meet the EC's deadlines on bank restructuring, but fall short on other reform priorities - in particular on pension sustainability. In the first case, speculation on the true cost of bank recaps sends Slovenian long-term yields toward 7%, while the latter scenario suggests underperformance given still high (though declining) sensitivity of the local economy weakness and reversal of search-for-yield trades. Were the sale of Mercator give legs to privatization motion and the cabinet can leverage the EC pressure to augment efforts on bank/structural reforms, this could pave the way to a third bull case and help reduce (re)financing risks. Until then we do not expect the markets to price out a medium-term bailout threat premia built into yields for policy implementation risks.

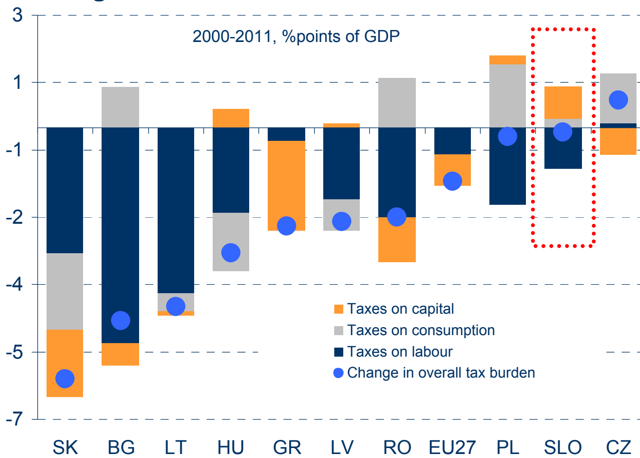
Slovenia's data trends

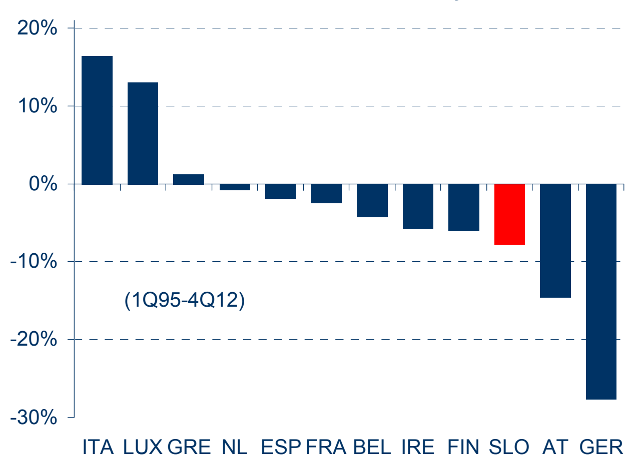












Source: Slovenian National Bank, Statistical office of the Republic of Slovenia, Ministry of Finance, ECB, European Commission, Bloomberg, HAAB research

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013F	2014F
Activity								
Nominal GDP (EURbn, current prices)	34,6	37,2	35,6	35,6	36,2	35,5	35,0	35,2
Nominal GDP (USDbn)	47,4	54,8	49,6	47,2	50,4	45,6	44,9	44,0
GDP per capita (EUR)	17.120	18.437	17.295	17.286	17.636	17.292	17.070	17.165
GDP per capita (USD)	23.463	27.117	24.123	22.916	24.560	22.238	21.873	21.457
Real GDP (constant prices YoY, %)	7,0	3,4	-7,8	1,2	0,6	-2,3	-2,2	-0,5
Private consumption (YoY, %)	6,2	2,5	0,2	1,4	1,0	-2,9	-4,5	-2,2
Fixed investment (YoY, %)	13,3	7,1	-23,2	-13,8	-8,1	-9,3	-5,8	-1,7
Industrial production (YoY, %)	7,2	2,5	-17,3	7,1	1,3	0,7	-0,8	1,6
Unemployment rate (ILO, average %)	4,9	4,4	5,9	7,3	8,2	8,9	10,2	10,5
Prices								
CPI inflation (average % YoY)	3,6	5,7	0,9	1,8	1,8	2,6	2,0	2,2
CPI inflation (end-year % YoY)	5,6	2,1	1,8	1,9	2,0	2,7	2,0	2,1
PPI inflation (average % YoY)	4,2	3,9	-1,3	2,1	4,5	0,9	1,8	2,0
PPI inflation (end-year % YoY)	3,4	2,2	-1,2	4,2	3,6	0,4	2,4	2,4
Net wage rates (% YoY, nominal)	5,9	7,9	3,4	3,9	2,1	0,4	-0,8	0,4
Fiscal balance (% of GDP)								
State budget balance (ESA-95)	0,0	-1,9	-6,2	-5,9	-6,4	-4,0	-8,8	-4,7
Public debt	23,1	22,0	35,0	38,6	46,9	54,1	67,5	76,3
External balance								
Export of goods and services (EURbn)	23,944	25,252	20,757	23,378	26,104	26,550	27,086	27,855
Import of goods and services (EURbn)	-24,562	-26,213	-20,090	-23,090	-25,704	-25,183	-24,931	-25,505
Merchandise trade balance (EURbn)	-1,240	-2,385	-0,498	-0,997	-1,043	-0,335	0,688	0,784
Merchandise trade balance (% of GDP)	-3,6	-6,4	-1,4	-2,8	-2,9	-0,9	2,0	2,2
Tourism receipts (EURbn)	2,362	1,827	1,804	1,925	1,952	2,006	2,046	2,083
Current account balance (EURbn)	-1,646	-2,295	-0,246	-0,209	0,002	0,818	1,857	1,934
Current account balance (% of GDP)	-4,8	-6,2	-0,7	-0,6	0,0	2,3	5,3	5,5
Net FDI (EURbn)	-0,3	0,3	-0,7	0,4	0,6	0,2	0,3	0,4
FDI (% of GDP)	-0,7	0,9	-1,8	1,2	1,8	0,5	0,9	1,1
FDI cover (%)	n/a	14,3	n/a	205,9	n/a	n/a	n/a	n/a
Gross international reserves (EURbn)	0,724	0,687	0,749	0,803	0,767	0,722	0,680	0,750
Import cover (months of imports)	0,4	0,3	0,4	0,4	0,4	0,3	0,3	0,4
Debt indicators								
Gross external debt (EURbn)	34,783	39,234	40,294	40,723	40,241	40,838	41,538	42,638
Government (EURbn)	3,036	3,736	6,559	8,167	8,715	11,065	13,265	14,015
Private (EURbn)	28,159	31,866	30,140	30,181	28,517	25,070	23,273	23,623
Gross external debt (% of GDP)	100,5	105,3	113,3	114,4	111,2	115,1	118,6	121,1
Gross external debt (% of exports)	145,3	155,4	194,1	174,2	154,2	153,8	153,4	153,1
Exchange rates and money growth								
EUR/USD (end-year)	1,46	1,40	1,43	1,34	1,30	1,32	1,24	1,26
EUR/USD (average)	1,37	1,47	1,39	1,33	1,39	1,29	1,28	1,25
Money supply M1 (% YoY)*	-6,6	-3,7	7,7	13,5	1,5	4,4	2,4	3,2
Broad money M3 (% YoY)*	5,0	8,9	2,6	2,4	3,5	-1,4	-1,0	2,7
Domestic credit (% YoY)	n/a	n/a	1,1	1,6	-4,6	-5,8	-11,3	-5,1
ECB reference rate (end-year %)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,25
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,18	0,30
SLO 5Y yield (average %)	-	-	-	3,03	3,96	4,55	4,50	4,80
SLO 10Y yield (average %)	-	4,49	4,35	3,84	4,98	6,01	6,00	6,20

* Since 2007 ECB data

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

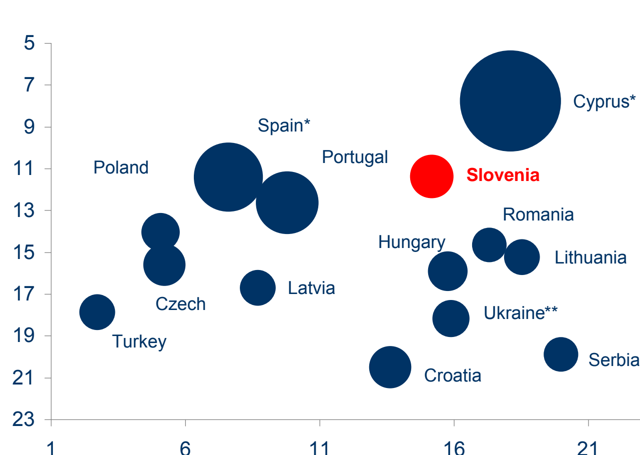
SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011	2012	2013F	2014F
Balance sheet figures and ratios								
Assets (EURm)	n/a	47.628	51.612	50.319	48.748	46.126	43.681	43.026
Loans (EURm)	n/a	33.530	33.910	34.450	32.875	30.962	27.463	26.064
Loans (% YoY)	n/a	n/a	1,1	1,6	-4,6	-5,8	-11,3	-5,1
Loans (% of GDP)	n/a	90,0	95,4	96,8	90,9	87,3	78,4	74,0
Deposits (EURm)*	n/a	20.612	23.570	23.507	24.170	23.856	23.641	23.712
Deposits (% YoY)	n/a	n/a	14,4	-0,3	2,8	-1,3	-0,9	0,3
Deposits (% of GDP)	n/a	55,3	66,3	66,0	66,8	67,3	67,5	67,4
Loans-to-deposit ratio (%)	n/a	162,7	143,9	146,6	136,0	129,8	116,2	109,9
Capital adequacy ratio (%)	n/a	11,7	11,6	11,3	11,6	12,1	12,7	12,2
P&L figures and ratios								
Net interest income (EURm)	n/a	945	932	1.038	1.018	886	770	755
Total operating income (EURm)	n/a	1.360	1.425	1.474	1.447	1.561	1.239	1.217
Net reservations & adjustments (EURm)	n/a	278	500	810	1.207	1.594	1.012	559
Pre-tax profit (EBT, EURm)	n/a	306	161	-101	-537	-771	-463	10
Net interest margin (%)	n/a	2,0	1,9	2,0	2,1	1,9	1,7	1,7
Cost-to-income ratio (%)	n/a	57,1	53,7	51,9	53,7	47,5	55,7	53,3
ROEA (Pre-tax income/equity, %)	n/a	6,2	2,8	-2,4	-11,3	-20,0	-9,4	0,2
ROAA (pretax, %)	n/a	0,6	0,3	-0,2	-1,1	-1,7	-1,1	0,0
Non-performing loans (%)	n/a	3,2	5,2	7,3	11,5	16,5	9,0	9,4
Cost of risk (% of outstanding bank loans)	n/a	0,8	1,5	2,4	3,7	5,1	3,7	2,1

Highlights: Slovenian banks made a pre-tax loss of EUR41.5m in the first four months of 2013, driven by further asset impairmets, as NPL ratio jumped to 15.2%. We expect net interest income generation to remain weak in 2H13 as a result of subdued credit demand, further de-leveraging (-1.8% ytd) and asset quality deterioration. On funding, after Cyprus episode deposit outflow has accelerated, and we see further decrease amid record high unemployment, wage deflation, entitlement spending cuts and slow corporate restructuring. Meanwhile, the government has established bad bank (BAMC), to ring-fence EUR3.3bn in bad loans from top three state banks. In return, the banks will receive EUR1.1bn bonds issued by BAMC and backed by the state. Transfers to BAMC are expected by end-Q3, with risk that operation may be delayed by the EC's audit. Besides the ongoing banking sector clean-up process, bank captal needs, which we put at EUR1.5bn, remain a conundrum.

Net interest margin (%)

Capital Adequacy and NPLS (%)



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

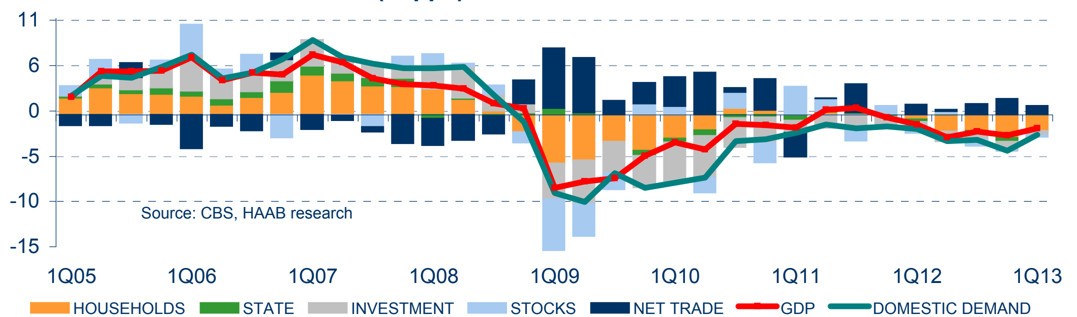
Inaction Prolongs Recession

Croatia finally joins the EU, but severe structural shortcomings build up over years, fiscal complacency, legal uncertainty and initial competitiveness shock overshadow potential benefits. Internal devaluation has reversed and the impact of the recent shift in risk in global markets on Croatia must not be downplayed. Fiscal consolidation has likewise reversed as VAT undershoots, but the EDP shall provide a policy anchor.

We maintain FY13 GDP forecast at -2.0% yoy on weaker H2 relative to H1

Despite an election-driven construction works and weather-buoyed energy output, the Q1 GDP -1.5% yoy drop reflected consumer and investment recession, partly offset by positive net trade contribution. The 1% industry uptick is disheartening given that SEE peers largely saw mid-single-digit gains on foreign demand in contrast to Croatian producers lacking competitiveness and loosing capacity amid restructuring. Consumer spending stays weak given rising unemployment, wage restraint, de-leveraging and poor income expectations. Electioneering helped Q2 activity too, but the industry decline, weak external environment and consumers' diet forebode another 1.5%-alike GDP slump. After better Q1, we keep the FY12 -2.0% GDP forecast on private de-leveraging, driven by pre-bankruptcy stalemate and poor households fundamentals, non-existent investment rebound and the initial EU-entry competitiveness shock. The latter is exacerbated by the loss of preferential trade status on CEFTA markets and the consequent production relocation, plus the EMU dimmed outlook.

Croatia: contributions to GDP (in pps)



Limited credit flows, competitiveness and policy constarints extend recessionary developments to 2014

The last months have seen the emergence of downside risks to growth. For starters, it looks as if big reform ambitions have faded away, and internal devaluation efforts are cut notably. This is seen in MoF acknowledgement that tax burden cuts are not likely in the next years in what resembles a failure to launch property tax before business-friendly wage contribution cuts. Pension and health reforms won't reach parliament before Q4, but at least flexi-security labour reforms continue just like talks on collective deals rationing. Meanwhile, it has to be seen to which extent controversial policies to ease people's debt situation and stricter bank provisioning rules add to de-leveraging. Limited credit flows, coupled with broad policy and competitiveness constraints (incl from energy prices) deterring private capex, demand adjustment via unemployment, and weaker outlook in the key trade partners lead us to drop 2014 GDP forecast to -0.7%. Our estimates would improve if a few large infrastructure deals are unfrozen, corporate insolvency model is improved and regulatory uncertainty is reduced.

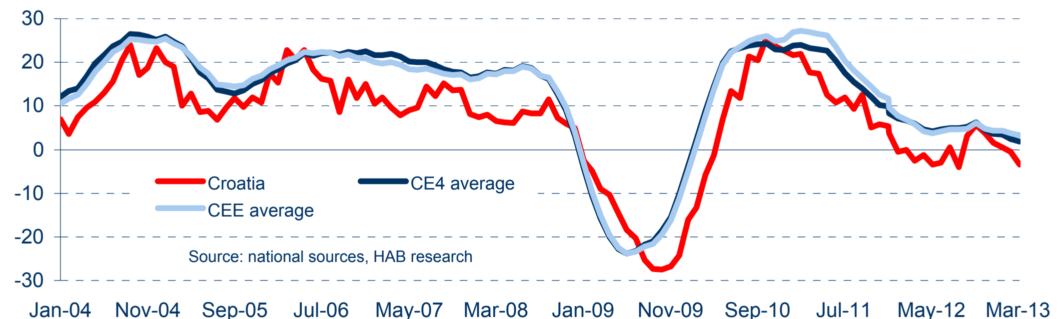
Inflation pressures at bay

Given the persistent weakness in consumer demand and the labour market, and waning effect of administered/indirect price hikes, we expect inflation to fall to 2.8% on average in 2013 and further to 2.4% in 2014. The imported commodity prices disinflation as a result of large pockets of global excess capacity, ongoing de-leveraging and favourable supply shifts only strengthens our conviction. Path-wise, we expect CPI inflation down to 1.5% this autumn, even after factoring in the EU-related energy excise hikes. During 2014, as internal demand stabilizes and energy prices continue to adjust higher towards market levels, we expect a slight recovery, pointing to rates around 3% by year-end. Come what may, we are adamant the ongoing demand subduedness alongside falling unit labour costs (a reliable long-term inflation leading indicator) and stability-orientated monetary policy will keep the medium-term inflation path in check.

Notwithstanding some export-driven trade gap widening, service surplus and transfers to ensure the C/A stays in surplus

The stabilization in goods trade deficit is largely a by product of import demand weakness as exports also took a hit from shipyard restructuring and lower food shipments. Notwithstanding some export-driven trade gap widening amid CEFTA agreement termination and fledgling EU demand in 2H13, we expect higher service surplus and transfers to ensure the C/A stays in surplus. We see flattish tourism receipts, but if downside risks from austerity tourism rivalry across Mediterranean and weather conditions materialize, then this would undermine our C/A gap-to-GDP ratio on both sides of the equation. Given poor FDI and private de-leveraging, C/A funding stays dependent on portfolio inflow largely via USD bond issuance. Although the basic balance (C/A+FDI) surplus (2-3pp/GDP) reduces the need for new debt, the focus remains on 35%+/GDP short-term roll-over needs and the public sector's affordable funding abroad now that the normalization of core interest rates (and risk premium) is bound to start.

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



No Rate Cut Now – But Easing Bias Stays

The CNB stays on hold as the incoming data have not been deemed sufficiently weak - or sufficiently 'one directional' (CNB saw private credit recovery) to justify monetary easing. Also, the tightening of risk provisioning requirement implies any CNB action is impending on consolidating banks' balance sheets. All this is obviously not the result of a misjudgement of weak economic conditions, but rather the awareness that reserve cuts is counterproductive (given ample liquidity in the system and prudential easing is always a question of adequate risk-sharing schemes. The fact that the CNB stresses ample liquidity provision - up to now only helping to 'subsidise' Minfin borrowing costs - as the most powerful monetary policy tool illustrates the CNB's frustration to find 'monetary magic' while parent banks are de-leveraging and continue to de-risk, and private firms fear bleak economic prospects. If the recovery fails to materialize, as we expect, the CNB will have to cautiously choose one of the above options as always allowed by the FX stability, fiscal backstop and external risk mitigation.

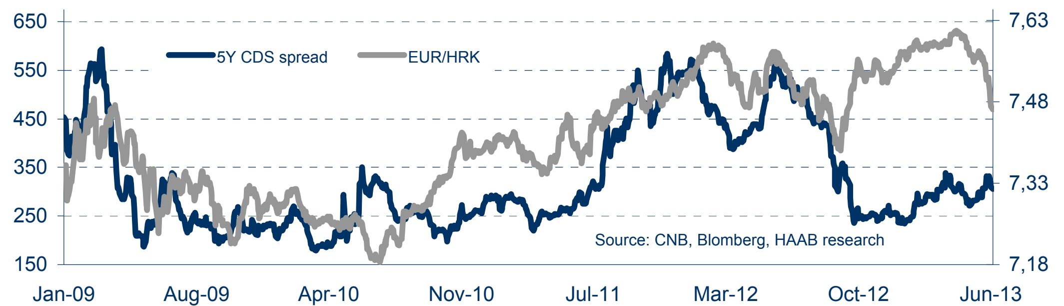
We see slightl weaker kuna towards year-end on fading risk appetite and weaker Croatian fundamentals

The kuna strength owed to investor positioning ahead of July's large FX-linked bond and state firms' borrowing, tourism FC inflow and hefty EUR1.2bn corporate supply in Q2. The latter offset FC demand amid bank provisioning and weaker goods trade trends. The FX stability and the CNB maintenance of HRK6bn+ excess interbank liquidity, plus HRK4.5bn liquidity creation potential via conversions of March USD bonds (effectively monetary easing), and the O/N depo rate cut to 0.0% anchored short-end rates at record lows (0.2-1.5%). Croatian bonds underperformed CEE peers on weaker fiscal comps (Romania, Hungary getting the EDP exit card), local supply concerns on top of large EUR3.3bn loans/market debt maturities in Q3. Meanwhile, fears of an earlier tapering of Fed's QE3 and the spillover from soaring benchmark USTs emphasized by stronger USD outlook has seen EM debt loosing favour.

Despite supportive seasonal patterns, we are cautious on the kuna given the combination of faster bank risk provisioning, worsening trade dynamics and ongoing private-sector external de-leveraging. Apart from the accelerated provisioning cycle not least due to regulatory rules, we expect the prospects for looser monetary conditions will see the kuna weaken somewhat. In a medium term, though, tighter provisioning rules has a stabilizing effect on the EURHRK, in that the CNB measures are designed to reduce parent banks' propensity to repatriate capital/profits. The final downside risk is fading global risk appetite when Croatian assets may suffer disproportionally as the growth/fiscal underperformance and competitiveness issues become more apparent in 2H13. Fortunately, the CNB has liquidity tools to ensure FX stability, and non-interrupted (quasi)sovereign borrowing strengthens capacity for possible FX interventions. All being said, we'd therefore use down moves in EURHRK towards the 7.45 region to enter medium term EURHRK long positions before taking profit around 7.65 level.

After near-term respite, further USTs sell-off potential suggests Croatian USD bonds underperformance on weaker fiscal comps

Croatia: 5Y CDS spreads and EUR/HRK



Despite seasonal HRK2-3bn higher demand for cash in circulation alongside liquidity-sapping bank risk provisioning, short-end rates will in our view merely inch higher given the ongoing HRK6-7bn excess liquidity in the system. That said, we do not exclude some volatility a the short-end should the CNB temporarily 'park' bond receipts as it used to do in the past in order to prevent unwanted liquidity bulge. The pressure on T-bills is equally absent also due to the MinFin intention to extend debt maturity profile. With 2013 funding well advanced and stable BB+ rating outlook on the EU rule-based policy anchor, there is respite from issuance and pressure on spreads near term. However, progress on structural reforms is meeting delays and GDP concerns have resurfaced, which forebodes underperformance of Croatian USD bonds amid hefty prefinance for 4M14 (in international markets in Q4). Despite further USTs sell-off potential, a crumb of comfort is that real-money accounts still see better fundamentals in EM vs DM, which suggests Croatian spreads won't see too sharp spread widening.

Fiscal consolidation has reversed as VAT undershoots

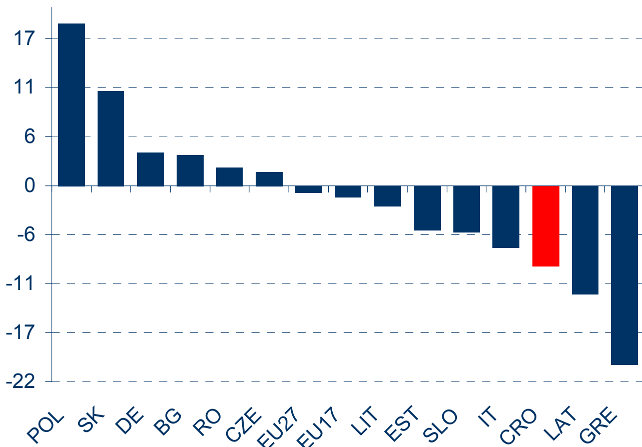
The budget gap soared (+65% yoy) in the first four months amid HRK1.1bn lower firms' profit taxes and VAT underperformance as tax-driven consolidation efforts discourage consumption and investment. Meanwhile, outlays rose 3.4% yoy on interest costs, advanced payment of subsidies and higher pension bill. Overall, given the lack of reform bias on expenditures, shipyard restructuring charges and overspending in healthcare, demand-inflicted tax revenue undershoot (up to HRK4bn for the FY13) and a net contribution to the EU budget, we expect the MinFin to miss its fiscal gap target and exceed 5% of GDP. One unknown is the extent of VAT undershoot due to changes in payment criteria. While the structure of the deficit renews the focus on more practical, gradual discretionary spending rationing and investment cuts, our concern is that such an unfortunate policy reaction hurts credibility and stunts growth potential. Local elections indicate voter disillusionment over hitherto government measures, opposition to austerity and mean the SDP-led coalition lacks a clear electoral mandate, both of which are credit negative for the sovereign and its ability to pursue fiscal consolidation.

Public debt unsustainability clearly makes the country susceptible to markets volatility and rating pressures

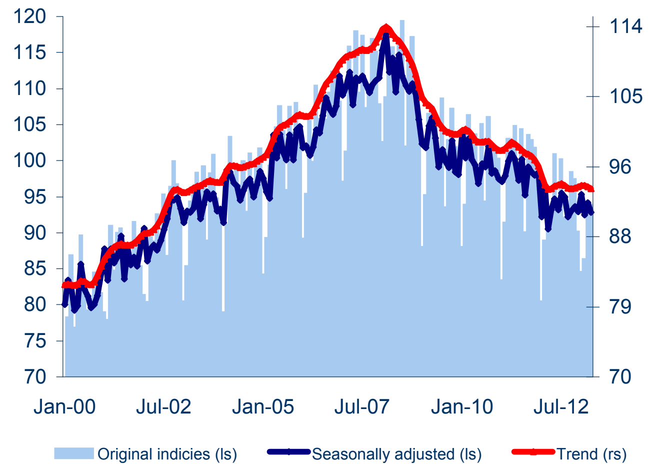
The key take-away from the EC's policy recommendations are material deviations in both the economic and fiscal outlook, with our views slightly more bearish then the EC forecast. It did not just represent a general suggestion to boost credibility, but they also pointed to the need, in between the lines, to enhance administration capacity in attracting FDI and the EU funded projects. The success in the latter will be of paramount importance for public investment and GDP growth. Low potential growth hits tax revenue, and ultimately poor EU funds absorption implies greater need for tax hikes and/or spending cuts. The good news is that 2014 budget will be subject to the EC's ex-ante assessment, and the degree of observance of the EU recommendations will weigh on future decisions that are legally binding as Croatia enters the EDP. With fiscal progress reactive to market pressures rather than pre-emptive, we hope the cabinet to leverage up the EC pressure for steadier fiscal consolidation - combined with monetization/privatization efforts - all being needed to put public debt on a sustainable path in the medium term. Until then, in the usual no-policy-change scenario (fiscal overshoot up to 1.5-2pp/GDP), public debt (incl guarantees and the CBRD) goes above 80% of GDP by 2014, which makes the country susceptible to a sudden deterioration in the international financial environment and further rating pressures.

Croatia's data trends

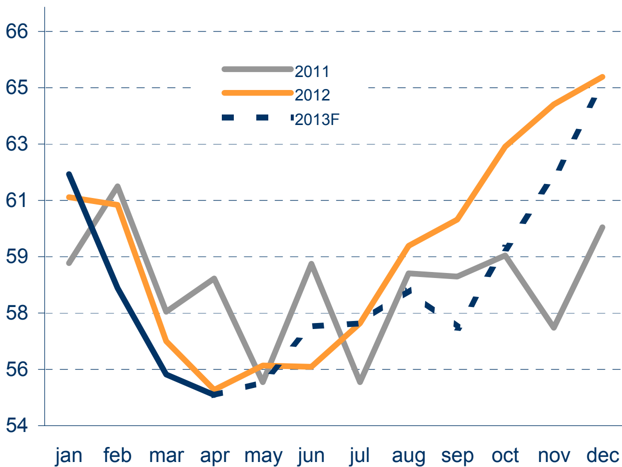
Real GDP growth change (2007-2012)



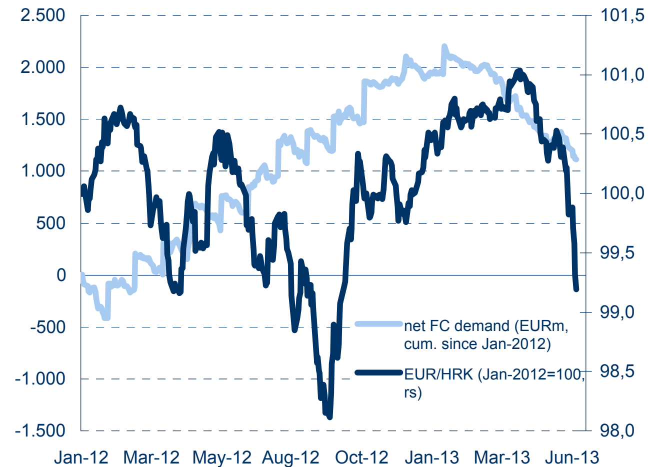
Industrial production, 2010=100



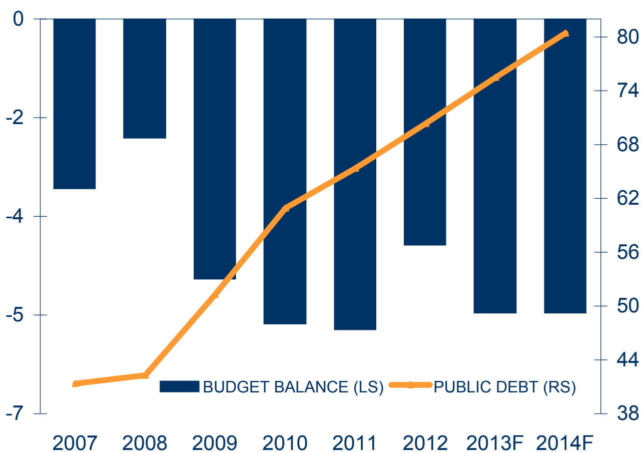
Merchandise import cover (% 3mma)



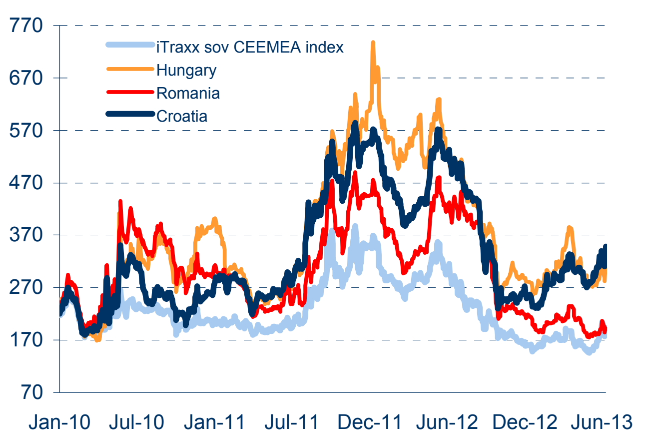
EUR/HRK and interbank FX market



Budget balance and public debt (%/GDP)



5Y CDS spreads (bps)



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

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013F	2014F
Activity								
Nominal GDP (HRKbn, current prices)	318,3	343,4	328,7	323,8	330,2	330,2	331,4	335,9
Nominal GDP (EURbn)	43,4	47,5	44,8	44,4	44,4	43,9	43,8	44,2
Nominal GDP (USDbn)	59,3	69,6	62,2	58,9	61,8	56,5	56,2	55,3
GDP per capita (EUR)	9.781	10.722	10.111	10.059	10.377	10.295	10.291	10.401
GDP per capita (USD)	13.372	15.696	14.054	13.326	14.437	13.239	13.186	13.001
Real GDP (constant prices YoY, %)	5,1	2,1	-6,9	-2,3	0,0	-2,0	-2,0	-0,7
Private consumption (YoY, %)	6,3	0,8	-7,6	-1,3	0,2	-3,0	-2,5	-0,9
Fixed investment (YoY, %)	7,1	8,2	-14,2	-15,0	-6,4	-4,6	-1,8	0,9
Industrial production (YoY, %)	5,7	1,8	-9,2	-1,4	-1,2	-5,5	-2,4	2,2
Unemployment rate (ILO, average %)	9,6	8,4	9,1	11,8	13,5	15,9	19,4	21,0
Prices								
CPI inflation (average % YoY)	2,9	6,1	2,4	1,1	2,3	3,4	2,8	2,5
CPI inflation (end-year % YoY)	5,7	2,9	2,0	1,8	2,1	4,7	2,0	3,0
PPI inflation (average % YoY)	3,4	9,7	-0,4	4,3	6,4	7,0	0,0	0,1
PPI inflation (end-year % YoY)	5,8	9,6	1,6	5,7	5,8	6,9	0,0	0,0
Net wage rates (% YoY, nominal, euros)	5,0	8,6	0,9	1,3	-0,2	-0,4	-1,6	-0,3
Fiscal balance (% of GDP)								
State budget balance	-3,0	-2,1	-4,6	-5,4	-5,5	-4,0	-5,2	-5,2
Public debt	41,4	42,3	51,3	60,9	65,4	70,4	75,5	80,4
External balance								
Export of goods and services (EURbn)	18,271	19,843	16,315	17,715	18,777	19,100	19,007	19,497
Import of goods and services (EURbn)	-21,375	-23,622	-17,831	-17,685	-18,740	-18,729	-18,498	-19,005
Merchandise trade balance (EURbn)	-9,829	-11,232	-7,691	-6,232	-6,699	-6,586	-6,664	-6,915
Merchandise trade balance (% of GDP)	-22,7	-23,6	-17,2	-14,0	-15,1	-15,0	-15,2	-15,6
Tourism receipts (EURbn)	6,753	7,459	6,380	6,230	6,617	6,829	6,938	7,105
Current account balance (EURbn)	-3,151	-4,255	-2,282	-0,468	-0,385	0,035	0,125	0,207
Current account balance (% of GDP)	-7,3	-8,9	-5,1	-1,1	-0,9	0,1	0,3	0,5
Net FDI (EURbn)	3,5	3,3	1,5	0,4	1,1	1,1	0,8	1,1
FDI (% of GDP)	8,0	6,9	3,4	1,0	2,4	2,4	1,8	2,4
FDI cover (%)	110,1	77,0	66,5	93,2	274,8	n/a	n/a	n/a
Gross international reserves (EURbn)	9,307	9,121	10,376	10,660	11,195	11,236	11,704	12,432
Import cover (months of imports)	5,2	4,6	7,0	7,2	7,2	7,2	7,6	7,8
Debt indicators								
Gross external debt (EURbn)	34,086	40,956	45,244	46,483	45,734	44,935	45,353	46,141
Government (EURbn)	6,171	4,732	5,739	6,602	6,996	8,342	9,902	9,902
Private (EURbn)	27,914	36,224	39,505	39,881	38,738	36,594	35,452	36,240
Gross external debt (% of GDP)	78,6	86,1	101,0	104,6	103,0	102,3	103,5	104,4
Gross external debt (% of exports)	186,6	206,4	277,3	262,4	243,6	235,3	238,6	236,7
Exchange rates and money growth								
USD/HRK (end-year)	4,99	5,16	5,09	5,57	5,82	5,72	6,13	6,10
USD/HRK (average)	5,37	4,93	5,28	5,50	5,34	5,85	5,90	6,08
EUR/HRK (end-year)	7,33	7,32	7,31	7,39	7,52	7,55	7,60	7,65
EUR/HRK (average)	7,34	7,22	7,34	7,29	7,43	7,52	7,56	7,60
Money supply M1 (% YoY)	19,3	-4,6	-14,6	4,2	7,5	1,6	6,5	4,0
Broad money M4 (% YoY)	18,3	4,3	-0,9	4,4	1,6	3,2	3,4	3,2
Domestic credit (% YoY, euros)	14,5	14,5	2,5	6,1	4,0	-2,6	-3,5	-3,0
ZIBOR 3M interest rate (average %)	5,70	7,20	8,90	2,40	3,30	3,19	1,12	1,50
HRK 1Y yield (average %)	4,09	5,96	7,39	3,81	3,79	3,93	2,52	2,70
HRK 10Y yield (average %)	-	-	-	6,34	6,68	6,67	5,42	5,50

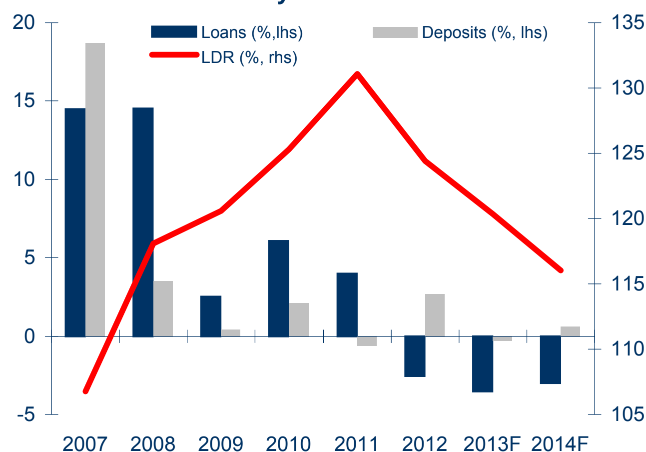
Source: Croatian National Bank, Central Bureau of Statistics, Ministry of Finance, HAAB research

SELECTED BANKING SECTOR DATA

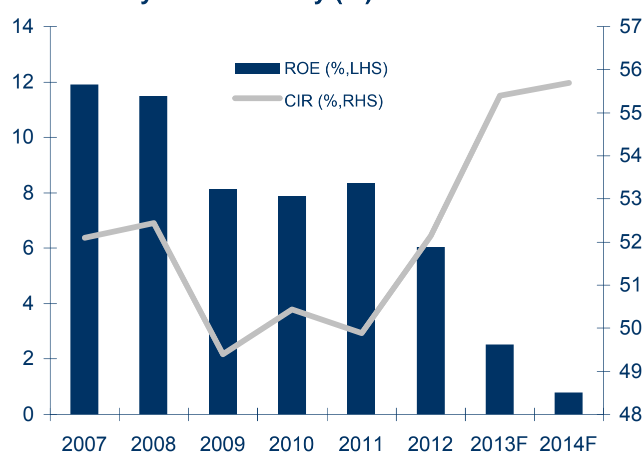
	2007	2008	2009	2010	2011	2012	2013F	2014F
Balance sheet figures and ratios								
Assets (EURm)	46.771	50.233	51.650	53.660	54.943	54.052	52.728	51.779
Loans (EURm)	29.852	34.184	35.040	37.173	38.660	37.668	36.339	35.249
Loans (% YoY)	14,5	14,5	2,5	6,1	4,0	-2,6	-3,5	-3,0
Loans (% of GDP)	68,8	71,9	78,2	83,6	87,0	85,7	82,9	79,7
Deposits (EURm)	27.962	28.946	29.055	29.673	29.495	30.280	30.202	30.383
Deposits (% YoY)	18,7	3,5	0,4	2,1	-0,6	2,7	-0,3	0,6
Deposits (% of GDP)	64,4	60,9	64,9	66,8	66,4	68,9	68,9	68,7
Loans-to-deposit ratio (%)	106,8	118,1	120,6	125,3	131,1	124,4	120,3	116,0
Capital adequacy ratio (%)	16,4	15,2	16,4	18,5	19,2	20,6	21,2	22,0
P&L figures and ratios								
Net interest income (EURm)	1.167,8	1.359,6	1.306,9	1.484,6	1.539,7	1.401,1	1.190,9	1.098,1
Total operating income (EURm)	1.731,4	1.961,9	2.093,7	2.204,4	2.220,3	2.041,7	1.796,7	1.679,9
Net reservations & adjustments (EURm)	128,1	149,9	473,0	509,9	493,8	519,1	607,4	682,7
Pre-tax profit (EBT, EURm)	701,4	783,1	586,4	582,7	618,8	458,1	194,0	61,6
Net interest margin (%)	2,5	2,7	2,5	2,8	2,8	2,6	2,3	2,1
Cost-to-income ratio (%)	52,1	52,4	49,4	50,4	49,9	52,1	55,4	55,7
ROEA (Pre-tax income/equity, %)	11,9	11,5	8,1	7,9	8,3	6,0	2,5	0,8
ROAA (pretax, %)	1,5	1,6	1,1	1,1	1,1	0,8	0,4	0,1
Non-performing loans (%)	4,8	4,9	7,8	11,2	12,4	13,9	16,0	16,7
Cost of risk (% of outstanding bank loans)	0,4	0,4	1,3	1,4	1,3	1,4	1,7	1,9

Highlights: Croatian banks posted 25.7% yoy lower pre-tax profit in 1Q13 driven by ongoing deterioration in NII on the back of subdued interest income and higher funding costs. The former is a function of system-wide de-leveraging (-5.5% yoy FX-adjusted in April) and higher NPL ratio that reached 14.6% in 1Q13. Deposits grew 3.7% yoy thanks to stable households' savings growth and increased corporate deposits. Looking ahead, we think private sector will remain in de-leveraging mode despite recent the CNB efforts aimed at reviving credit activity (O/N deposit rate cut to 0%). Namely, the bigger issues prevail, we think, in investment demand and balance sheet restructuring requirements rather than supply factors. Besides, the announced MinFin's policies to ease citizen's debt burden and the CNB's tightening provisioning requirements could only add to de-leveraging. Consequently, falling operating income and rising provisioning cost will only keep opex optimization in focus going forth.

Balance sheet industry trends



Profitability and efficiency (%)



All sources: Croatian National Bank, HAAB research

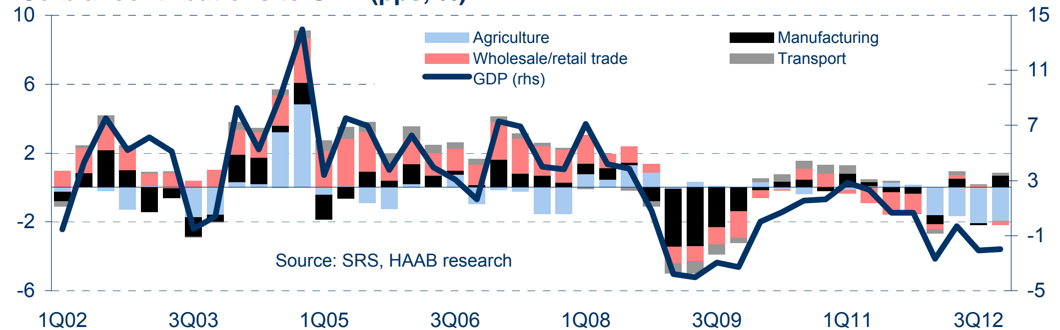
Focus Turns to Fiscal Risks

In 2013, we maintain 0.7% GDP forecast given stronger-than-expected net trade contribution, offsetting delays in public capex. Personal spending remains the weakest link therein. The focus is also on limiting fiscal slippage that have recently fuelled sentiment deterioration and increased rating downgrade risks. We expect the dinar weakening through 2H13 mostly on less carry trades and private de-leveraging.

GDP rebounded in Q1, some sobering likely in Q2

The Q1 GDP (1.9% yoy) rebounded thanks to export-driven net trade improvement and low base effects from 1Q12's weather-inflicted industrial output. Also positive for Q1 performance was that the government secured the lion's share of its near-term (re)financing needs abroad, which reduced crowding-out pressures on private sector and supported the dinar. This alongside higher workers' remittances from abroad cushioned households' spending contraction otherwise driven by rising unemployment, real net wage deflation and fiscal tightening. With less favourable base effects, we see Q2 GDP posting a 1%-alike growth on the back of positive net trade contribution offsetting continued personal expenditure demise, private capex diet, delays to large public infrastructure projects and sentiment deterioration caused by elevated fiscal risks and rating downgrade concerns.

Serbia: contributions to GVA (pps, %)



We still forecast the FY13 GDP at 0.7%, with net trade improvement largely behind

We keep the FY13 0.7% GDP forecast on stronger-than-expected net trade improvement that offsets delays in public investments. A positive net trade contribution is skewed to exports of cars, fuels and a few successful manufacturing stories. Meanwhile, GDP gains in public infrastructure capex are smaller than expected as project launches are delayed, however this also means smaller drag from capital goods imports. The key negative within national accounts is personal spending against real income slump, higher unemployment and credit rationing. We maintain our sub-consensus 2014 GDP forecast before we see how external demand recovery plays out. The EU prospects have darkened with the decision on membership talks likely delayed at least until October-2013, however any advance there would not materially lift investments in the near term as full membership is not on the cards in the foreseeable future. Non-existent IMF back-up due to fiscal slippage is another downside risk for the economy as it could lead to rating downgrade. The cabinet would then be compelled to an even harsher growth-hurting fiscal tightening had it not started earlier. This is more important when observing the narrowness of industrial/export base that needs cheap funds to develop and make economic growth less susceptible to sentiment swings.

C/A gap drops to around 8% of GDP this year

The 4M13 C/A deficit sank 46% yoy to EUR758m largely on lower merchandise trade gap, higher workers' remittances (+19% yoy) and less interest payment. The key drivers of goods trade improvement were car and chemicals exports, offsetting weakness in agriculture and base metals. Although high base effects loom large for car exports through 2H13, we nonetheless see the latter as critical item behind the FY13 C/A gap decline towards 8% of GDP, with a more normal harvest season and the full-year impact of fuels exports out of Pancevo oil refinery adding to the overall exports increase. Even then we maintain a rather conservative approach to export forecasts given the weaker foreign demand prospects. Imports will mark a relatively smaller rise this year as private sector's weakness offsets most of (quasi)sovereign capex-fuelled rise in capital goods imports.

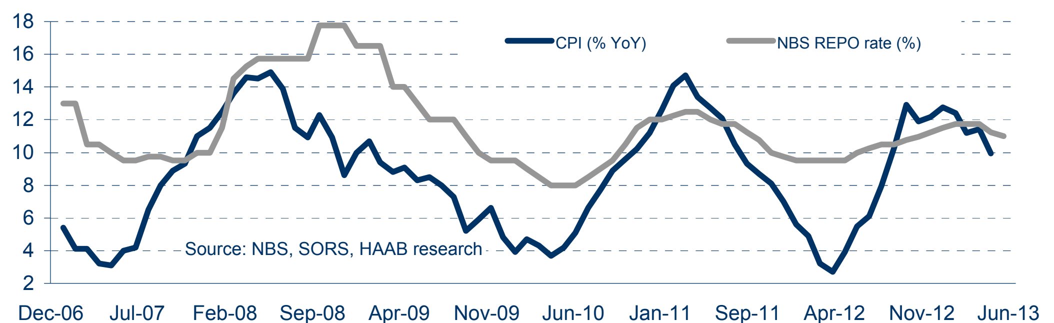
C/A funding mix remains weak, with NBS FX reserves potentially under pressure

Given private-sector de-leveraging (EUR293m in 4M13) and lacklustre FDI, the C/A financing is largely secured by the sovereign borrowing via February's USD1.5bn Eurobond and ~EUR320m non-residents' inflow into high-yielding Serbian T-bills/bonds. Although a few sectors - mostly suppliers in car industry - continue to attract FDI on wage competitiveness, we nevertheless see poor FDI performance elsewhere due to uncertain political and institutional framework in the medium-term that weighs on business prospects. Neither do we see any material support in privatizations, with Telekom Srbije sale again taken off the agenda. The implied 30%-alike FDI cover suggests that portfolio flows remain the dominant channel of the C/A funding in the next quarters, albeit less pronounced given elevated fiscal risks and rating downgrade concerns, possibly exerting pressure on the NBS FX reserves.

CPI lower in 2H13

The recent decline in CPI inflation owed to i) fuels price disinflation, ii) stabilizing food prices and iii) delayed pass-through from the dinar strength, offsetting excise tax hikes on tobacco/alcohol. The next few months will see a bumpy CPI yoy pattern on the long overdue electricity price hike and higher seasonal food prices. From mid-3Q13, we expect inflation to land in just above 6% yoy by end-2013 as high base effects kick in and domestic demand weakness persists. The main offsetting factor is sharper-than-expected dinar depreciation relative to our earlier projections. Gradual recovery of the world's biggest commodity consumers has not lifted commodity price expectations as some key central banks consider tapering QE. All said, we see the FY13 CPI average around 9%, with risks mostly on the upside in case of stronger-than-expected administered price hikes to contain fiscal slippage.

Serbia: CPI inflation and NBS REPO rate



We expect the NBS to cut REPO rate to 9% by end-2013 alongside falling inflation

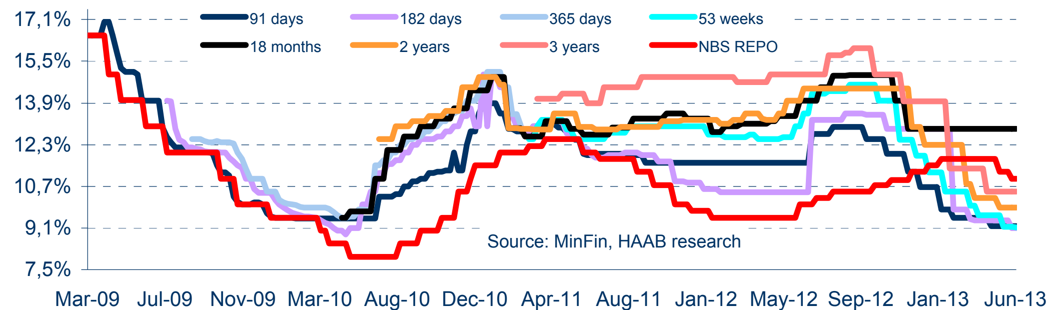
Earlier in Q2 the dinar firmed on i) improved EU prospects, ii) sovereign external borrowing, iii) carry trades and iv) improved goods trade. The NBS curbed the dinar rally around 110/euro by purchasing EUR90m on the market followed by a stronger-than-expected 50bp REPO rate cut in May. The dinar then fell victim to the IMF-stressed fiscal risks that reduced carry trade allure. With the dinar losses also from private external de-leveraging, the NBS sold EUR255m on the market to smooth FX volatility. The short-end dinar rates still fell to record lows as the MinFin covered near-term (re)financing from abroad early in the year and the NBS created liquidity via Eurobond conversions. With internal devaluation seemingly out of the authorities' agenda, we think a further 25bp REPO cut to 11.00% in June (and more to come) suggests the NBS is pursuing nominal adjustment by letting the dinar depreciate. To smooth depreciation pressures, the NBS is gradually reversing Eurobond conversions via small-sized FC sales - our readers may recall this is the same pattern the NBS followed in 1H12 when it reversed conversions of USD 2021.

With downside CPI inflation trajectory ahead, we still expect the NBS to cut the REPO to 9% by end-2013. However, the major difference compared to our hitherto view is that now we see the easing cycle being slower than before, with rate cuts disbursed within a wider time frame to avoid unwanted FX/interest rate volatility against non-existent IMF back-up. This way the NBS would allow CPI inflation to fall faster relative to the pace of rate cuts, implying positive real REPO rate. Assuming a stressed case - not our baseline though - in which de-leveraging-related capital outflows shape a severe dinar weakness of say 10%+ in 2H13 and the government is forced to rely on short-term domestic funding, the NBS could not only hike the REPO rate but also boost banks' liquidity demand by lifting the dinar part of FC component of banks' mandatory reserves.

Dinar faces downside in the rest of 2013

The dinar faces further downside in 2H13 given less carry trade potential amid fiscal risks, no IMF support and slower non-residents' positioning in RSD assets in the event that the RSD depreciation potential eats up nominal returns. Also RSD negative are private external de-leveraging and net trade gains waning out on high base. For now, we do not see non-residents materially reducing exposure in RSD T-bills/bonds as selling these in rather thin secondary market risks sizeable losses, perhaps even greater than from dinar depreciation. Although the NBS is by and large biased to cut rates going forth, we nevertheless see the central bank's role in securing financial stability - via FC sales and/or elevated REPO rates if necessary - as the key factor curbing the dinar slide. The final piece of puzzle is that the government will look for any pocket of sentiment improvement to tap foreign markets again.

Serbia: T-bills/notes yields



RSD yields seen around current levels

In the next months, we see RSD yields around current levels as abundant interbank liquidity and private de-leveraging leave investors without much options, but fiscal risks do not allow further yield compression. Even as the MinFin's T-bills roll-over needs are high in 2H13 (see below), the sovereign's Eurobond considerations cap short-term dinar yields. The NBS will continue to dose liquidity in the system, aiming to avoid FX/interest rate volatility. The short-end RSD yields could inch down in case the sovereign strengthens fiscal credibility. Conversely, we would expect the short-end RSD rates rising to low teens in a stressed case scenario of wider fiscal slippage and the NBS squeezing out liquidity to safeguard the dinar.

Budget rebalance does not fully capture fiscal risks

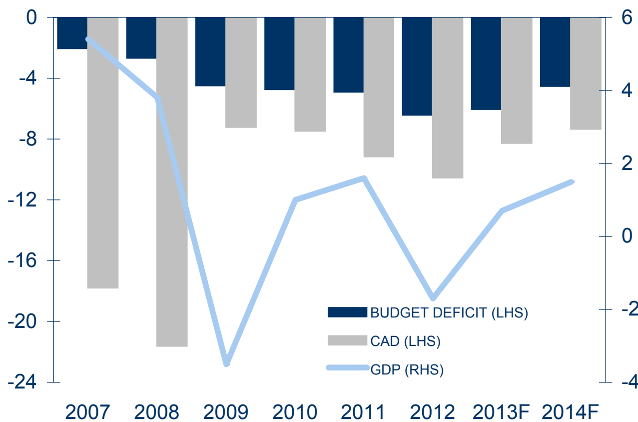
The MinFin's 5M13 data show 14% yoy lower consolidated budget deficit at RSD78.3bn or ~60% of the original FY13 target due to VAT/excise tax undershoot, smaller corporate tax collection and higher social assistance outlays. The recent budget rebalance targeting 1.6pp higher deficit at 5.2%/GDP does not fully capture fiscal risks, in our view, with most adjustment in reduced public capex outlays and subsidies alongside 0.5% public wage/pension hike in October. Indeed, with an ongoing lack of reform content (eg labour flexibility measures adjourned), we see the 2013 fiscal gap at around 6%/GDP given less rosy macro assumptions, no material mandatory spending adjustment and shutdown costs of state owned firms. Moreover, export-led GDP rebound offers the best chance to carry out painful tightening such as public wage/pension adjustments and broadening tax base (eg the IMF-advised 2pp hike to reduced 8% VAT rate), since their virtues could add to competitiveness gains delivered via REER-based dinar depreciation (14% since mid-2010).

Rating downgrade risks increased recently

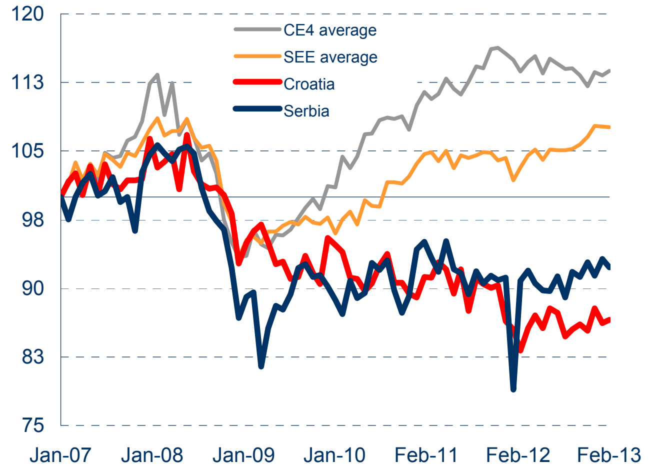
The MinFin's net USD1.9bn overall borrowing to date amid hefty investors' demand - incl T-bills bid/cover 1.9x vs 1.4x in 2012 - secures about three-quarters of 2013 budget deficit, however the MinFin is not in a comfortable seat as the remaining (re)financing must be secured in a more volatile environment. The extent of banks' excess liquidity opens room for more aggressive local borrowing, but in a failure to tap the foreign markets this could come at higher cost given USD1.4bn T-bills roll-over in 2H13. In case T-bills are fully rolled-over, another USD750m Eurobond (vs the MinFin's USD500m plan) could wrap up this year's financing, but the government may be forced to target shorter 5-7Y tenure at 400-500bp spread as fiscal sinners are increasingly penalized by the markets - especially for one of the highest twin-deficits in CESEE - amid halted global hunt for yield after Fed's tapering. Also negative for public borrowing costs are rating downgrade risks as the absence of bold fiscal measures leaves public debt on unsustainable path to just below 70%/GDP in 2013-2014. Indeed, fiscal slippage if accompanied by further delays to start EU talks could prompt rating agencies to downgrade Serbia into B zone. All said, Serbian USD bonds cannot reverse the recent underperformance vs peers until the government bites the bullet on painful measures.

Serbia's data trends

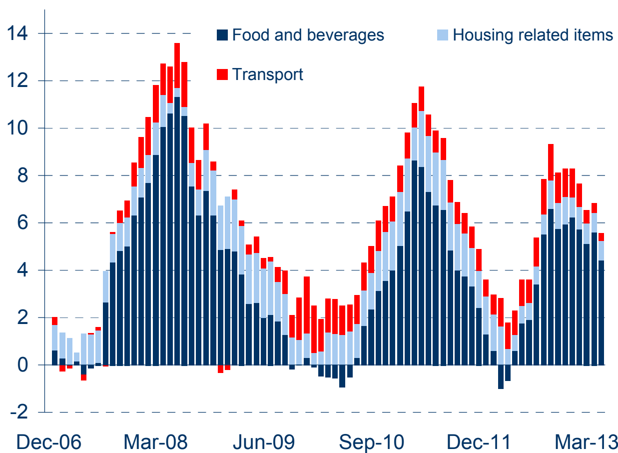
Budget and current account gaps (% of GDP) vs. real GDP growth (%)



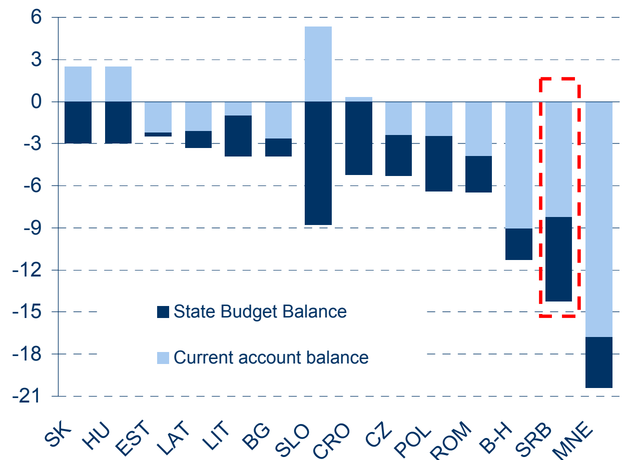
Industrial production Jan-2007=100



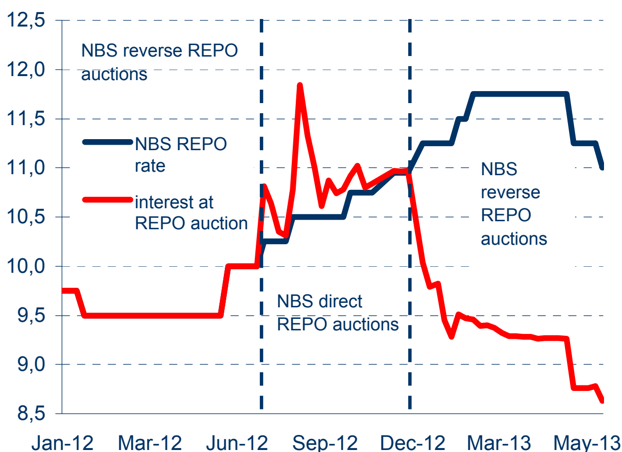
CPI contribution - key categories (pps)



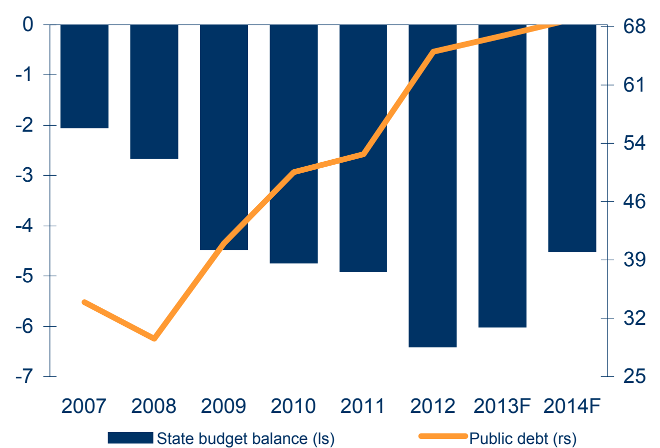
Twin deficits (2013F, % of GDP)



NBS REPO auctions (%)



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	2013F	2014F
Activity								
Nominal GDP (RSDbn, current prices)	2.277	2.661	2.720	2.882	3.209	3.386	3.689	4.013
Nominal GDP (EURbn)	28,5	32,7	29,0	28,0	31,5	29,9	32,1	32,9
Nominal GDP (USDbn)	39,0	47,8	40,3	37,1	43,8	38,4	41,1	41,1
GDP per capita (EUR)	3.857	4.445	3.955	3.841	4.336	4.134	4.503	4.621
GDP per capita (USD)	5.277	6.498	5.499	5.085	6.027	5.307	5.770	5.777
Real GDP (constant prices YoY, %)	5,4	3,8	-3,5	1,0	1,6	-1,7	0,7	1,5
Private consumption (YoY, %)	7,8	6,8	-2,7	-1,0	-1,2	-2,0	-0,9	0,6
Fixed investment (YoY, %)	29,7	8,5	-22,1	-5,5	8,4	-3,4	1,8	4,2
Industrial production (YoY, %)	4,1	1,4	-12,6	2,5	2,1	-2,9	3,2	4,3
Unemployment rate (ILO, average %)	18,1	13,8	16,1	19,2	23,0	24,0	25,5	24,5
Prices								
CPI inflation (average % YoY)	6,5	11,7	8,4	6,5	11,0	7,8	9,0	7,1
CPI inflation (end-year % YoY)	11,0	8,6	6,6	10,2	7,0	12,2	6,2	7,6
PPI inflation (average % YoY)	5,9	12,4	5,6	12,7	14,2	5,6	4,7	7,5
PPI inflation (end-year % YoY)	9,8	9,0	7,4	16,2	9,7	6,4	4,0	8,5
Net wage rates (% YoY, nominal, euros)	34,5	15,8	-16,0	-1,9	12,4	-1,8	1,0	0,5
Fiscal balance (% of GDP)								
State budget balance	-2,0	-2,6	-4,5	-4,7	-4,9	-6,4	-6,0	-4,5
Public debt	34,1	29,6	41,3	49,9	52,2	64,7	66,7	68,7
External balance								
Export of goods and services (EURbn)	8,687	10,157	8,478	10,070	11,472	11,912	12,865	13,765
Import of goods and services (EURbn)	-16,016	-18,843	-13,578	-14,838	-16,627	-17,210	-17,778	-18,596
Merchandise trade balance (EURbn)	-7,069	-8,501	-5,118	-4,774	-5,318	-5,451	-5,365	-5,386
Merchandise trade balance (% of GDP)	-24,8	-26,0	-17,7	-17,0	-16,9	-18,2	-16,7	-16,4
Remittances, net (EURbn)	2.134	1.770	2.668	2.422	2.110	1.989	2.188	2.341
Current account balance (EURbn)	-5,053	-7,054	-2,084	-2,082	-2,870	-3,156	-2,640	-2,404
Current account balance (% of GDP)	-17,7	-21,6	-7,2	-7,4	-9,1	-10,5	-8,2	-7,3
Net FDI (EURbn)	1,8	1,8	1,4	0,9	1,8	0,2	0,8	0,8
FDI (% of GDP)	6,4	5,6	4,7	3,1	5,8	0,8	2,5	2,4
FDI cover (%)	36,0	25,9	65,8	41,3	63,7	7,7	30,3	33,3
Gross international reserves (EURbn)	9,634	8,162	10,602	10,002	12,058	10,914	10,247	10,168
Import cover (months of imports)	7,2	5,2	9,4	8,1	8,7	7,6	6,9	6,6
Debt indicators								
Gross external debt (EURbn)	17,139	21,088	22,487	23,786	24,125	25,721	26,094	26,819
Government (EURbn)	6,285	6,521	7,764	9,076	10,773	12,187	13,436	14,311
Private (EURbn)	10,854	14,568	14,724	14,710	13,352	13,534	12,658	12,508
Gross external debt (% of GDP)	60,2	64,6	77,7	84,9	76,7	85,9	81,4	81,5
Gross external debt (% of exports)	197,3	207,6	265,3	236,2	210,3	215,9	202,8	194,8
Exchange rates and money growth								
USD/RSD (end-year)	53,73	62,90	66,73	79,28	80,87	86,18	97,18	98,96
USD/RSD (average)	58,39	55,76	67,47	77,91	73,34	88,12	89,79	97,55
EUR/RSD (end-year)	79,24	88,60	95,89	105,50	104,64	113,72	120,50	124,20
EUR/RSD (average)	79,96	81,44	93,95	103,04	101,95	113,13	115,05	121,94
Money supply M1 (% YoY)	24,0	-13,5	-0,8	-10,9	16,9	-3,3	-0,7	2,0
Broad money M3 (% YoY)	42,0	-1,8	12,3	2,6	11,2	0,7	1,7	3,4
Domestic credit (% YoY, euros)	40,0	20,8	7,4	15,3	8,9	0,9	-3,2	0,5
NBS REPO (average %)	10,38	14,67	13,08	9,13	11,54	10,14	10,65	10,50
NBS REPO (end-year %)	10,00	17,75	9,50	11,50	9,75	11,25	9,00	11,00
6M BELIBOR interest rate (average %)	11,34	15,68	14,52	11,00	13,13	11,96	11,05	11,50

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

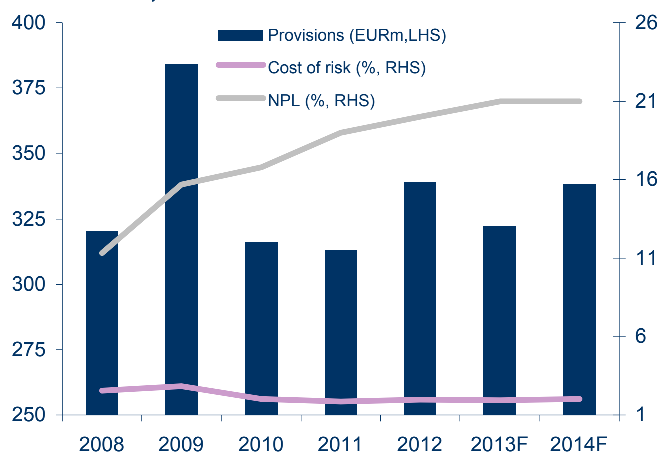
SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011	2012	2013F	2014F
Balance sheet figures and ratios								
Assets (EURm)	16.072	20.055	22.530	24.015	25.324	25.093	24.541	24.590
Loans (EURm)	10.442	12.609	13.544	15.621	17.013	17.162	16.613	16.696
Loans (% YoY)	40,0	20,8	7,4	15,3	8,9	0,9	-3,2	0,5
Loans (% of GDP)	36,7	38,6	46,8	55,8	54,1	57,3	51,9	50,8
Deposits (EURm)	10.299	10.019	11.440	11.897	13.099	13.309	13.442	13.711
Deposits (% YoY)	50,3	-2,7	14,2	4,0	10,1	1,6	1,0	2,0
Deposits (% of GDP)	36,2	30,7	39,5	42,5	41,6	44,5	42,0	41,7
Loans-to-deposit ratio (%)	101,4	125,9	118,4	131,3	129,9	129,0	123,6	121,8
Capital adequacy ratio (%)	27,9	21,9	21,4	20,0	19,1	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	996	998
Total operating income (EURm)	1.986	1.820	1.598	1.541	1.590	1.484	1.454	1.451
Net reservations & adjustments (EURm)	n/a	320,3	384,4	316,3	312,9	339,2	322,2	338,3
Pre-tax profit (EBT, EURm)	294	429	213	246	304	231	237	222
Net interest margin (%)	6,5	5,9	5,2	4,6	4,5	4,1	4,0	4,1
Cost-to-income ratio (%)	n/a	58,8	62,6	63,5	61,2	61,5	61,5	61,4
ROEA (Pre-tax income/equity, %)	8,5	9,1	4,7	5,8	6,0	4,6	4,8	4,5
ROAA (pretax, %)	1,7	2,1	1,0	1,1	1,2	0,9	1,0	0,9
Non-performing loans (%)	5,1	11,3	15,7	16,8	19,0	20,0	21,0	21,0
Cost of risk (% of outstanding bank loans)	n/a	2,5	2,8	2,0	1,8	2,0	1,9	2,0

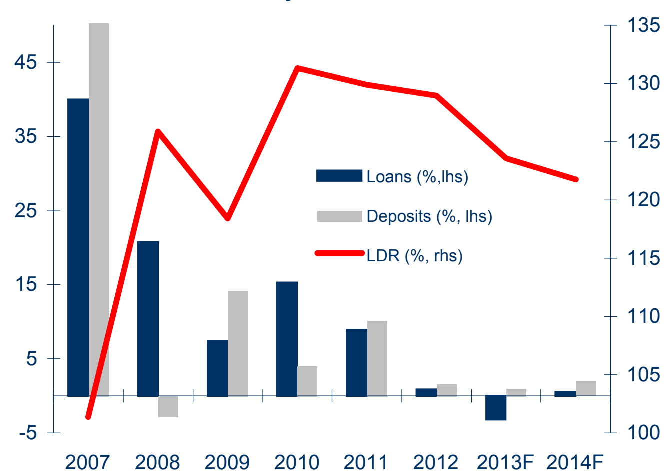
** Excluding Agrobanka*

Highlights: Serbian bank's 1Q13 pre-tax profit grew 12.8% yoy on lower provisioning (-24.0% yoy) and opex (-1.1% yoy). Still, NPL continued to rise reaching almost 20.0% at end-2012 given corporate liquidity contraction particularly in construction and manufacturing sectors. Interest income was down by 2.3% yoy, whereby slide in interest expense outpaced the interest income drop by 260bp, preserving NII from deeper drop. Credit activity has been slowing down since end-2012 to 0.0% yoy fx adjusted growth rate in April (+1.6% in March). We expect further decrease of credit stock, in an absence of subsidized loans in 2013, potential selling of banking bad loans and faster de-leveraging this year (EUR350m in 1Q13 following EUR535m through 2012). Deposits in euro terms have stagnated in the year to date, primarily thanks to corporate deposits drop by 1%. Some state banks undergone process of liquidation and acquisitions, and we still expect to see further banking consolidation in 2013.

Provisions, cost of risk & NPL



Balance sheet industry trends



All sources: National Bank of Serbia, HAAB research

Minding the Must-Do's

In 2013, forecast GDP stagnation given higher public capex, non-existent net trade contribution and weak personal spending. The ongoing fiscal consolidation is the key to secure the IMF support, with the importance of medium-term structural reforms gaining more traction. The C/A funding mix remains weak as IFI money covers most of external (re)financing.

Industrial production rises on capacity reallocations from Croatia and energy generation

High frequency data suggest the economy is gradually bottoming out, with industrial production growth in high single-digits led by non-durable goods and weather-boosted energy generation. The former reflects Croatian producers' capacity reallocations - notably food processing - before Croatia's exit from favourable CEFTA agreement upon the EU entry. Merchandise trade trends also improved, with 700bp yoy higher import cover at 56.8% (on 3mma basis) in May mirroring stronger exports. Meanwhile, private consumption remains depressed by rising unemployment, real net wage decline and fiscal tightening.

We forecast GDP stagnation in 2013, domestic demand stay weak

Adjusting for better-than-expected 2012 GDP outcome, we now see GDP stagnation in 2013 on IFI-funded public investments in road infrastructure and mining facilities. Meanwhile, private capex falls victim to scarce and expensive funding, and weak profit prospects. We, however, expect non-existent net trade contribution as stronger SEE-directed exports upon Croatian producers' capacity reallocations are partly offset by export losses towards Croatia after its CEFTA exit. Capital goods for public capex will lift imports, but the rebound is still limited by domestic demand weakness elsewhere. Private consumption stays the weakest link given higher unemployment, falling real disposable income and private de-leveraging. Risks to our view are mostly on the downside in case external demand deteriorates and/or political risks gain traction, endangering IMF support. Downside risks also include potentially more capacity reductions, notably in metals sector, with the shut-down of loss-making aluminium smelter Aluminij Mostar adjourned by political decision.

Fiscal consolidation is the key to funds' access

The government plans 0.5pp lower consolidated budget deficit at 2.0%/GDP largely on 1% reduction in public wage bill and sizeable one-off dividend payment of state-owned electricity utility Transco (0.4%/GDP), offsetting higher capex outlays. However, we see slower fiscal consolidation mostly due to weaker macro assumptions alongside possible slippage in public wage bill cuts. VAT hikes remain an option in case fiscal slippage endangers access to IFI money. The latest policy moves highlighted FB-H's 30% reduction of privileged pensions on average. With the labour market still not improving, the importance of medium-term structural reforms has gained more traction, especially within entitlement rights by penalizing early retirement, rationalizing health-care spending and controlling local government/off-budget expenditure.

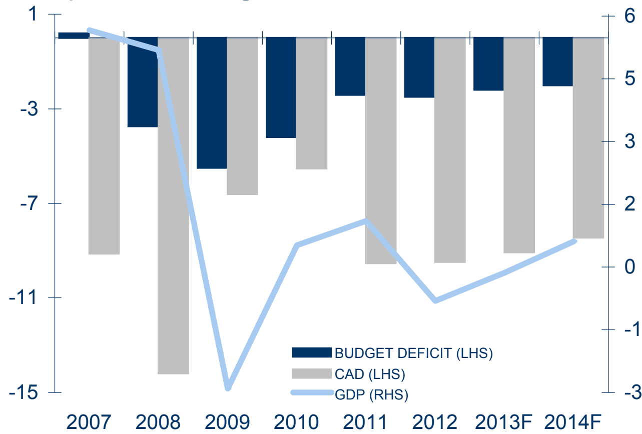
IFI funds cover most of this year's gross public financing needs (~3% of GDP), however delays to the third EUR40m SBA tranche - that was eventually paid in early May - saw RS rolling over BAM44m/EUR22m T-bills maturities at ~20bp higher spreads over Euribor (362bp on average) than in Q1. There are BAM102m/EUR52m overall T-bill maturities in 2H13 with RS' part twice as large than that in FB-H. Assuming the IMF support in place that also secures the EU's EUR100m loan as well as 'B' credit rating, we see local debt roll-over at around current spread levels. Also underlying our view is that the local investors are left without much alternatives given private credit weakness.

C/A deficit inches lower in 2013, inflation expected to fall below 2% on average

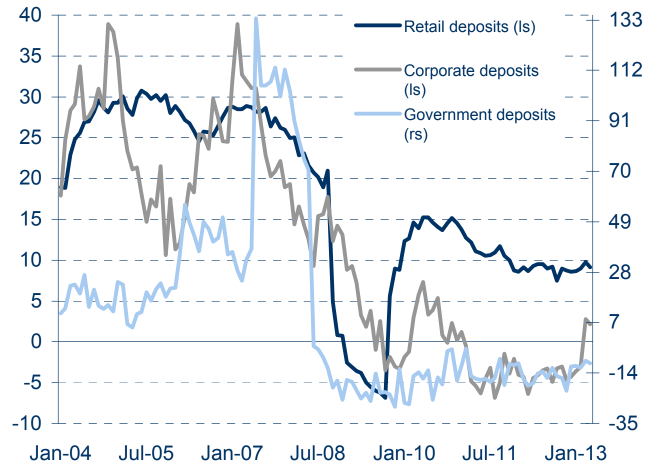
This year, we forecast the C/A deficit merely inching lower to around 9% of GDP as goods exports growth outpaces imports only slightly. Also pulling the CAD down are workers' remittances rising on better income dynamics at the key source markets. The C/A funding mix remains weak, with a low 30%-alike FDI cover against halted privatization, no access to global financial markets and consequently most cards played on IFI money to cover most of 13%/GDP gross external (re)financing needs. Meanwhile, this year's CPI inflation average falls below 2% on high base effects in food prices and domestic demand weakness. While global commodity prices seem capped by less monetary stimulus by key central banks, upside risks to our view can arrive on excise tax hikes to comply with the IMF's targets.

Bosnia and Herzegovina's data trends

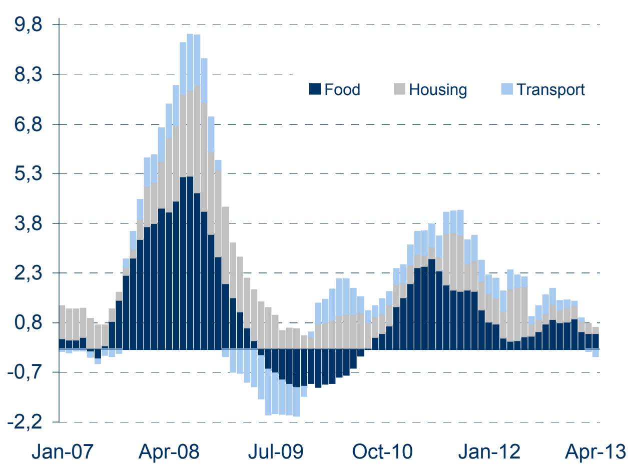
Budget and current account gaps (% of GDP) vs. real GDP growth



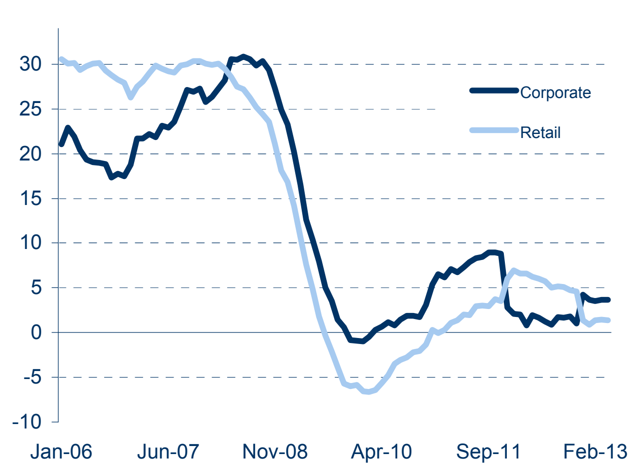
Deposits growth (%, YoY)



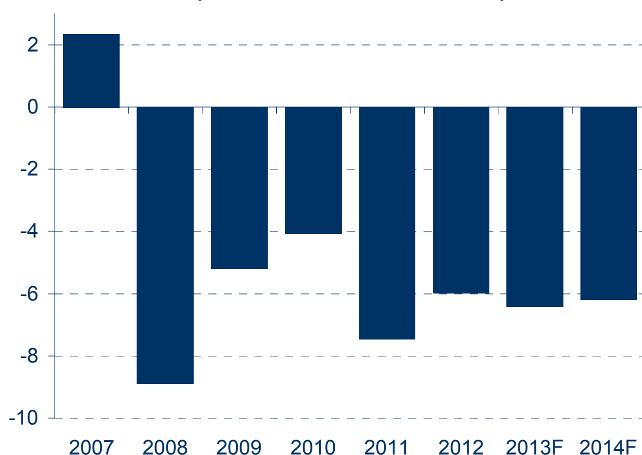
Key CPI contributions (pp)



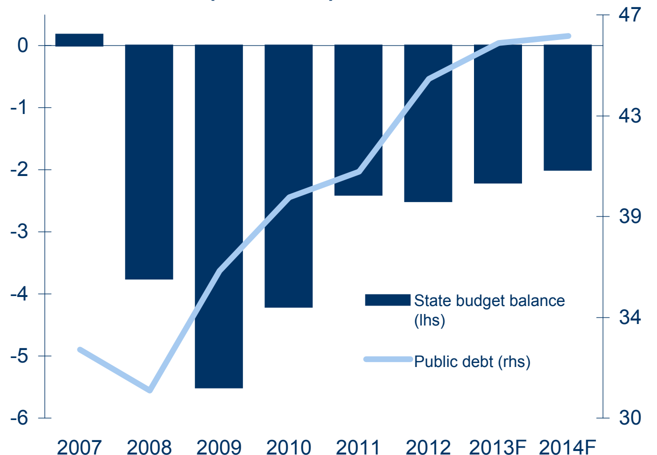
Private credit dynamics (%, YoY)



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	2013F	2014F
Activity								
Nominal GDP (BAMbn, current prices)	21,8	24,8	24,1	24,6	25,5	25,9	26,3	27,3
Nominal GDP (EURbn)	11,2	12,7	12,3	12,6	13,0	13,2	13,4	14,0
Nominal GDP (USDbn)	15,3	18,6	17,2	16,7	18,1	17,0	17,2	17,5
GDP per capita (EUR)	2.906	3.295	3.200	3.296	3.417	3.445	3.498	3.634
GDP per capita (USD)	3.976	4.821	4.449	4.365	4.753	4.430	4.483	4.542
Real GDP (constant prices YoY, %)	6,1	5,6	-2,9	0,7	1,3	-0,7	0,0	0,8
Private consumption (YoY, %)	n/a	n/a	-2,4	-0,1	3,2	-1,2	-0,4	0,3
Fixed investment (YoY, %)	n/a	n/a	-21,4	-15,9	-7,7	2,3	1,0	3,4
Industrial production (YoY, %)	8,6	7,9	-3,3	1,6	5,6	-5,2	2,7	2,3
Unemployment rate end-year (ILO, %)	29,0	23,4	24,1	27,2	27,6	28,0	29,2	28,6
Prices								
CPI inflation (average % YoY)	1,5	7,5	-0,4	2,1	3,7	2,1	1,6	3,0
CPI inflation (end-year % YoY)	5,0	3,8	0,0	3,1	3,1	1,8	2,8	2,7
PPI inflation (average % YoY)	n/a	8,6	-3,2	0,9	3,7	1,5	1,8	2,5
PPI inflation (end-year % YoY)	3,4	6,2	-3,5	4,0	1,4	0,9	3,2	1,9
Net wage rates (% YoY, nominal)	10,1	16,6	5,2	1,3	2,0	1,2	0,0	1,0
Fiscal balance (% of GDP)								
State budget balance	0,2	-3,8	-5,5	-4,2	-2,4	-2,5	-2,2	-2,0
Public debt	32,9	31,2	36,2	39,3	40,4	44,3	45,8	46,1
External balance								
Export of goods and services (EURbn)	2,980	3,353	3,071	3,700	4,111	4,031	4,124	4,274
Import of goods and services (EURbn)	-6,363	-7,586	-6,080	-6,498	-7,307	-7,292	-7,365	-7,501
Merchandise trade balance (EURbn)	-4,568	-5,453	-3,981	-3,901	-4,267	-4,318	-4,241	-4,227
Merchandise trade balance (% of GDP)	-40,9	-43,1	-32,4	-31,0	-32,8	-32,6	-31,6	-30,3
Remittances (EURbn)	1,417	1,289	1,028	1,015	1,027	1,066	1,076	1,100
Current account balance (EURbn)	-1,019	-1,795	-0,813	-0,695	-1,242	-1,253	-1,219	-1,181
Current account balance (% of GDP)	-9,1	-14,2	-6,6	-5,5	-9,5	-9,5	-9,1	-8,5
Net FDI (EURbn)	1,3	0,7	0,2	0,2	0,3	0,5	0,4	0,3
FDI (% of GDP)	11,5	5,3	1,4	1,5	2,1	3,5	2,7	2,3
FDI cover (%)	125,8	37,5	21,7	26,8	21,9	37,1	29,5	27,1
Gross international reserves (EURbn)	3,425	3,219	3,176	3,302	3,285	3,327	3,056	2,860
Import cover (months of imports)	6,5	5,1	6,3	6,1	5,4	5,5	5,0	4,6
Debt indicators								
Gross external debt (EURbn)	5,806	5,823	6,763	6,486	6,382	6,869	7,006	7,221
Government (EURbn)	2,025	2,168	4,083	3,193	3,373	3,653	3,888	4,188
Private (EURbn)	3,780	3,655	2,681	3,293	3,009	3,216	3,119	3,034
Gross external debt (% of GDP)	52,0	46,0	55,0	51,6	49,0	51,9	52,1	51,7
Gross external debt (% of exports)	194,8	173,7	220,2	175,3	155,3	170,4	169,9	169,0
Exchange rates and money growth								
USD/BAM (end-year)	1,34	1,40	1,37	1,46	1,51	1,48	1,58	1,56
USD/BAM (average)	1,43	1,33	1,40	1,47	1,40	1,52	1,53	1,56
EUR/BAM (end-year)	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
Money supply M1 (% YoY)	20,9	-0,7	-2,6	6,4	4,8	-0,7	-0,2	0,5
Broad money M2 (% YoY)	20,7	4,1	2,2	7,2	5,8	3,4	1,6	2,9
Domestic credit (% YoY)	28,8	22,4	-3,2	3,5	5,3	4,1	-0,1	1,3
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,18	0,30

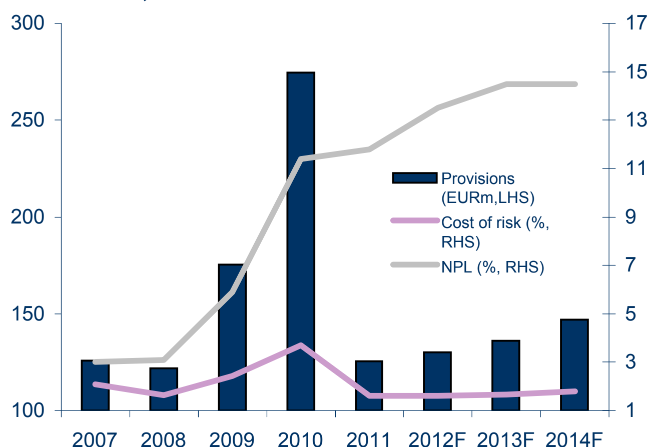
Source: Central Bank of Bosnia and Herzegovina, The Agency for Statistics, IMF, Ministry of Finance, HAAB research

SELECTED BANKING SECTOR DATA

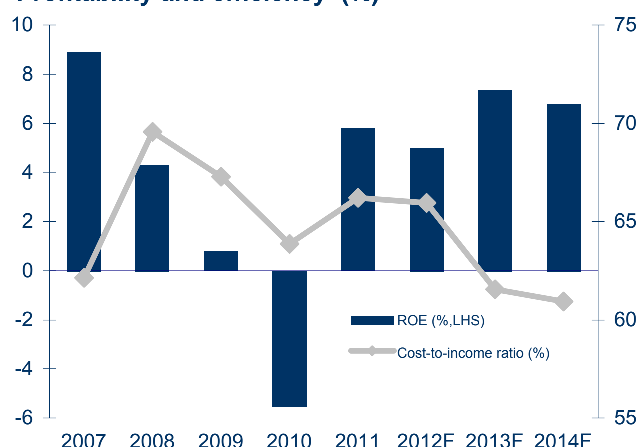
	2007	2008	2009	2010	2011	2012	2013F	2014F
Balance sheet figures and ratios								
Assets (EURm)	10.023	10.798	10.742	10.828	11.196	11.414	11.357	11.494
Loans (EURm)	6.060	7.419	7.184	7.436	7.828	8.151	8.140	8.246
Loans (% YoY)	28,8	22,4	-3,2	3,5	5,3	4,1	-0,1	1,3
Loans (% of GDP)	54,3	58,6	58,4	59,2	60,1	61,6	60,6	59,1
Deposits (EURm)	6.180	6.072	6.183	6.407	6.643	6.814	6.886	7.051
Deposits (% YoY)	37,9	-1,8	1,8	3,6	3,7	2,6	1,1	2,4
Deposits (% of GDP)	55,4	48,0	50,3	51,0	51,0	51,5	51,2	50,5
Loans-to-deposit ratio (%)	98,0	122,2	116,2	116,1	117,8	119,6	118,2	116,9
Capital adequacy ratio (%)	17,1	16,3	16,1	16,2	17,1	17,0	17,5	18,0
P&L figures and ratios*								
Net interest income (EURm)	333,5	358,3	361,8	365,7	395,8	388,7	378,2	382,0
Total operating income (EURm)	554,9	585,0	581,0	608,9	620,5	610,5	595,3	598,2
Net reservations & adjustments (EURm)	125,7	122,0	175,2	274,6	125,4	130,1	136,0	146,9
Pre-tax profit (EBT, EURm)	84,4	56,2	14,9	-54,6	84,3	77,9	93,0	86,9
Net interest margin (%)	3,3	3,3	3,4	3,4	3,5	3,4	3,3	3,3
Cost-to-income ratio (%)	62,1	69,5	67,3	63,9	66,2	65,9	61,5	60,9
ROEA (Pre-tax income/equity, %)	8,9	4,3	0,8	-5,5	5,8	5,0	7,4	6,8
ROAA (pretax, %)	0,8	0,5	0,1	-0,6	0,7	0,6	0,8	0,8
Non-performing loans (%)	3,0	3,1	5,9	11,4	11,8	13,5	14,5	14,5
Cost of risk (% of outstanding bank loans)	2,1	1,6	2,4	3,7	1,6	1,6	1,7	1,8

Highlights: B-H banks recorded 47% yoy higher pre-tax profit in 1Q13 thanks to lower opex and provisioning. The former mostly came on intensified branch optimization and headcount cuts. Operating income was flat as 1.5% yoy drop in NII was annulled by increase in non-interest income. Loans grew 1.1% ytd in April mostly on the wings of corporate and public sector, while households' credit stagnated. However, asset quality continued to deteriorate as NPLs grew to 13.8% in 1Q13 driven by corporate segment (notably, construction and agriculture firms). Deposits grew modestly (+0.85% ytd) courtesy of stable citizens' savings and further outflow of government deposits. Going forth, we see a stagnant lending activity in 2013 as rising unemployment will weigh on citizens' debt appetite, while firms' restructuring will restrain new investments. Nevertheless, B-H banking system remains stable due to its resilient capital buffer depicted in CAR of 17.2%, well above regulatory minimum of 12%.

Provisions, cost of risk & NPL



Profitability and efficiency (%)



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

Two Sides of the Same Coin

In 2013, we expect GDP to creep up on stronger personal spending largely influenced by tourism-related income. Private capex remains the weakest link within national accounts, even with some tourism/energy investment plans for late 2013. Fiscal consolidation is enforced with July's 2pp VAT hike, however we still see fiscal slippage.

Industrial rebound is driven by electricity generation, while metals sector remains a drag on activity

The recent rebound in industrial production growth to mid-teens largely owed to electricity generation amid favourable weather conditions and low base effects. A few smaller production sectors such as chemicals, rubber and paper industry contributed positively to industrial output as well. Elsewhere, the activity continued to falter, notably in metals sector. High frequency data also show net trade improvement, with lower merchandise trade deficit as a combination of electricity-led exports spike and lower imports reflecting investment diet. Retail trade growth maintains pace around mid-single digits, with tourism-related income and retail credit generation offsetting higher unemployment and net wage deflation.

We expect GDP to inch up this year thanks to tourism

In 2013, we see 0.4% GDP growth largely on the back of stronger households' expenditure, with tourism-related income offsetting fiscal tightening. An even firmer private spending is prevented by further destaffing especially in labour intensive industries where labour cost - the key element of competitiveness - is affected by 10pp minimum wage hike. Despite some projects planned in tourism/energy for late 2013, private capex is still expected to be the biggest drag on GDP headline as industrial sector is by and large in restructuring mode and payment arrears weigh on the activity. Whatsoever, investments will firstly lift capital goods and service imports, thus nullifying tourism-driven export gains for a non-existent contribution of net trade in GDP formation. However, once new tourism capacities are put to work, this will further improve the economy's balance of services and generate net trade gains.

Fiscal consolidation is further enforced by 2pp VAT hike

The MinFin's 5M13 data show 45% yoy lower budget deficit largely on 20% higher VAT intake and better tax discipline. The budget gap was further reduced by almost halved procurement spending and subsidy cuts for ailing producers. Efforts to decrease fiscal deficit are further targeted via July's 2pp VAT hike to 19%, which is still substantially lower than in other SEE economies. More importantly, tourism-related activities are still taxed with the lower 7% VAT rate, essentially mirroring the economy's concentration on services-driven growth model. However, the 0.4pp lower budget deficit target (2.3%/GDP) is still out of reach as we assume less optimistic macro backdrop, modest effectiveness of higher VAT rate accounting for only half of consumers' spending basket, and the producing sector's payment arrears limit higher VAT gains. Furthermore, with additional funding support for ailing aluminium smelter KAP (incl guarantee calls) and fiscal rules effective only in 2014, we forecast public debt rising to just below 60%/GDP this year.

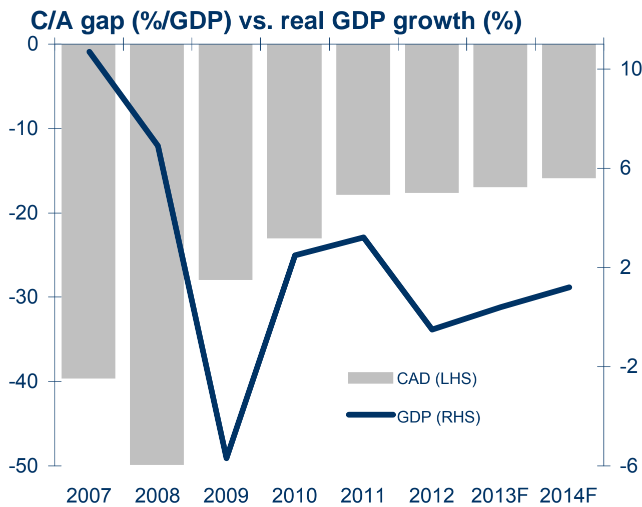
CPI inflation rises mostly on VAT hike

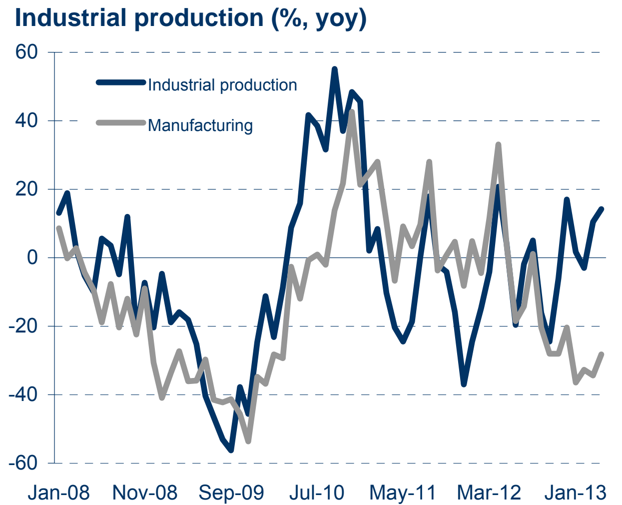
The recent decline in CPI inflation to just above 2% yoy largely owed to high base effects in food prices, fuels prices and the last year's excise tax hikes on tobacco and alcohol. The next few months will see CPI inflation rebound due to 2pp VAT hike and additional tobacco excise tax hikes, with even higher base effects curbing inflation speed-up to some extent. That said, we have revised our FY13 inflation average forecast upwards to just above 3%. Expectations over the global commodity prices are nested between mixed recovery signals for the biggest commodity consuming economies and less easing by the key central banks.

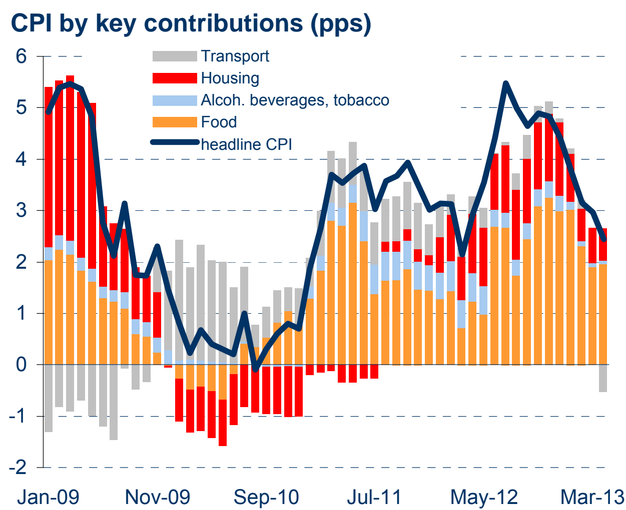
C/A gap falls on stronger tourism and energy exports

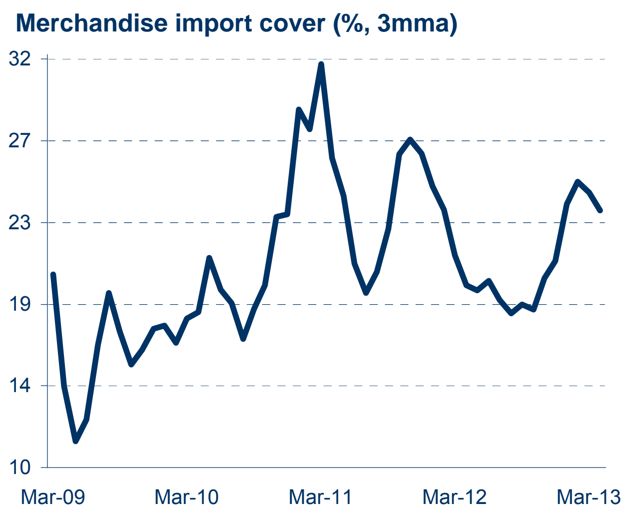
The key driver of the FY13 C/A deficit decline to 17% of GDP are tourism exports as nearby Croatia's introduction of visa regime for some of its thriving source markets has transferred tourists to nearby destinations, incl Montenegro. Also, energy exports add to better picture given favourable weather conditions and reduced KAP's demand. Industrial restructuring and consumers' rationing weigh on imports, however investments in tourism and energy will lift capital goods imports. Although accelerated fiscal consolidation improves investment environment, the economy must see more structural reforms, notably liquidating non-profit business before FDI improves materially. With gross external (re)financing needs at around 30% of GDP, application for the IMF back-up remains an option if considering EUR200m Eurobond issue, that could be priced within 400-500bp spreads.

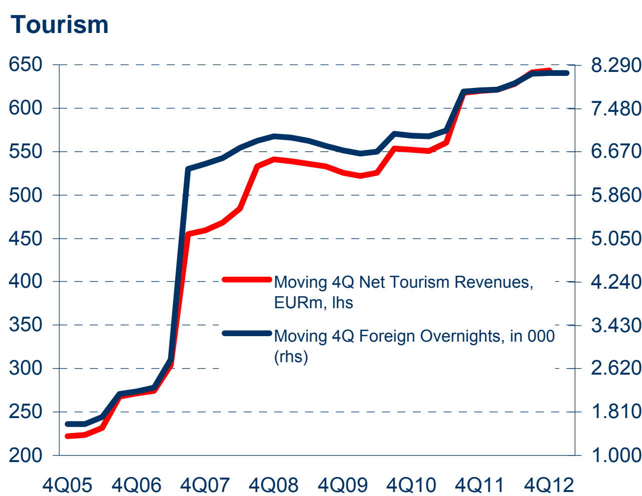
Montenegrin data trends

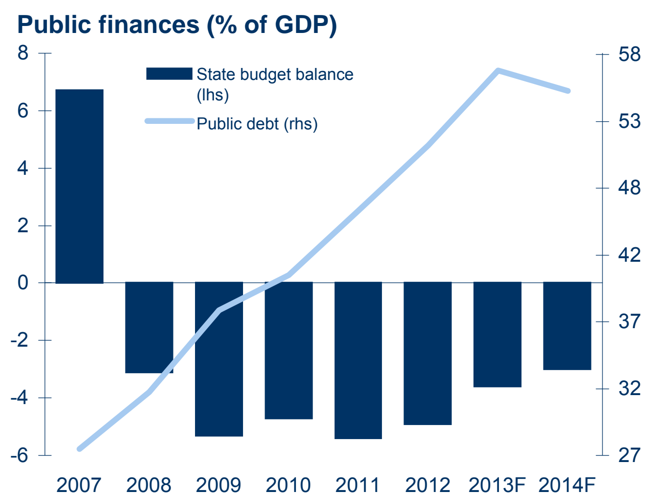












Source: Montenegrin National Bank, MONSTAT, Ministry of Finance, IMF, HAAB research

SELECTED ECONOMIC FORECASTS

	2007	2008	2009	2010	2011	2012	2013F	2014F
Activity								
Nominal GDP (EURbn, current prices)	2,7	3,1	3,0	3,1	3,2	3,3	3,5	3,6
Nominal GDP (USDbn)	3,7	4,5	4,2	4,1	4,5	4,3	4,4	4,6
GDP per capita (EUR)	4.282	4.907	4.720	5.011	5.211	5.346	5.543	5.828
GDP per capita (USD)	5.870	7.219	6.584	6.648	7.257	6.875	7.102	7.286
Real GDP (constant prices YoY, %)	10,7	6,9	-5,7	2,5	3,2	-0,5	0,4	1,2
Private consumption (YoY, %)	n/a	n/a	n/a	n/a	n/a	2,4	1,0	1,0
Fixed investment (YoY, %)	n/a	n/a	n/a	n/a	n/a	-2,5	-1,0	2,1
Industrial production (YoY, %)	0,1	-2,0	-32,2	17,5	-10,3	-9,7	-2,5	1,9
Unemployment rate (ILO, average %)	19,4	16,8	19,1	19,7	19,7	19,7	20,7	20,4
Prices								
CPI inflation (average % YoY)	4,3	8,6	3,4	0,5	3,3	4,0	3,3	3,9
CPI inflation (end-year % YoY)	7,7	7,2	1,5	0,7	3,0	4,4	4,8	2,3
PPI inflation (average % YoY)	8,5	14,0	-3,9	-0,9	3,2	5,7	2,9	1,1
PPI inflation (end-year % YoY)	14,5	7,1	-3,4	0,4	1,0	5,4	0,4	2,2
Net wage rates (% YoY, nominal)	19,9	23,1	11,3	3,5	1,0	0,7	0,0	1,3
Fiscal balance (% of GDP)								
State budget balance (ESA-95)	6,7	-3,1	-5,3	-4,7	-5,4	-4,9	-3,6	-3,0
Public debt	27,5	31,9	38,2	40,9	45,9	50,9	56,7	55,1
External balance								
Export of goods and services (EURbn)	1,156	1,226	1,028	1,158	1,383	1,389	1,422	1,488
Import of goods and services (EURbn)	-2,306	-2,881	-1,949	-1,961	-2,100	-2,166	-2,197	-2,258
Merchandise trade balance (EURbn)	-1,544	-2,025	-1,322	-1,267	-1,306	-1,389	-1,405	-1,432
Merchandise trade balance (% of GDP)	-57,6	-65,6	-44,3	-40,8	-40,4	-41,5	-40,5	-39,2
Tourism receipts (EURbn)	0,460	0,541	0,526	0,552	0,619	0,643	0,666	0,706
Current account balance (EURbn)	-1,059	-1,535	-0,830	-0,710	-0,573	-0,587	-0,583	-0,575
Current account balance (% of GDP)	-39,5	-49,8	-27,9	-22,9	-17,7	-17,5	-16,8	-15,8
Net FDI (EURbn)	0,6	0,6	1,1	0,6	0,4	0,5	0,4	0,4
FDI (% of GDP)	21,2	18,9	35,8	17,8	12,0	13,6	12,2	10,1
FDI cover (%)	53,6	37,9	128,5	77,7	67,9	77,3	72,9	64,4
Gross international reserves (EURbn)	0,468	0,313	0,397	0,416	0,303	0,348	0,513	0,468
Import cover (months of imports)	2,4	1,3	2,4	2,5	1,7	1,9	2,8	2,5
Debt indicators								
Gross external debt (EURbn)	1,986	2,802	2,787	2,992	3,231	3,420	3,744	3,904
Government (EURbn)	0,461	0,481	0,701	0,913	1,054	1,335	1,697	1,999
Private (EURbn)	1,525	2,320	2,087	2,080	2,177	2,085	2,047	1,905
Gross external debt (% of GDP)	74,1	90,8	93,5	96,4	99,9	102,2	107,9	107,0
Gross external debt (% of exports)	171,8	228,4	271,2	258,5	233,7	246,2	263,4	262,3
Exchange rates and money growth								
EUR/USD (end-year)	1,46	1,40	1,43	1,34	1,30	1,32	1,24	1,26
EUR/USD (average)	1,37	1,47	1,39	1,33	1,39	1,29	1,28	1,25
Money supply M1 (% YoY)*	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
Domestic credit (% YoY)	n/a	n/a	n/a	-4,8	-6,3	-0,7	5,0	5,0
ECB reference rate (end-year %)	4,00	2,50	1,00	1,00	1,00	0,75	0,25	0,25
EURIBOR 3M interest rate (average %)	4,27	4,64	1,22	0,81	1,39	0,58	0,18	0,30

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

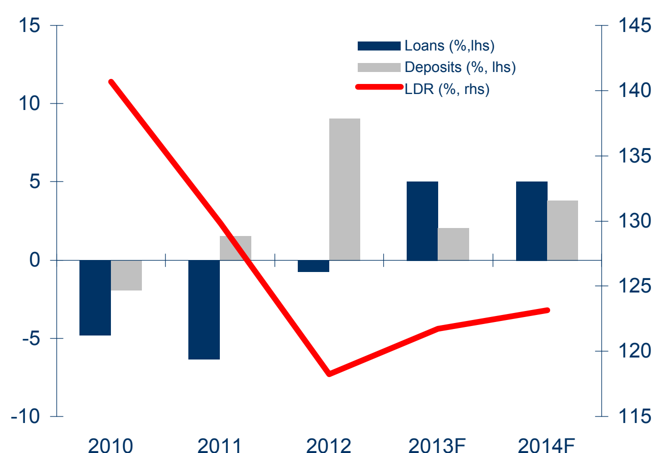
SELECTED BANKING SECTOR DATA

	2007	2008	2009	2010	2011	2012	2013F	2014F
Balance sheet figures and ratios								
Assets (EURm)	n/a	n/a	3.025	2.944	2.810	2.808	2.911	3.009
Loans (EURm)	n/a	n/a	2.644	2.518	2.359	2.342	2.460	2.583
Loans (% YoY)	n/a	n/a	n/a	-4,8	-6,3	-0,7	5,0	5,0
Loans (% of GDP)	n/a	n/a	88,7	81,1	72,9	70,0	0,0	0,0
Deposits (EURm)	n/a	n/a	1.825	1.790	1.817	1.981	2.021	2.097
Deposits (% YoY)	n/a	n/a	n/a	-1,9	1,5	9,0	2,0	3,8
Deposits (% of GDP)	n/a	n/a	61,2	57,7	56,2	59,2	58,2	57,5
Loans-to-deposit ratio (%)	n/a	n/a	144,9	140,7	129,8	118,2	121,7	123,1
Capital adequacy ratio (%)	n/a	n/a	15,8	15,9	16,5	13,6	13,0	12,5
P&L figures and ratios*								
Net interest income (EURm)	n/a	n/a	121,4	113,7	106,2	106,0	108,8	112,1
Total operating income (EURm)	n/a	n/a	162,0	157,1	221,0	174,8	178,7	182,8
Net reservations & adjustments (EURm)	n/a	n/a	81,1	136,3	116,3	120,5	124,1	109,2
Pre-tax profit (EBT, EURm)	n/a	n/a	-19,7	-80,9	-1,8	-58,4	-63,7	-47,3
Net interest margin (%)	n/a	n/a	4,0	3,9	3,8	3,8	3,7	3,7
Cost-to-income ratio (%)	n/a	n/a	62,2	64,7	48,2	64,5	66,2	66,1
ROEA (Pre-tax income/equity, %)	n/a	n/a	-5,9	-26,0	-0,6	-20,2	-21,2	-15,4
ROAA (pretax, %)	n/a	n/a	-0,7	-2,7	-0,1	-2,1	-2,2	-1,6
Non-performing loans (%)	n/a	n/a	13,5	20,9	15,5	18,0	20,0	20,0
Cost of risk (% of outstanding bank loans)	n/a	n/a	3,1	5,4	4,9	5,1	5,0	4,2

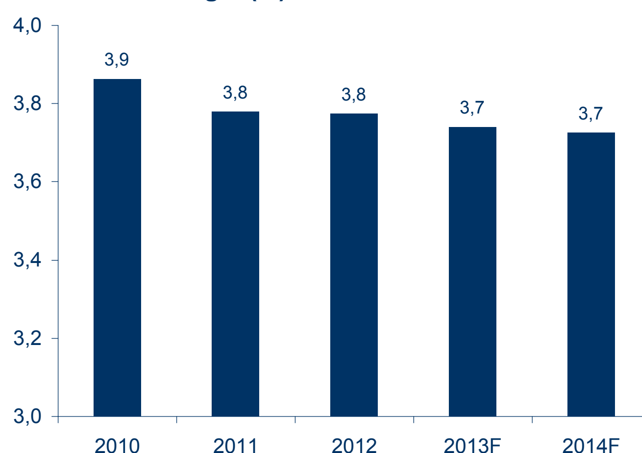
* P&L figures and ratios for 2012 are HAAB estimate:

Highlights: The introduction of IFRS brought a part of written-off loans back into banks' balance sheets that artificially lifted loan stock in 2012. Adjusted for IFRS-effect, banks' loan books started to expand (+5.3% ytd in April). Corporate credit led the way with 11.1% ytd growth followed by 7.8% higher retail credits. As for funding, banks have slashed foreign liabilities in their efforts to become self-funded. However, corporate deposit outflow and subdued households' savings collection bodes ill for banks funding profile depicted in LDR ratio of 126% in April. What's worse, deposit maturity structure is still unfavorable as ca 90% are short-term. Looking ahead, EIB and Montenegrin IDF-backed credit programs could have positive effects on lending, but will depend on banks' risk aversion as citizens and corporate balance sheets remain heavily burdened with debts. Besides, labor market woes can only push migration of hitherto performing loans into NPLs bringing their share to 20%-alike level.

Balance sheet industry trends



Net interest margin (%)



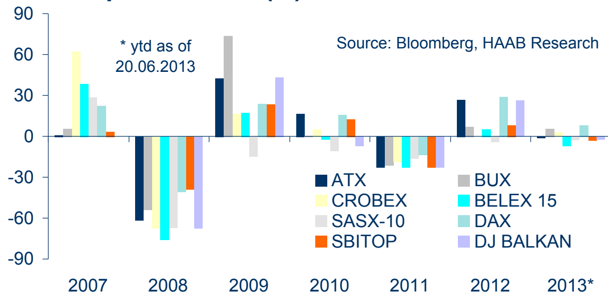
All sources: CBCG, HAAB research

Turning More Defensive

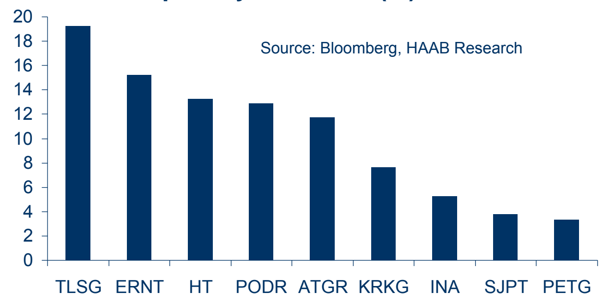
SEE markets turned negative in 2Q13 after early year rally given new capital inflow and global market optimism on global central bank's readiness to stick to ultra easy monetary policy. All SEE region benchmark indices are now ytd negative, except Crobex (+2.5%) which currently broke support level at 1.800 pts without much resistance. Crobex's way down started with weak 1Q earnings season which showed deterioration in companies' operating profits relative to 1Q12. Among the positive surprises, ERNT reported 1Q13 sales of HRK330m (+34.6% yoy) and net profit of HRK49m (+37% yoy). However, HT surprised on the downside as net income drop 34.7% drop yoy, while EBITDA margin decreased 730bp yoy to 35.9%. In Slovenia positive surprise was a 1Q13 result of Zavarovalnica Triglav with 29.9% yoy higher net profit of EUR22.9m. NIS continued with good sales results (+5.9%) in 1Q13, while operating profitability eroded almost 10pp due to higher COGS (+21.4%) and D&A (+35.8%). Major event that marked second quarter was Agrokor's acquisition of 53.12% stake in biggest Slovenian retailer Mercator for EUR240m or EUR120 per share. In our calculation, acquisition multiples (based on 2012 data) are P/S 0.16x, P/EBITDA 4.2x and P/B 0.68x, which is quite below the average acquisition multiples in European retail sector during the last twelve months (P/S 0.65x, P/EBITDA 7.58x, P/B 4.56x). In our view, there is apparently a significant potential for operating cost cutting through joint procurement, logistics, marketing and economy of scale, while indebtedness is our biggest concern since on a pro-forma basis net debt amounts to EUR2.45bn or net debt/EBITDA of 5.2x. Agrokor's ZSE-quoted subsidiaries that are part of vertically integrated system could be main gainers as enhanced retail network should result in wider product placements across SEE markets.

Valuation-wise, Crobex 2013e earnings gauge of 11.7x is overvalued vs CE3 peers (10.9x) and regional indices, SBITOP (9.3x) and BELEX15 (7.5x). Going forth, we turn to a more defensive stance when it comes to regional equity markets given (i) increased likelihood the FED will begin scaling back its bond buying program until the end of 2013, (ii) a still poor macroeconomic forecasts for most of the SEE countries, (iii) continued de-leveraging, decreasing disposable income and further fiscal tightening and (iv) Croatia's exit from CEFTA, which will deteriorate competitiveness and profitability of Croatian food&beverage companies and downsize trade in SEE region. In all, focus should be on companies with good growth track record, ability to generate free cash flows and export oriented revenues.

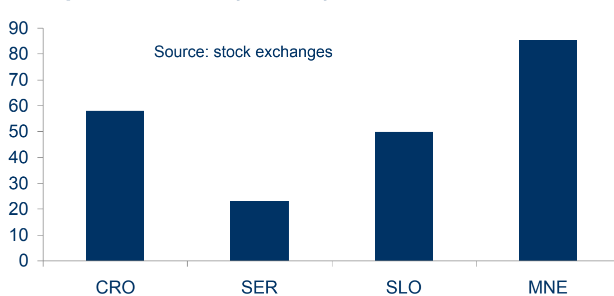
Indices performance (%)



SEE blue chips fcf yield 2013E (%)



MCap at end-2012 (% GDP)



VIX vs DJ STOXX Balkan 50

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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Hrvoje Stojic, Economic Research Director (+385-1-603-0509)
Boris Mazurin, Team Leader Capital Market Research (+385-1-603-1848)
Andrej Knez, Senior Analyst (+385-1-603-2143)
Ana Vitaic Gladovic, Analyst (+385-1-603-3267)
Ivana Kovacic, Junior Analyst (+385-1-603-3405)

Matjaz Music, Head of Economic Research (+386-01-580-4222)

Jasna Atanasijevic, Chief Economist Serbia (+381-11-222-6836)
Olivera Radisa, Analyst (+381-11-222-6619)
Marko Danon, Analyst (+381-11-222-6861)

Hypo Alpe-Adria-Bank d.d.
Slavonska avenija 6, 10000 Zagreb
hypo.economic-research@hypo-alpe-adria.com
phone: +385-1-603-2143
fax: +385-1-606-7143