IC MACRO OUTLOOK

InterCapital Research

December 2017

Incipient Economic Expansion in the Region Unravels in Years to Come

A notable divergence was visible on GDP growth rate in the region and differences could be attributed to idiosyncratic forces – a surge in investment driven by new EU fund withdrawal period boosted Slovenian output, rising real wages assured continued economic expansion in Croatia, while one off factors contained Serbian GDP expansion. In 2018 and 2019 we expect a convergence to happen all over again, supported by rising household spending, low interest rates in the monetary neighborhood and rising confidence in public sector creditworthiness across the board.

CROATIA (to read more click here)

As personal consumption growth turns secular, the driving force behind increased household purchasing power seems to be higher real wage and increased confidence. Investment in tourist facilities is a mirror image of rising revenues from services export; this trend will stay with us for longer than just 2018-2019. With external deleveraging still taking place, the CA surplus will set the stage for further appreciation of kuna, usually coming hand in hand with rising liquidity in the financial system and pressure on short term yields to drop even further. Rising government expenditure makes it naive to expect a balanced budget any time soon, but the rising nominal GDP assures that the trend of decreasing public debt as a share of GDP to be continued – rating upgrade might be in the cards sooner than you expect.

SLOVENIA (to read more click here)

Slovenian GDP growth rate close to 5% this year was definitely eye-catching. Economic expansion was broad based supported by consumption, investment and net exports. In the following years we expect growth to continue at a slightly decelerated pace due to possible overheating of the labor market and structural challenges. Improvements on the fiscal front should support downward trend of public debt as a share of GDP that could fall below 70% by the end of 2020.

SERBIA (to read more click here)

A string of setbacks occurring this year contained Serbian output growth, but since all of these appear to be one off events, we stick to the belief that GDP growth in 2018 and 2019 would compensate for lousy 2017. Improved competitiveness and an increase in productivity set the stage for a trend of rising real wages, which is a foundation of sustained personal consumption growth. FDI flows fully cover for the CA surplus and in 2017 alone FX inflows caused impressive strengthening of dinar, in spite of central bank interventions. Recent credit rating upgrades have been the most valuable accolade the country could get from global Wall Street.

Table 1. Macroeconomic Indicators Across Region

Macroeconomic Indicator	2012	2013	2014	2015	2016	2017 (e)	2018 (f)	2019 (f)
GDP GROWTH (real growth rate, YoY)								
Croatia	-2.2%	-0.6%	-0.1%	2.3%	3.2%	3.1%	2.8%	2.7%
Slovenia	-2.7%	-1.1%	3.0%	2.3%	3.1%	4.8%	3.9%	3.1%
Serbia	-1.0%	2.6%	-1.8%	0.7%	2.8%	1.8%	3.0%	2.8%
UNEMPLOYMENT RATE (ILO unemployment rate, average, YoY)								
Croatia	15.8%	17.4%	17.3%	16.1%	13.4%	11.2%	10.3%	9.5%
Slovenia	8.9%	10.1%	9.7%	9.0%	8.0%	6.2%	5.8%	5.5%
Serbia	23.9%	22.1%	19.2%	17.7%	15.3%	13.2%	12.6%	12.0%
INFLATION (CPI. average, YoY)								
Croatia	3.4%	2.2%	-0.2%	-0.5%	-1.1%	1.2%	1.5%	1.6%
Slovenia	2.8%	1.9%	0.4%	-0.8%	-0.2%	1.5%	1.7%	1.8%
Serbia	7.3%	7.9%	2.1%	1.4%	1.2%	3.5%	3.0%	3.0%
FISCAL DEFICIT (% of GDP, ESA 2010)								
Croatia	-5.3%	-5.3%	-5.1%	-3.3%	-0.9%	-0.6%	-0.6%	-0.7%
Slovenia	-4.0%	-14.7%	-5.3%	-2.9%	-1.9%	-0.8%	-0.2%	0.2%
Serbia	-6.8%	-5.5%	-6.6%	-3.7%	-1.3%	-0.8%	-1.0%	-1.3%
PUBLIC DEBT (% of GDP, ESA 2010)								
Croatia	70.7%	81.7%	85.8%	85.4%	82.9%	79.7%	77.5%	75.5%
Slovenia	53.8%	70.4%	80.3%	82.6%	78.5%	77.0%	74.3%	72.9%
Serbia	55.9%	58.8%	68.8%	74.7%	71.6%	64.0%	62.0%	60.0%

Source: Statistical Offices, Central Banks. Ministries of Finance, Bloomberg, InterCapital

CREDIT RATING (Croatia)

S&P:	**BB** positive outlook
Moody's:	**Ba2** stable outlook
Fitch:	**BB** stable outlook

CREDIT RATING (Slovenia)

S&P:	**A+** stable outlook
Moody's:	**Baa1** stable outlook
Fitch:	**A-** stable outlook

CREDIT RATING (Serbia)

S&P:	**BB** stable outlook
Moody's:	**Ba3** stable outlook
Fitch:	**BB** stable outlook

CREDIT RATING SCHEDULE:

12.1.2018	Fitch: Croatia
23.2.2018	Fitch: Slovenia
23.3.2018	S&P: Croatia
15.6.2018	Fitch: Serbia
	S&P: Serbia, Slovenia
6.7.2018	Fitch: Croatia
10.8.2018	Fitch: Slovenia
21.9.2018	S&P: Croatia
9.11.2018	Fitch: Serbia
7.12.2018	Fitch: Croatia
14.12.2018	S&P: Serbia, Slovenia

*Moody's rating schedule at the time of compiling this research was not available

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Household Consumption Pushed up by Higher Real Wages as Country Braces for the First Credit Rating Upgrade in a while

Table 1. Overview of Selected Macroeconomic Indicators

Macroeconomic Indicator	2012	2013	2014	2015	2016	2017 (e)	2018 (f)	2019 (f)
GDP (real growth rate, YoY)	-2.2%	-0.6%	-0.1%	2.3%	3.2%	3.1%	2.8%	2.7%
ILO unemployment rate (average)	15.8%	17.4%	17.3%	16.1%	13.4%	11.2%	10.3%	9.5%
Inflation rate (CPI. average, YoY)	3.4%	2.2%	-0.2%	-0.5%	-1.1%	1.2%	1.5%	1.6%
EUR/HRK exchange rate (average)	7.52	7.57	7.63	7.61	7.53	7.46	7.44	7.42
Current account balance (% GDP)	0.0%	1.0%	2.1%	4.8%	2.6%	4.2%	3.1%	2.5%
Fiscal deficit (% GDP, ESA 2010)	-5.3%	-5.3%	-5.1%	-3.3%	-0.9%	-0.6%	-0.6%	-0.7%
Public debt (% GDP, ESA 2010)	70.7%	81.7%	85.8%	85.4%	82.9%	79.7%	77.5%	75.5%

Source: CBS, CNB, Ministry of Finance, InterCapital

The incipient recovery from 2014 has by the first two quarters of 2017 evolved into fully-fledged output expansion with real growth rate averaging 2.9% YoY in the first three quarters of 2017. This was far better compared to EU28 average of 2.2% YoY recorded in EU28, but still below late EU entrants such as Romania and Bulgaria. Compared to the gilded years of 2006 and 2008, this time it appears that the expansion is grounded in exports growth and household consumption, two aggregates which would deliver confident output growth rates in the coming years as well.
Here is an outline of the most important trends affecting the Croatian macroeconomic blueprint in 2018-2019 time span, in which we expect that the economy would deliver a 2.8% YoY real growth rate in 2018, followed by a 2.7% YoY print in 2019:

(+) personal consumption: household spending is on a steady growth trajectory, but this time real wages are at the driver's seat of expansion since emaciated labor market cannot add more jobs to the aggregate wage bill

(+) once the Agrokor restructuring hits the balance sheets next year, **gross investment** is likely to decelerate, but remain confidently in the positive territory

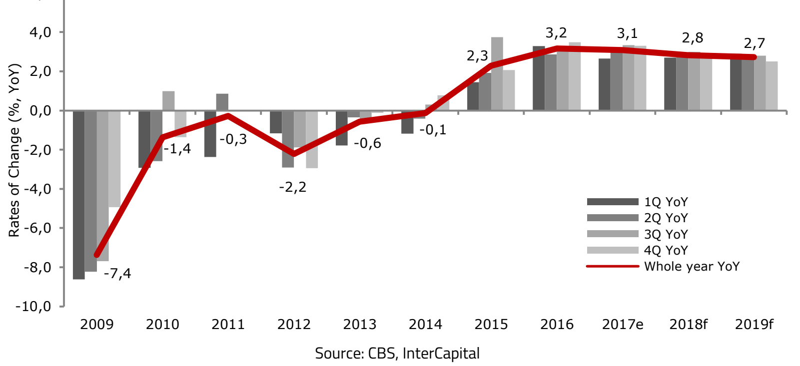
(+) net exports is on the rise, with another stellar tourist year behind us; investment into hospitality facilities give us plenty reason to keep our hopes up, as tourist season gets extended due to brand new capacities

(+) monetary policy: CNB is expected to keep EURHRK exchange rate stable and liquidity elevated; short-term interest rates are to remain low, definitely a supportive factor for the overall economic activity

(+) fiscal policy: public revenues are gently rising as a mirror image of increased personal spending from both residents and tourists; even with increased public spending next year, the fiscal gap will remain in check and stars might finally be aligned for the first rating upgrade in a while.

(0) other factors: although the global growth appears to be balanced and equally distributed across both developed and developing countries, a rise in interest rates across the Atlantic could cause the US yield curve to flatten and bring about all that comes with it; considering the eurozone, even with slower pace of ECB's public asset purchase and the monetary policy divergence among European countries, the environment is still supportive for the extension of output expansion

Chart 1. Croatian GDP, Real Growth Rates (%, YoY)



Source: CBS, InterCapital

CREDIT RATING

S&P: **BB** positive outlook
Moody's: **Ba2** stable outlook
Fitch: **BB** stable outlook

Real GDP growth to remain robust in both 2018 and 2019, while consumer prices are also poised to rise modestly.

As employment growth decelerates, rise of wages takes the driver's seat of household consumption growth.

Global macroeconomic environment is supportive for longer period of solid real growth as interest rates appear to stay at their historic lows (at least in euro area).

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Real Economy: Household Consumption Shouldered by Real Wage Rise. Employment Growth Runs into Thin Air?

PERSONAL CONSUMPTION. Through the first three quarters of the current year personal consumption increased by +3.6% YoY in real terms, adding some 3.47b HRK in the first nine months alone to the aggregate GDP figure. This is a slight acceleration compared to the same period last year when the largest single GDP aggregate (comprising some 56.64% of the total output figure) increased by +3.5% YoY. You might assume that listing the forces contributing to the sustained growth of personal consumption might resemble to a rerun of old sitcoms, however there are some striking differences between this year's and last year's growth of household spending.

Household consumption at the driver's seat of overall output growth.

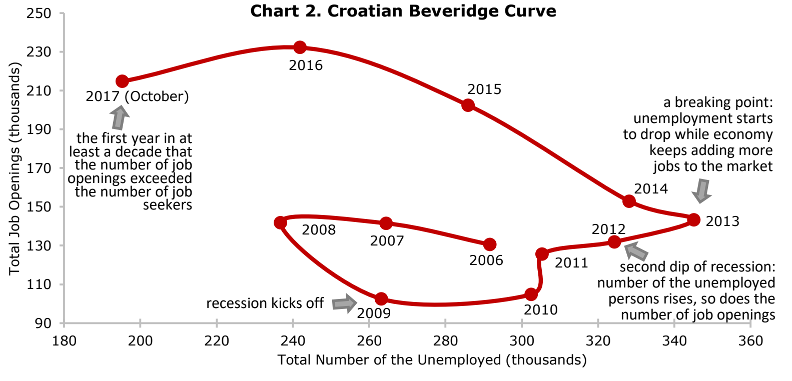
First of all, it looks like **real net wage growth** shoulders the expansion of personal consumption in this year. In the first nine months alone, real net wage increased by +4.2% YoY on average, much faster compared to +2.8% YoY recorded in the same time span last year. To estimate the effect of the tax cuts it's sufficient to mention that in the first nine months of 2017 real gross wage increased by +2.6% YoY, meaning that the remaining 1.6% of annual growth could have come from lower income tax. Average Croatian employee was certainly better off compared to last year, but what about the number of total persons employed in legal entities?

This is where the grey contours emerge – the average **number of the persons employed** in legal entities decreased by -2.0% YoY in the first ten months of 2017 (from 1.177m in 2016 to 1.154m in 2017). At the same time the average number of people actively looking for jobs dropped from 243k (January-October 2016) to 195k (January-October 2017) – this is a 20% YoY drop in the number of persons unemployed. In a nutshell, real wages are on the rise in both net and gross terms, but fewer people are working and looking for work. The notorious and somewhat obvious culprit for this change could be the immigration to developed countries of the EU, but nevertheless the official data about this population shift appear to be a bit dismal – it's clear that young families are looking for other places to start new life, but the full effect of net migration is quite difficult to measure due to technical difficulties.

Unemployment evaporates from the economic system, but the employment slightly decreases – could a shortage of workers become a hard constraint on the output growth?

Disaggregated data of the Croatian Employment Service offer a bird's eye perspective on the **disbalances on the Croatian labor market** (Chart 2.). Although Croatian overall economy was in the technical recession between 2009 and 2014, the economy started adding jobs as soon as 2010 and after 2014 the job creation process kicked off full steam ahead. But here is something more to look at: the year 2017 (January-October average) is the only year on the chart in which the number of job openings exceeds the number of unemployed persons. This might also be the cause why for the first time since 2010 the total number of job openings dropped – why would private enterprises open new capacity when the prospects of hiring the proper workforce in a timely manner look dim? Croatian Beveridge curve supplements the story of rising gross wages with a picture of emaciated labor market slack putting upward pressure on the wages. We expect that this trend – i.e. rising real wages offsetting a drop in employment – might be continued at the same pace in 2018 and 2019, meaning that the real household consumption is likely to remain on an upward trajectory. Nevertheless, the figures tell a story of personal consumption growth slowly approaching the zone of thin air and unless government eases restrictions on hiring foreign workers, the labor shortage would put a hard constraint on the long-term output growth.

A new phase in the economic expansion? As the number of unemployed persons drops, so does the number of newly opened jobs.



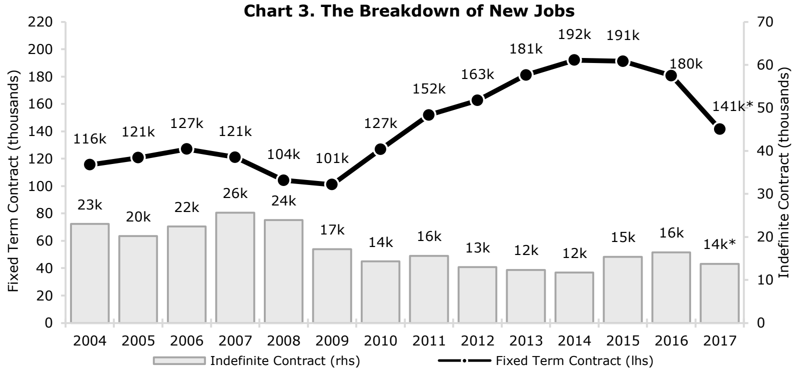
Source: Croatian Employment Service, InterCapital

Before closing our personal consumption chapter, it's worth mentioning that **household deleveraging** seems to have ended in February 2017 when overall bank loans to households ended up at 107.5b HRK (according to aggregate data disseminated from the central bank). By end August of 2017 bank loans to households inched up by some 2.0b HRK (to 109.5b HRK), which is a meager growth rate of 1.9%, but nevertheless could signal that the deleveraging cycle might be over and consumer confidence might finally be on the rise. Here is one more thing to look at – in period January-August 2017 short-term cash loans had increased by 1.6b HRK, taking up four fifths of the mentioned growth.

To make the long story short, **wages are on the rise, labor market is getting tight** and although consumers have stopped to deleverage, **taking up new loans still seems to add a bitter taste to the average Croatian household**. Chart 3. might explain why is that – in the first ten months of 2017, 90% of the newly created jobs were on a fixed term basis; this ratio was always in the favor of precarious jobs (ten years ago 80% of the newly added jobs were on a fixed term), nevertheless the chart still highlights the fact the overwhelming majority of the newly created jobs came with a fixed job tenure defined in the contract. This might be the underlying cause of reluctance of households to incur new liabilities, in spite of improving consumer confidence.

Labor market slack diminishes, which leaves it's mark on the pace of creating new jobs. Although household loans gradually rise, average consumer is reluctant to incur new liabilities.

Chart 3. The Breakdown of New Jobs



*2017 includes only January-October period
Source: Croatian Employment Service, InterCapital

INVESTMENT. In the first nine months of 2017, **gross capital formation increased by +5.63% YoY** to 55.5b HRK. Last year gross capital formation reading printed 70.8b HRK (FY2016), which is indeed a seven-year high, but still a far cry from 107.5b HRK reported in 2008. Currently, investment comprise 21.4% of the total GDP (2016 data), but since the growth rate exceeds the average GDP growth rate, investment gradually takes a larger share of total GDP.

The Ministry of Finance reiterated numerous times that this year some 800m EUR in total were **invested in tourist facilities** and **the figure could go up to 1.3b EUR next year** as investment into wellness resorts could top 350m EUR. The 1.3b EUR figure put as a benchmark by the Minister of Tourism looks ambitious, albeit attainable.

Investment in tourist capacities aligned to increase revenues from services export and contribute to extended tourist season.

A big boost for investment so far has been **funding from EU structural and cohesion funds**: in 2014-2020 withdrawal period, the country has been allocated 10.7b EUR through four national programs; together with national funds, this amounts to a total of 12.6b EUR. The withdrawal period for the current program looks a bit dismal: out of the total 12.6b EUR allocated, only 2.8b EUR (22.3%) has been decided and 340m EUR (2.7%) has been spent (data retrieved from the European Commission on December 6th, 2017). For comparison purpose, Slovenian progress isn't much better either: the Alpine country was allocated a total of 3.9b EUR through three programs which together with national funds make up a total of 4.9b EUR. Out of this 4.9b EUR, 1.3b EUR has been decided (27%) and only 134m EUR (2.8%) has been spent. Now back to Croatia – the largest of the facilities is European Regional Development Fund (ERDF) where Croatia has been allocated 5.1b EUR; 1.5b EUR has been decided (30%), while 282m EUR has been spent (5.5%). Considering the European funds, inflows from previous withdrawing periods are increasing the level of investment, but a switch to the new withdrawal period might cause a debasement of investment just as it had done in Slovenia in 2016.

Withdrawal from EU funds set to improve in the coming years, boosting infrastructure investment.

Total **foreign direct investment** in Croatia reached **2.93% of 2016 GDP** in the first two quarters last year, but this year this investment gauge managed to get a bit lower at 2.7% GDP in the first two quarters of 2017 (617m EUR). So far the effects of Agrokor restructuring seem to have been contained and only a handful of companies entered pre-bankruptcy procedure due to unforseen impairment cost. Nevertheless, we do expect the full effect of restructuring to enter into force as soon as next year. The effects are currently difficult to forecast, but some sort of write off combined with debt to equity swap is certain to be put into force.

NET EXPORTS. In period June 2016 - June 2017 **Croatian CA surplus reached 2.60% GDP** (measured against nominal GDP in the same period, data retrieved from CNB table H1). Croatian track record of CA surpluses began in 2013 when a strong contraction of merchandise imports helped to close the trade gap (falling energy prices played a role in this move). After the EU accession exports started to gradually rise as domestic companies became better integrated into European supply chains. The growth of merchandise exports was the underlying cause of CA surplus rising to 2.1% GDP in 2014 and to 5.0% GDP in 2015 (according to EC Country report, February 2017). The mirror image of increased CA surplus was the decreasing net international investment position, which dropped from -88.9% GDP (2013) to -77.7% GDP (2015) and then to -70.1% GDP (2016). For comparison, Slovenian net international investment position stood at -36.9% GDP in 2016.

Among other things, EU accession contributed to rising net exports, creating in turn conditions for a CA surplus.

Continued external deleveraging assures that CA surpluses would continue to appear in years to come.

In the first eight months of 2017, **merchandise exports increased by +14.6% YoY** and with a +11.3% YoY of imports growth, the coverage of imports by exports ended up at 61.9%. As expected, manufacturing goods shouldered a lion's share of exports growth. About two thirds of Croatian merchandise trades is directed to or from EU countries and this geographical segment printed a +9.9% YoY growth in the first eight months; since imports from EU countries increased by +10.3% YoY, we can say that the trade balance deteriorated slightly. About one sixth of the merchandise trade flows between Croatia and CEFTA countries and in the period January-August Croatia reported a 5b HRK trade surplus with this geographical segment .

According to data disclosed by the central bank (H1 table), in the first six months of the current year **net revenues from services exports increased by +7.8% YoY** (from 2.44b EUR in Jan-Jun 2016 to 2.63b EUR in Jan-Jun 2017). Needless to say, this data doesn't include the net revenues generated at the pinnacle of tourist season (associated with third quarter), nevertheless tourist arrivals and overnight stays point to the fact that a year of stellar tourist growth might be behind us. According to CBS data, tourist arrivals in the first ten months of 2017 increased by +10.8% YoY, while overnight stays grew at a pace of +10.0%. Although we doubt that these double digit growth rates might stay with us for longer, they still give us plenty to reasons to have our hopes up since investment into tourist accommodation give ample tourist capacity to be filled starting from next year.

Double digit growth in tourism arrivals and overnight stays is the crown jewel in Croatian macroeconomic blueprint.

In our **baseline scenario** Croatian **exports of goods and services** should continue to **grow at solid pace in the coming two years**, nevertheless a commensurate rise in imports might square off some rise in CA surplus. The CA surplus would continue to be transferred into external deleveraging since the credit growth mentioned in the previous chapters might come from new LCY loans. In 2018 we therefore expect the CA surplus to slightly decrease to 3.10% GDP, followed by a 2.50% GDP print in 2019; in the same time net export of goods and services is expected to remain a supportive factor to overall output.

Monetary and Fiscal Policy: Kuna Keeps Strengthening in 2018-2019; Public Deficit at Historic Lows, while the First Credit Rating Upgrade Might Be just around the Corner

MONETARY POLICY. 2017 brought around another episode of monetary expansion – it was promising from the start: **the excess liquidity in the Croatian financial system swollen from 9.1b** HRK (December 2016) to **16.3b HRK** (January 2017), an end effect of two FX interventions. This cash pile slowly decreased as the year progressed, dropping to 14.7b HRK in May, but remained at elevated, double digit values (measured in billions of HRK). As spring turned into summer, strong FX inflows from the tourist season forced the central bank to intervene more. With four summer FX interventions, the central bank **placed additional 4.4b HRK in the financial system**.

Export generated FX inflows prompted four summer central bank interventions to curb kuna strength.

What happened with all of the **cash generated in the process of safeguarding exchange rate stability** and curtailing FX volatility? It certainly didn't go into short-term paper issued by the Ministry of Finance: at the end of 2016 there were 16.8b HRK of outstanding treasury bills, while one year later we see the outstanding amount virtually unchanged at 16.9b HRK. Nevertheless, elevated excess liquidity did leave its mark on the short term yields and 1Y treasury bill yield dropped from 0.65% (December 2016) to 0.20% (December 2017).

What about mid-term HRK fixed income instruments? Last year in summer Croatian Ministry of Finance issued 5Y LCY bond (RHMF-O-217A) and the banks got hold of some 3.6b HRK of total 6.0b HRK amount outstanding. Back then this paper seemed ideal as a collateral for CNB's structural REPOs due to its moderate maturity and attractive yield. This year two additional mid-term HRK auctions took place: RHMF-O-222A in February and RHMF-O-23BA in November. However, the central bank data shows that **banks simply rolled over the positions they had in shorter fixed income instruments** that were maturing at the same time without significantly increasing their positions.

Although the excess liquidity generated through FX interventions didn't go directly into HRK paper, the Croatian LCY yield curve still managed to move significantly to the south due to the liquidity coming from other sources. Here is something worth thinking about: **back in December 2016 total assets of the Croatian obligatory pension funds stood at 84.1b HRK** and by **October 2017** this amount had increased to **90.7b HRK** (+7.8% increase); some 3.4b HRK of this increase went straight into government bonds (data retrieved from Croatian Financial Services Supervisory Agency or HANFA).

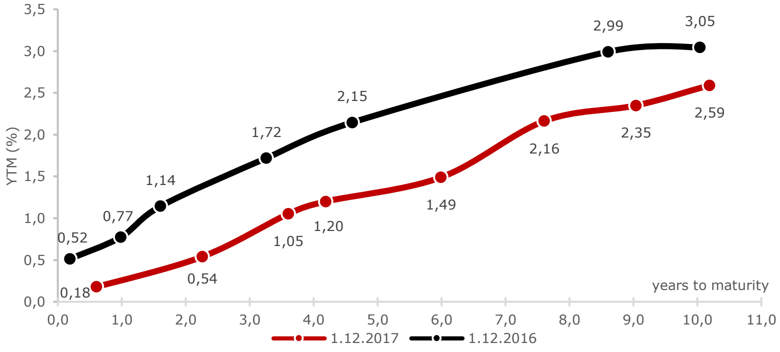
FX interventions lower the short-term LCY yields; liquidity coming from large domestic asset managers causes yields to dwindle.

Domestic pension funds were not the only sources of demand: UCITS bond funds' AUM stood at **3.9b HRK in December 2016** and throughout ten months' time this figure grew to **5.7b HRK** (+46.0%); seems that bond funds were probably the biggest beneficiary from deposit holders' disappointment with low interest rates. Chart 4. depicts the effects this shift had on the Croatian LCY yield curve.

By comparing the black line on the curve (yields on 6th December 2016) with the ones depicted on the red line (yields on 6th December 2017), one could note two interesting observations. First, although it's obvious that the yield curve moved significantly to the south, the **contraction was of the highest magnitude on the mid part (4-6 years)** where it reached almost a full percentage point. Second, there is **a small dent on the red curve** (December 2017) right there on the 6Y maturity, which says enough about the demand for Croatian mid-term paper. Overall, the monetary policy would remain accommodative and supportive for the overall growth rate in 2018 and quite likely in 2019 as well.

LCY yield curve moved significantly to the south, but the move was most intensive on the mid part of the curve.

Chart 4. Croatian LCY Yield Curve



Source: Bloomberg, InterCapital

EURHRK exchange rate is **expected to remain relatively stable**, however some appreciation pressures on domestic currency are likely to materialize. Accordingly, in 2018 we see the EURHRK exchange rate moving south and settling down around 7.30 level. In 4Q 2018 depreciation pressures on HRK could reemerge and push EURHRK towards 7.50 level.

Switching to inflation theme, Croatian **economy managed to escape deflation in late 2016**, although full year average annual CPI change still ended up at -1.1% YoY. Most of this drop of consumer price index came from "Housing, water, electricity, gas and other fuels", an aggregate comprising 16.5% of the total index; this portion of consumer basket reported a -2.5% average annual change back in 2016, dragging down whole consumer price index with it. Furthermore, since annual inflation in the euro area stood at 0.2% YoY in FY2016, it's reasonable to assume that appreciation of kuna versus the euro might have played a key role in bringing the prices down compared to eurozone.

Strong kuna puts a lid on inflation rates at home, and this phenomena is likely to stay with us in 2018 and 2019.

In **first ten months of 2017 euro area HICP rate averaged 1.4%** (measured as a rate of change compared to the same period previous year, retrieved from Eurostat), indicating that the disinflation monster might finally be at bay. At the same time Croatian CPI rate averaged 1.1% YoY, lagging the euro area, but pushing higher to more sustainable levels. Thanks to rising wages and higher prices in the eurozone, we expect Croatian CPI change to average 1.5% in 2018 and 1.6% in 2019; since we expect that external deleveraging might continue, as well as a continued improvement in current account balance, Croatian CPI will likely lag the eurozone inflation gauges since strong kuna would probably not let inflation pressures from the euro area to be transferred into Croatian economy unabated.

FISCAL POLICY. According to the data disseminated from the **Ministry of Finance**, in period **January-August 2017** general government reached a **surplus in size of 1.16%** of estimated 2017 nominal **GDP** (363.47b HRK assuming a 4.02% YoY nominal growth rate); in absolute terms, general consolidated government surplus amounted **to 4.2b HRK** (GFS 2001) and Chart 5. indicates that this is the second government surplus on the record since 2008. According to ESA 2010, in the same time span (January-August 2017) general government was slightly in deficit in size of 0.32% of estimated nominal 2017 GDP, which amounts to some 1.15b HRK (data disseminated from the central bank, table I1).

Thanks to swollen government revenues, Croatia is very close to balanced budget in 2017 according to ESA 2010 (by using GFS 2001, the budget recorded a considerable surplus).

To put things into perspective, according to GFS 2001 methodology disclosed by the Ministry of Finance, general government consolidated surplus in the first eight months of 2016 amounted to 1.3b HRK (0.37% of nominal 2016 GDP), or 1.22b HRK for the full year 2016. In other words, using the "cash method**", public finances were already in green last year**. Behind this improvement are mostly higher revenues from value added tax (+6.0% higher in first eight months of 2017 compared to the same period last year, or 1.7b HRK in absolute terms), higher revenues from capital gains and interest tax (+11.6% YoY, or 776m HRK) and finally better transfers from the EU (+8.3% YoY, or 425m HRK). On the other side, expenditures seem to be fixed since they increased by mere +0.75% YoY (662m HRK). Looking under the hood, one could see that there was a certain degree of rebalancing within the expenditure side: a drop of interest rate expenditures in size of 614.7m HRK in the first eight months of 2017 (-7.7% YoY) was gradually squared off with rising public employee salaries (+430m HRK, +3.9% YoY); this rise of salaries could be connected to demand of the trade unions to remove the public wage cut introduced back in 2009, which should have been removed automatically as soon as Croatian economy left recession times behind.

In the first eight months of 2017, lower interest expenditures were squared off with a rise in public sector wages.

Similar trends are outlined for 2018 in the latest draft of government budget for 2018: **a +7.3% YoY growth rate in value added tax** should bring some extra 3.4b HRK in additional revenues. It's interesting to note that the Ministry of Finance expects to harvest some 8.2b HRK in corporate tax in 2018, which is +16.0% more compared to 2017 plan. There are reasons to be reserved to this expectation – government forecast comes in the midst of Agrokor restructuring and in the first half of this year due to provisions for losses Croatian banks reported merely 988m HRK of earnings versus 2.8b HRK in the same period of 2016. Of course, banks are obviously not the only moneymakers in Croatia that pay a corporate tax levied on their profits, but so far bank earnings have been quite a good predictor of aggregate earnings and corporate tax revenues. Considering the government's plan to resolve the situation with INA, we stick to the belief that any plan would be executed in such a manner that it has no efect on the level of public debt.

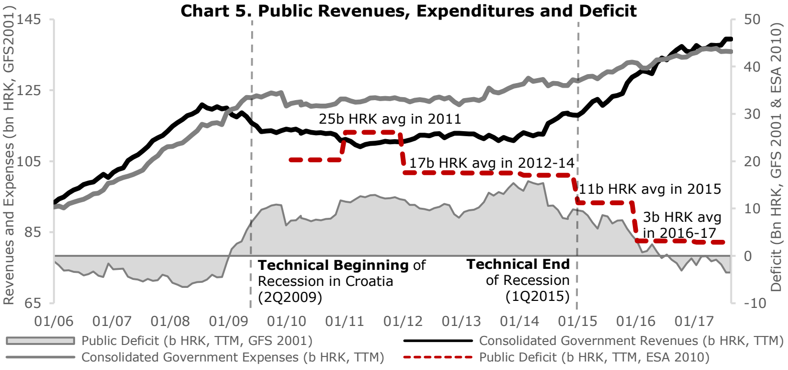
Agrokor restructuring might put a lid on public revenue growth next year, although higher tourist capacities and higher wages give ample reason for optimism on income from VAT.

The expenditure side of the 2018 looks quite realistic and reflects certain items which have gained quite a media attention. First of all, **public salaries would increase by 1.4b HRK** due to the liabilities stemming from collective negotiating with public sector trade unions as a mirror image of a rise in private sector wages. The central government also plans to **transfer 500m HRK to Croatian Health Insurance Fund (HZZO)** to settle some of the overdue liabilities; also, a lion's share of the planned 627m HRK are planned to be funneled into public health services such as hospitals. Government also plans to undertake significant **investment in defense sector**, which is going to incur 793m HRK of additional cost next year. Overall, the government plans **2018 revenues in size of 129.0b HRK** (versus 121.6b HRK planned for 2017 or 6.1% increase) and government **expenditures in size of 133.3b HRK** (versus 128.4b HRK planned for 2017 or 3.8% increase). The 2018 deficit under GFS 2001 methodology would then amount to 4.3b HRK (6.8b HRK planned for 2017) or 1.1% of planned 2018 GDP. After all the necessary adjustments, the ESA 2010 public deficit for 2018 is expected at 0.5% GDP. Our baseline public deficit forecast for 2018 is just a couple basis points higher (0.8% GDP) because of the possibility that the VAT revenues might not grow so rapidly as expected due to the possibility of slower employment growth. In a nutshell, increase in government expenditure would remain supportive for overall GDP growth, while higher revenues would help keep the deficit in check.

A modest rise in government spending comes from higher public wages, aid to health sector and defense spending.

Improvement in public finance might set the stage for the upgrade of Croatian sovereign rating. First regular reviews are on January 12th (Fitch) and March 23rd (S&P Global Ratings).

Chart 5. Public Revenues, Expenditures and Deficit



Source: CNB, InterCapital

Strong Economic Swing in 2017, One Step Closer to the End of Pro-Cyclical Growth?

Table 1. Overview of Selected Macroeconomic Indicators

Macroeconomic Indicator	2012	2013	2014	2015	2016	2017 (e)	2018 (f)	2019(f)
GDP (real growth rate, YoY)	-2.7%	-1.1%	3.0%	2.3%	3.1%	4.8%	3.9%	3.1%
ILO unemployment rate (average)	8.9%	10.1%	9.7%	9.0%	8.0%	6.2%	5.8%	5.5%
Inflation rate (CPI, average, YoY)	2.8%	1.9%	0.4%	-0.8%	-0.2%	1.5%	1.7%	1.8%
Current account balance (% GDP)	2.1%	4.4%	5.8%	4.4%	5.2%	5.9%	5.8%	5.6%
Fiscal deficit (% GDP, ESA 2010)	-4.0%	-14.7%	-5.3%	-2.9%	-1.9%	-0.8%	-0.2%	0.2%
Public debt (% GDP, ESA 2010)	53.8%	70.4%	80.3%	82.6%	78.5%	77.0%	74.3%	72.9%

Source: Statistical Office, Central Bank, Ministry of Finance, InterCapital

CREDIT RATING

S&P: **A+** stable outlook
Moody's: **Baa1** stable outlook
Fitch: **A-** stable outlook

Credit rating uplift by two notches at once is not something we are used to witness and that is exactly what happened in September 2017 when Moody's upgraded Slovenia's rating from Baa3 to Baa1. This year's surge of investment, exports and household consumption accompanied by improvements in fiscal and foreign trade blueprint is expected to continue in the next two years, although the pace could moderate due to potential limits – which is the basis to expect GDP growth to print 3.9% YoY in 2018 and 3.1% YoY in 2019.

Strong and diversified economic growth should continue, but at a slightly decelerated pace.

The pillars supporting our Slovenian outlook in the coming years are listed below:

(+) personal consumption has been rising consistently in the last four years driven by favorable developments on the labor market and rising consumer sentiment. As time goes by, we could witness some gradual slow-down.

(+) investment looks bright in the following period as the new EU program is kicking in. After strong drop in 2016 companies, households and government are accelerating their investment that will in turn drive economic growth in the future.

(+) net exports could keep a good pace as investment will increase competitiveness while foreign demand is expected to rise further.

Fiscal balance improving, overturn in surplus in the next two years looks achievable.

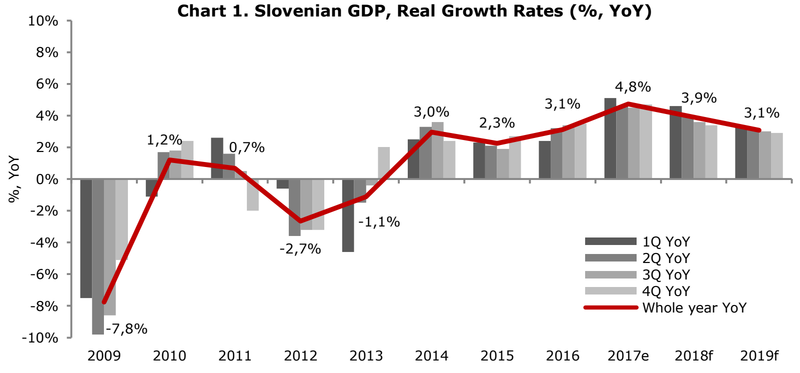
(0/-) monetary policy continues being supportive and APP is intended to last at least until September 2018 at a decreased pace, or beyond if necessary. The end of QE should be on the horizon as European economy becomes more resilient and inflation slowly rises towards 2%.

(+) fiscal consolidation is backed by economic growth and structural improvements. After reaching almost 15% deficit 4 years ago, Slovenian government now plans to roll over into budget surplus as soon as in 2018. If the trend lasts, debt as a share of GDP could fall below 70% until 2020.

Demographic structure is becoming one of the main challenges for the Slovenian government.

(-) other: demographic structure will be the main challenge for Slovenian government in the mid-term. As Slovenians get older with labor force slowly diminishing, further structural changes and immigration will come into primary focus.

Chart 1. Slovenian GDP, Real Growth Rates (%, YoY)



Source: Slovenian Statistical Office, InterCapital

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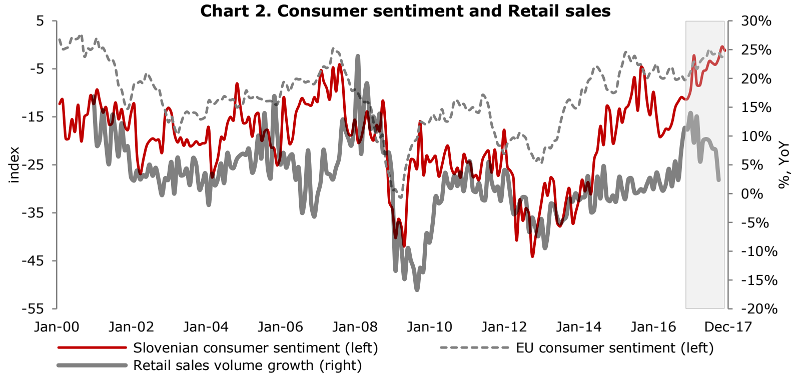
Real economy: Robust and Diversified Growth to Be Continued, Investment Cycle Tops

PERSONAL CONSUMPTION. Slovenian GDP performance in the first three quarters of 2017 at 4.7% YoY puts the Alpine country among the EU-28 star students. So far, growth in 2017 was broad-based, driven by personal consumption, investment and exports although the surge of imports somewhat decreased favorable overall result. Despite investment stealing the show this year, personal consumption has been the **backbone of Slovenian growth** in the last three years. We expect that it will fulfill that role in the coming period as well, mostly driven by improvements on the labor market and high consumer sentiment.

Personal consumption is the largest single GDP aggregate and would continue to be the locomotive of overall output growth.

Consumer sentiment indicator in Slovenia has been below EU average (since March 1996) until October 2017 when it **reached its all-time high**. Namely, sentiment in Slovenia has seen a large drop and widening versus the EU average in the period from August 2015 to May 2016. However, since then it started to recover backed by macroeconomic improvements. Chart 2. depicts the relation of EU and Slovenian sentiment through more than a 15 year long period, combined with Slovenian retail sales growth. The 2017 figures regarding retail sales growth signal that a deceleration of the personal consumption might be just around the corner so we expect the largest single GDP aggregate could grow slightly above 2.0% in the next two years. Interesting part of the Chart is the evident correlation between consumer sentiment and retail sales that turned to negative in 2017 (highlighted by the grey area) which could be explained by low base of retail sales in 2015. This factor resulted in enormous growth in 2016 and now coming back to 2.0% growth rate which is our baseline scenario for the following period.

Chart 2. Consumer sentiment and Retail sales



Source: Eurostat, InterCapital

Labor market improved significantly in 2017 reving up consumer spending. In the next two years we expect employment growth to decelerate as Slovenia is coming close to full employment.

Continuation of favorable trends in personal consumption was mainly ensured by ameliorations visible on the **labor market** as **unemployment rate** dropped from 8.1% to **6.3%** in the first nine months of the year resulting in the aggregate wage bill increasing by some 50k persons in 2017. Employment rate increased strongly this year and could increase further if it weren't for some structural limits. In particular, if unemployment rate falls below 5.0% there will be less than 50k people on the job market (frictional unemployment is ubiquitous around the world, rising from people who quit their job and are in the process of finding a new one). To emphasize what we wrote in our June's edition, in the next five years, 144k people would be entering full retirement (Slovenia raised pension age for both women and men to 65 in 2013 and plans to raise it further to 67) while on the other hand some 95k will enter the labor market which will leave the gap of 50k workers (5% of the labor force).

Consumer sentiment is improving and will push households into larger spending and investment.

Both OECD and the IMF list several measures to tweak the labor supply: life-long learning to retain older workers, increasing flexibility of open-ended employment contracts, implementing an apprenticeship program to develop technical skills and to review labor taxes. In absence of those actions, we still expect employment growth to continue in 2018 and unemployment rate reaching 5% but with consequences on labor costs which could then spill over into excessive **wage growth**.

Looking at the trailing twelve-month data, nominal net wages grew slightly faster than 2.0% in September, representing highest wage growth since 2011. The trend is expected to continue at a similar pace in the coming two years. Some of the labor cost pressures could be mitigated in case of privatizations of SOEs as it would increase productivity and raise competitiveness. However we expect privatizations to happen only in the mid-term.

Taking into consideration the abovementioned, the strong consumer sentiment, further employment improvements and favorable international environment **imply that personal consumption** doesn't look like losing steam in the short term. However, in our baseline scenario we **could witness some slowing down**. Nevertheless, there is still possibility that households will increase their leverage on strong consumer sentiment which would then keep the pace at the current levels or accelerate it further.

INVESTMENT. Investment renaissance is the main story this year as we have seen close to double digit growth (9,7%) in the first 3 quarters versus same period in 2016. All the components increased by high margin, with investment in buildings and structures, machinery and equipment leading the pack. Obviously, the main reason for such an increase lies in strong fall of investment in 2016 when EU funds withdrawal failed as Slovenia entered the new investment cycle. Namely, new EU funding program (2014 – 2020) was in implementation stage last year so results started to show in these years' balance. Interesting enough, investment in residential buildings grew at 7% in the first three quarters while we did not witness such a strong slowdown in 2016 as household investment are not dependent on EU funds.

Investment served as a bellwether of output growth in 2017, which could be viewed as a compensation for lower rate of increase in previous year.

Comparing investments at constant prices in the first three quarters of 2015 and 2017, the latter was 6.7% higher which implies that in the last two years investment actually grew by 3.3% YoY, **close to its long-term average**. Such data further indicates that investment recovery is not over yet and we therefore expect investment to grow substantially above its long-term average, mostly backed by successful EU funding cycle (2018-2019 span should be the most intense period after which we could witness modest deceleration of the governments' investment due to aging of the program).

Real sector investment is expected to increase due to strong consumer sentiment, low indebtedness and solid stock of savings.

Switching to **private investment** and its sources, credits to non-banking sector increased in the end of 2016. Since then they were rising at the very moderate pace, driven by both non-financials and households. Looking at the larger period, stock of loans dropped by some 40% since 2010 and although part of the decrease came from write-offs, there are other factors keeping them low: export sector being deeply integrated in European economy that uses cheaper external financing (IMF), inter-company financing and banks still being more reluctant to lend to SMEs than they were before the crisis as SME's still hold significant part of NPLs. Regarding **NPLs**, they were sold off in large scale in the last several years and creditworthiness of the lenders improved, resulting in drop to 4.6% of total loans or 7.1% of GDP at the end of 2017. It is also worth noting that liabilities to foreign banks fell to 5% of banks' total assets while being above 35% in 2008. Such movement reflects strong deleveraging sentiment in Slovenia that puts **Slovenians among the least indebted in the EU** which we expect to slowly change in the near future.

Banks are well capitalized and could support increased credit activity in case Slovenians decide to elevate their leverage.

On the other side of the banks' balance, deposits by the non-financial sector grew by nearly 6% in 2017, resulting in **loan to deposit ratio** to decrease even further. To be specific, in the beginning of 2010 the ratio stood at 140%, 5 years later was at 88% while in September 2017 was below 78%. The trend shows that banks are much less leveraged than they were in the past and aggregate data portrays that major banks have **large capital buffers** to support increased credit activity and consequently private investment growth in the next few years.

Foreign direct investment increased by 2.1% YoY in the first half of 2017 and reached EUR 15,3bn which is barely above 35% of GDP compared to EU average of 50%. In the following period, we expect investment from abroad to keep modest but stable growth pace until one of SOE privatizations takes the stage. In the end of 2016 there were some speculations that Telekom Slovenije could be the first big name but as time flies it seems that big SOE privatizations are not one of the main government's priorities in the short-term. Also, relatively high labor taxes and still restrictive labor regulations are the main obstacles for the foreign investors to increase their stakes so planned changes of the labor and pension law should be welcomed from investors' perspectives.

Still waiting for bigger privatization stories to come.

Tu sum up, we expect modest FDI growth. **Private investment should intensify** as strong consumer sentiment could spill into higher household investments and consequently push **producers** to **increase their capacities** further backed by the supporting environment of low interest rates and large savings stocks in the economy. Furthermore, since our main scenario involves another **successful period in EU fund withdrawals**, we wouldn't be surprised if investment proves itself again as the brightest star among GDP contributors rising above 5% in the next two years.

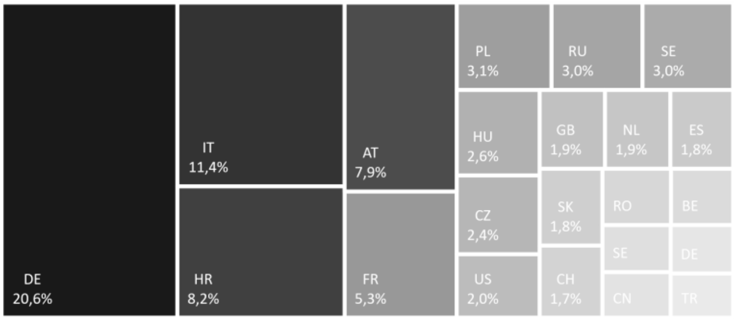
NET EXPORTS. Exports of goods and services rose by more than 10% in the first three quarters of 2017 with third quarter being 12% higher than last, reflecting strongest increase since 2010. To put things into perspective and to properly address the importance of Slovenian export sector, let's just say that exports of goods and services should constitute around 80% of total GDP in 2017. On the other hand, driven by prolonged robust domestic demand, imports of both goods and services grew by 9.5% in the same period. As a result, external trade balance equals 10% of total GDP in the same period (summing all three quarters at current prices).

Exports of goods and services constitute 80% of total Slovenian GDP.

Projections of solid economic growth among main trading partners and increase in competitiveness should assure that **growth of exports stays robust** and we expect 10%+ growth rates in 2018 and 2019.

In our opinion, **export risks in short term are tilted to the upside** as global economy is not losing steam. Looking at the industrial production forecasts from main trading partners it seems foreign demand could slightly decelerate in the next two years but still stay above average level. Further on, political situation in EU countries is relatively stable as we see diminishing trend of protectionism in the following years. Since EU constitutes 75% of Slovenian exports (Chart 3) we see economic performance in EU as the most crucial for the future exports.

Chart 3. Slovenian exports, by country in 2017



Source: SURS, InterCapital

75% of total exports goes into EU. Looking at economic development of these countries, export risks are tilted to the upside.

Furthermore, we expect investment to keep the strong pace as producers are increasing capacity and consequently their market share that will back up further rise of exports. Downside risk comes from labor market through skill shortage, leading to excessive wage rise and deterioration in international competitiveness.

Considering services, **Slovenian tourism** is sector getting more and more focus as last several years it has seen double digit growth. Namely, in first ten months of 2017 there was 13.8% tourist arrivals (4.2m) and 11.5% rise of stays compared to 2016. In its Sustainable Strategy for Slovenian Tourism 2017-2021 government states that it will focus more on developments in tourism. Objectives by 2021 are as follows: currency inflow of EUR 4bn (10% of GDP), 5m tourist stays and 18-22k new tourist rooms.

Imports of goods and services jumped in 2016 and 2017 driven by strong domestic demand. It is expected they could slow down moderately as personal consumption growth is converging towards lower rates.

On the other side, **imports of goods and services** could modestly decelerate in case of slowdown of domestic consumption although the rise of investment should increase demand of foreign goods. Therefore, we expect imports to keep rising somewhat below export rates which will result in **trade balance surplus staying close to 10% in the next two years.** Hence on that basis, **net exports should continue contribute positively to the overall GDP result**. As primary and secondary income negatively affect current account balance, we expect **CA surplus** to stay close to 5% of GDP in both 2018 and 2019.

Monetary and Fiscal Policy: Monetary Policy Tightening and Fiscal Surplus on Horizon

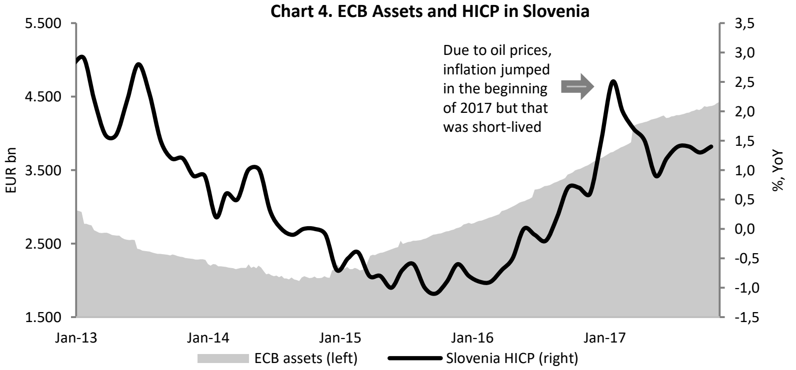
ECB's QE is planned to stay here at least until September 2018 and maybe beyond in case of any turbulences on the market.

MONETARY POLICY. On its October's meeting, the Governing Council of the ECB decided to continue purchases under the asset purchase program at the current pace of EUR 60bn until the end of 2017 and then to halve them, i.e. to continue buying bonds at the monthly pace of EUR 30bn from January 2018 until the end of September, or beyond if necessary. It means that if any shocks occur or inflation continues to be subdued, program could be easily prolonged. With the decision to leave the door wide open, ECB telegraphed that inflation developments are not satisfactory and we still have to wait and see when economic growth will spill into higher wages and into inflation that would reach long-term target of 2.00%.

Inflation in Eurozone breached zero level at mid-2016 and accelerated further until February 2017 when it peaked at 2.00%. That was not long-dated as it was backed by surging energy costs on annual basis (Chart 4).

Inflation peaked in 2017 but came back below 1.5%.

Chart 4. ECB Assets and HICP in Slovenia



Source: ECB, Eurostat, InterCapital

For 2017 as a whole we expect average inflation to reach 1.6% in Eurozone and 1.5% in Slovenia after which **inflation pressures could somewhat intensify**. Namely, in our base scenario we expect further employment improvements, continuous upward pressures on wages, stable oil prices, while rise of house prices could surpass this years' growth of 3.8% - this makes our projections for inflation set at 1.50%-1.80% band in 2018 and 2019, going in line with ECB's projections for the euro zone.

Labor market improvements could spill into higher prices so we expect inflation to reach 1.80% in 2019.

In scenario of stable prices growth, ECBs governor Mario Draghi could gently communicate end of unconventional measures and **slow transition into the policy tightening**. The first expected move could come in the second part of the 2018 and ECB balance would then go on the autopilot, just refinancing names. First rate hike (from current -0.40% rate) could be in the cards for 2019 or perhaps even later. FED already started balance trimming and hence we expect ECB to follow and start trimming the balance together with hiking rates in the next two years.

Banking sector in Slovenia is well capitalized and as we have seen, NPLs are at 4.60% (being above 17% in 2013). Loans to households are rising very slowly although rates are at their bottom. As memories on financial and banking crisis slowly fades and consumer confidence strengthens, we expect credit activity to expand in the next two years (despite likelihood of higher rates).

FISCAL POLICY. Moody's decision to upgrade Slovenia's credit rating from Baa3 to Baa1 in September 2017 was mostly backed by government's **favorable debt trend** that was driven by fiscal consolidation. Looking at the Chart 5. on the bottom you could see that Slovenia went from double digit numbers to budget deficit below 1% of GDP in 2017 with government planning to overturn the trend resulting in small budget surplus in 2018 and 2019. In absence of black swan events, government's plan involves public debt as share of GDP to fall below 70% until 2020 and to reach 60% until 2026.

Positive economic trend and fiscal discipline led to downward path of public debt.

Ministry of finance's data show **revenues** of consolidated general government increased by 6,4% (EUR 750m) in the first 9 months of 2017 compared with same period last year. Increase came from strong business results and better employment, resulting in higher corporate and personal income tax which added EUR 200m (27% of mentioned increase). Improvements on the labor market increased receipts from social security contributions while strong consumer sentiment added to higher VAT collections. In the same period governments' expenditures grew by 2.4%, reflecting fiscal discipline which we expect to intensify in the next period.

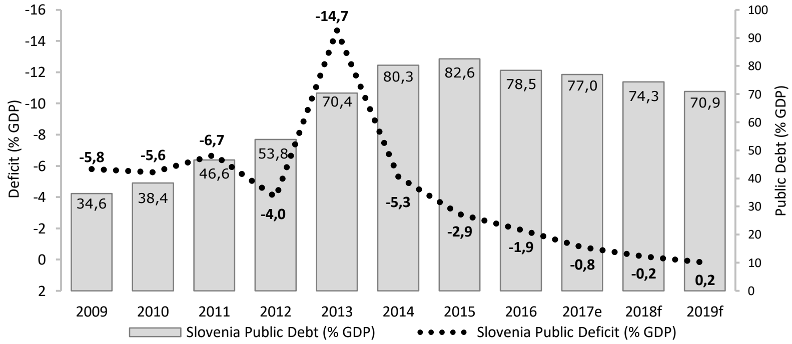
In its **budgetary plans for 2018 and 2019** from October 2017, government forecasts stable growth of revenues, i.e. 5.44% and 3.13% respectively. Expenditures are planned to increase at slower pace, 2.77% in 2018 and 2.14% in 2019. Revenues should grow backed by strong economic momentum and past implementation of restructuring measures that will increase taxes on income, social contributions and VAT revenues. Also, government expects EU funds to accelerate further in 2018 with estimate around EUR 1,1bn (compared to EUR 500m in 2016). On the **expenditure side** as mentioned above, wage bill should rise moderately in 2018 and 2019 while pensions will increase more than 4% due to new pension system. Gross fixed capital formation financed from public funds are planned to accelerate and to grow by double-digits in both years but still will not reach levels before the crisis. Interest expenditure should decrease to level of 2.6% of GDP in 2017 which was achieved among other factors by active debt management, that included several USD bonds buy-backs (50% of USD bonds) coupled with long EUR issuances in 2016 and 2017. Going ahead, Government expects **interest expenditures to decrease below 2% in 2018**. End of QE should mark the end of the lowest interest rates but we expect government's discipline and economic growth to fully absorb costs coming from rate increases.

Government plans to achieve fiscal surplus already in 2018 which is possible, but not probable.

Parliamentary elections next year could derail efforts to report a balanced budget.

We expect Slovenia to grow robustly in the next two years with diversified generators that should back up strong growth of the revenue side of the budget. Government's plans to raise expenditures very slowly (2.77% in 2018 and 2.14% in 2019) look optimistic and thus we believe they will slightly be overjumped. Hence, the plan to overturn the trend and score a positive result seems achievable i.e. the fiscal gap could be almost closed next year (-0,2%) and in absence of external shocks we could see **small fiscal surplus** (+0,2%) in 2019 (Chart 5).

Chart 5. Slovenian Public Debt and Deficit



Source: Bloomberg, InterCapital

In case of strong GDP growth and continued fiscal discipline, we could see debt as a share of GDP falling below 70% until 2020.

SERBIA MACRO OUTLOOK

InterCapital Research

December 2017

Improved Competitiveness and Confidence in Serbian Public Debt Underpins Future Output Expansion

CREDIT RATING

S&P: **BB** stable outlook
Moody's: **Ba3** stable outlook
Fitch: **BB** stable outlook

Table 1. Overview of Selected Macroeconomic Indicators

Macroeconomic Indicator	2012	2013	2014	2015	2016	2017 (e)	2018 (f)	2019 (f)
GDP (real growth rate, YoY)	-1.0%	2.6%	-1.8%	0.7%	2.8%	1.8%	3.0%	2.8%
ILO unemployment rate (average, YoY)	23.9%	22.1%	19.2%	17.7%	15.3%	13.2%	12.6%	12.0%
Inflation rate (CPI, average, YoY)	7.3%	7.9%	2.1%	1.4%	1.2%	3.5%	3.0%	3.0%
EUR/RSD (average)	113.0	113.1	117.3	120.7	123.1	121.4	119.4	120.0
Current account balance (% GDP)	-11.5%	-6.1%	-6.0%	-4.6%	-3.9%	-4.1%	-4.0%	-4.0%
Fiscal deficit (% GDP, ESA 2010)	-6.8%	-5.5%	-6.6%	-3.7%	-1.3%	-0.8%	-1.0%	-1.3%
Public debt (% GDP, ESA 2010)	55.9%	58.8%	68.8%	74.7%	71.6%	64.0%	62.0%	60.0%

Source: Statistical Office, Central Bank, Ministry of Finance, InterCapital

Last December it seemed as if Serbian economy was not just recuperating from a long recession period (a triple-dip recession started back in 2009), but also gathering momentum for a more aggressive period of economic growth as country was getting closer and closer to a full EU membership. A year ago forecasters surveyed by Focus Economics estimated Serbian 2017 real GDP growth at 2.60% YoY and nominal GDP growth at 5.10% YoY, which is quite an interesting remark once we bring to our attention the fact that back then Romanian GDP was expected to increase by +5.40% YoY in nominal terms. One year and four quarterly GDP readings later, the once upbeat analyst consensus has been educated by harsh economic reality since in the first three quarters of the current year Serbian GDP increased by merely +1.55% YoY in real terms and +4.48% YoY in nominal terms. At the same time (Jan-Sep 2017) Italian real GDP increased by +1.50%, Spanish by +3.10%, Slovenian by +5.10% etc.

A dismal performance in 2017 was driven by one off factors and should be compensated by higher growth in the coming years.

We expect Serbian real GDP growth to accelerate in 2018 and 2019 to 3.0% YoY and 2.8% YoY, respectively, based on the following:

(+) personal consumption: pensions and public sector wages are poised to rise substantially in 2018, which would in turn boost household spending

(0/+) investment: foreign companies are still fond of Serbian labor cost structure and FDI continues to flow into Serbia, setting up new jobs and raising private sector wages; nevertheless, lack of privatizations means that inefficiencies continue to persist in some manufacturing sectors

Labor cost structure coupled with EU accession serves as a magnet for foreign direct investment.

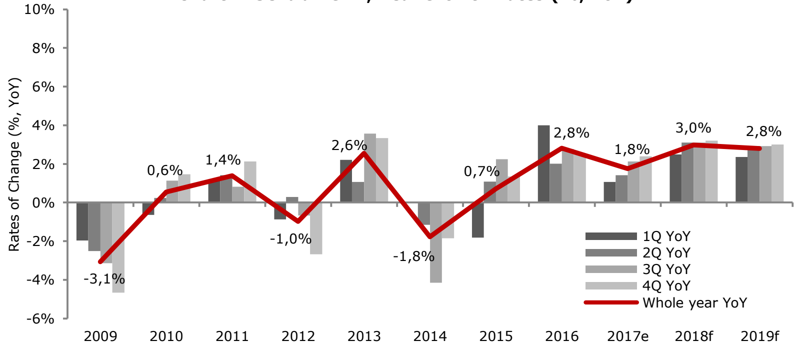
(+) net exports are on the rise in spite of drought, harsh weather conditions in the beginning of the year and a three-week strike in Serbian car manufacturer; the trend is likely to be continued in 2018 and 2019 as well

(+) monetary policy: although the direction of the interest rates remains uncertain, low interest rate environment is supportive for economic growth

(+) fiscal policy: two rating upgrades taking place in mid-December are a tap on the back for Serbian efforts to bring public deficit under control; risks for fiscal blueprint appear to be balanced as most of the public debt was incurred with a fixed interest cost and FX component of the public debt is not a problem when domestic currency appreciates.

Mid-December rating upgrade to BB by S&P/Fitch is probably the most striking accolade aimed at efforts to bring public finance in check.

Chart 1. Serbian GDP, Real Growth Rates (%, YoY)



Source: Serbian Statistical Office, InterCapital

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Real Economy: Rise in Employment and Real Wage Pave the Way for Economic Expansion to Continue

PERSONAL CONSUMPTION. Underlying causes of **the slower economic growth compared to peers** might be traced to household consumption and investment. In the first three quarters of 2017 Serbian **personal consumption increased on average by +1.8% YoY in real terms**, which is an acceleration compared to last year, but still slower compared to peers. This nevertheless still gives plenty of reasons for sober optimism regarding Serbian personal consumption in the near future, which might once again turn out to be the locomotive of overall GDP growth.

At first, Serbian **labor market seems to be profoundly influenced by government action** since out of the total **2.07m employees** (Q3 2017 data provided by SORS) some **612k** are employed in the **public sector**. In the first quarter of the current year the economy added some 58.7k new jobs (+3.0% YoY increase) once the individual agricultural producers are excluded; here is where things get quite interesting – at the same time government wage bill was cut by some 7k (-1.1% YoY). This is indicative of government share in the economy decreasing, a trend started in February 2015 once the stand by arrangement with the IMF was signed.

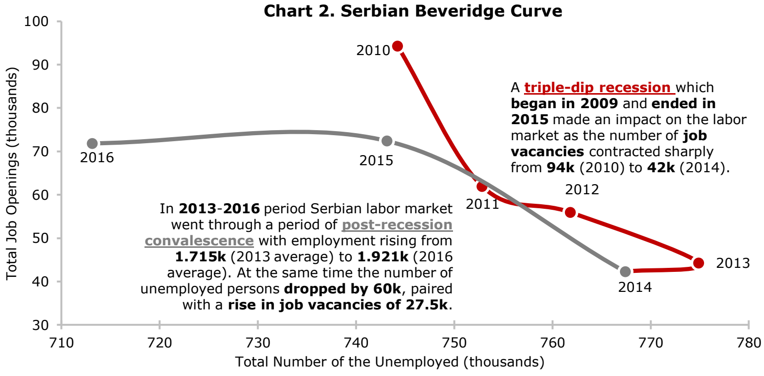
Although government continues to rightsize the public sector wage bill, the rekindled demand for labor winds down unemployment to all-time lows.

The International Monetary Fund brought to attention **relatively low labor force participation rate compared to EU average**, which might be viewed as quite a potential should discouraged workers return to the job market. In the penultimate quarter of 2017 SORS reported an employment rate of **59.2%**, meaning that out of 4.61m people in the 15-64 age bracket, only 2.73m were working. For comparison, EU28 average employment figure stands at **67.7%**; Slovenia, Romania and Bulgaria reported 69.1%, 65.5% and 67.2%, respectively, while Croatian employment figure is equal to Serbian (59.2% in the second quarter 2017). Serbian statistical bureau also reported a 31.6% inactivity rate in the 15-64 age bracket, meaning that some 1.46m people in the prime working age are simply left out of the labor force. Moreover, some 1.13m out of the inactive 1.46m have stated that they are out of the labor force because they do not want to work (due to schooling or training, disease or incapacity, pension, care of children etc.). The slack on the Serbian labor market still exists and as the wages rise and market conditions continue to improve, a possible rise in activity and employment rate pose a great upside opportunity for Serbian GDP as a whole.

High inactivity rate in Serbia could be seen as *„clandestine unemployment"* – from this point of view there is even more room for new labor posts being created as the job market slack is far from diminishing completely.

Data disseminated from the National Employment Service and depicted on Chart 2. (Serbian Beveridge curve) reveal how much **the figure of the unemployed dropped compared to 2013**, however **the number of vacant job posts is still very well below the 2010 level**. Here is another interesting fact: in describing the Croatian labor market we mentioned that fixed-term contracts make up a vast majority of the newly created jobs. In Serbia the situation is reverse: out of 58.7k new jobs created in Jan-Oct 2017, 53.5k (91%) were in long-term employment, while the residual of 5k (9%) was in temporary and occasional employment. Longer job tenures might be one of the reasons for the recent surge in household loans since they increased by +10.29% on average in the first ten months of 2017 compared to the same period last year. Both rise in employment (with considerable slack still left for utilization) and consumer credit boom are the reasons to keep our hopes up for the near term future.

Chart 2. Serbian Beveridge Curve



Source: National Employment Service, NBS, InterCapital

Serbian Beveridge curve charts the progress of the economy from recession through convalescence and finaly expansion.

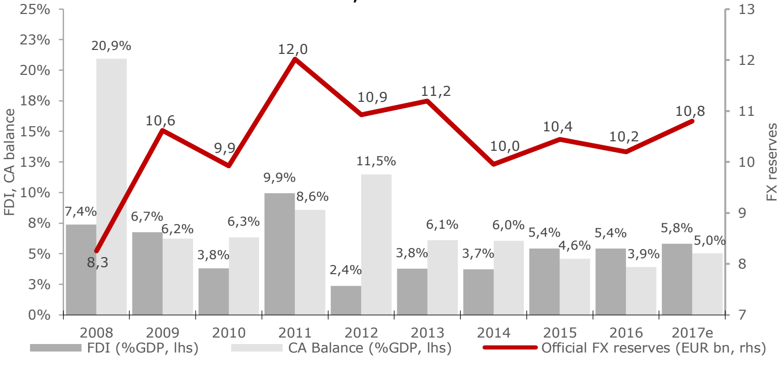
Net wages are the ultimate piece to the puzzle called Serbian household consumption. In Q3 2017 the average net wage had increased to **nearly 400.00 EUR** (NBS data), a +6.89% increase compared to FY2016 average of 374.10 EUR. For comparison purpose, **Croatian average net wage** rose to **794.40 EUR** in September (5,958.00 HRK @ 7.4545 average EURHRK exchange rate published by the CNB), while average Slovenian net wage rose to 1,050.00 EUR in August. As the country steadily follows the trail to full EU membership, the probability of real net wage rising even further appears to be realistic, supporting our working assumption that the period of confident GDP growth might be just around the corner.

INVESTMENT. Serbian investment renaissance is still under way as country leverages it's **comparatively low labor costs**, **geographical proximity to developed European countries** and **path toward full EU membership**. Gross capital formation constitutes some 17.7% of the Serbian GDP and the share has roughly been stable in at least a decade. It's interesting how investment growth decelerated in the first three quarters of 2017, reporting a 3.7% YoY increase compared to 5.2% YoY for FY2016 (all figures represent real terms).

A **secular trend of rising investment** was accompanied by a **considerable rise in net FDI** which in 2017 might end up as high as 2.2b EUR (**5.8% GDP**). This is considerably higher once compared to similar countries which are already full-fledged EU members, such as Croatia (3.7% GDP), Bulgaria (2.4% GDP) and Romania (2.5% GDP). Chart 3. depicts how net FDI inflows strengthened once the country signed it's three year stand-by arrangement with the IMF (in February 2015). It's also interesting to note that the share of reinvested earnings in net FDI gradually increases: for instance, back in 2008 reinvested earnings made up 9.6% of the total net FDI flow (238m EUR out of 2.48b EUR, according to NBS data); last year retained earnings take 48.1% of total FDI (913m EUR out of 1.9b EUR). Here is another interesting fact: in the first nine months of 2017 Serbia recorded net FDI in size of 1.6b EUR; however, if we subtract the amount of reinvested earnings, we get much lower figure, some 855m EUR. This still looks quite good as even this direct investment gauge appears to be on a track of six year consistent rise. Here is one more thing worth thinking about: according to a study compiled by fDi Intelligence, in 2016 Serbia attracted 12 times more greenfield investment than the amount suggested by the size of the economy. This placed Serbia on the very top of the list according to the strength to attract inbound greenfield investment, certainly a positive sign for the overall economy.

FDI as a share of GDP still looks astonishing once compared to geographical peers; but there is more than meets the eye – reinvested earnings take a larger and larger share of FDI flows.

Chart 3. FDI, CA deficit & FX reserves



Source: NBS, InterCapital

CA deficit fully covered by FDI flows – and this will stay in the coming years as well.

Surge in foreign direct investment was accompanied by **improvements** on both **WEF's Global Competitiveness Report 2017-18** and **World Bank's Doing Business 2017**. Back in 2012-13 Serbia was ranked 95th among 144 countries on Global Competitiveness Report; five years later, a visible improvement to 78th place was a tribute to efforts put in place to ramp up competitiveness. Looking at the twelve pillars of the report, Serbia ranks as equal to the developed countries in terms of health and primary education (52nd place), as well as higher education and training (59th place). However, the country still looks at the back of 109 countries on business sophistication scale (110th place), as well as goods market efficiency (110th place as well). The report uncovers not so pretty story of Serbian recent GDP growth as being based on low labor costs and government incentives to foreign business (something Serbia would have to discontinue once it enters the EU). Furthermore, poor ranking in capacity for innovation makes the country a good candidate for middle income trap in the far future. As long as there is slack on the labor market, wages are below the EU average and government has an opportunity to lure foreign investors with tax breaks and infrastructure projects, foreign direct investment would probably continue to flood the economy. Driven mostly by strong FDI and despite limping privatization efforts we expect a positive GDP contribution from investment in 2018-2019 time span.

The effervescence of FDI was underpinned by substantial improvement on WEF's Global Competitivenss Report and WB's Doing Business report.

NET EXPORTS. Serbian export renaissance continues as **merchandise exports** increased in the first ten months of the current year at an astonishing pace of **+13.5% YoY** (disclosed by the Statistical Office of the Republic of Serbia, or SORS). This growth nevertheless came in hand in hand with a commensurable +13.9% YoY increase in merchandise imports, meaning that the trade gap increased by +15.3% YoY to 3.36b EUR.

The **largest trade gap** was recorded on **energy compartment** of the **trade balance** – last year Serbia recorded a trade gap on energy products in size of 925m EUR, while this year this figure had widened to 1.33b EUR; most of this trade balance was recorded during winter and early spring when TENT was out of function due to lack of coal. it's also worth remembering that Brent crude prices increased in 2017 by +22.7% on average, which had a profound impact on Serbian net exports. It seems that commodity prices might be on the rise next year, which might have a profoundly negative effect on Serbian net goods exports, although we believe that a confident rise in merchandise exports would partially offset higher energy prices.

Widening of the trade gap was brought about due to larger energy imports.

About **two thirds of Serbian external trade** are directed to or from countries which are **members of European Union**; in the first ten months of 2017 merchandise trade balance with these countries was pushed even further into deficit (from 2.91b EUR in 2016 to 3.36b EUR in 2017). Additional **one quarter involves European countries which are not yet members of the EU** and it's interesting to note that throughout the first ten month of 2016 Serbia managed to report a **452m EUR trade surplus** with this group of countries; in the same time period this year this surplus had widened to 535.8m EUR. One of the largest trade surpluses on the record was reported with Montenegro and reached 568.4m EUR in January-October 2017. In the coming two years the structure of merchandise trade is likely to stay the same, although higher wages and pensions might increase merchandise imports, prompting a push further into trade deficit.

Serbia is a net importer from the EU and net exporter into non-EU European countries.

Since **2009** and a **joint venture between Fiat Chrysler and Serbian government was started**, manufacturing of motor vehicles made a greater and greater share of Serbian merchandise exports. So far in 2017 this trade segment represented the largest single manufacturing activity – namely, in the first ten months of 2017 manufacturing of motor vehicles took **13.22% of the total gross export value** (according to SORS). It's also worth noting that motor vehicle production reported a 307m EUR worth trade surplus in the first ten months, the third largest trade surplus of all manufacturing activities; it was overshadowed only by manufacturing of food products (10.3% of total gross exports) and manufacturing of rubber and plastic products (8.4% of total merchandise exports). Motor vehicle exports were debilitated by a three-week strike in summer of this year which made a minor impact on slower export growth in this industrial activity. It's worth our while to remember that in the past ten years between one quarter and one third of FDI inflows went into export-orientated manufacturing sector, which is now driving exports growth. Since FDI was rather diversified across the board of manufacturing activities, Serbian merchandise export became less reliant on a single component within the export stack. Therefore, even if Serbian motor vehicle export faces a cut in production, other sectors are likely to pick up the slack and continue to deliver positive growth figures in the coming two years.

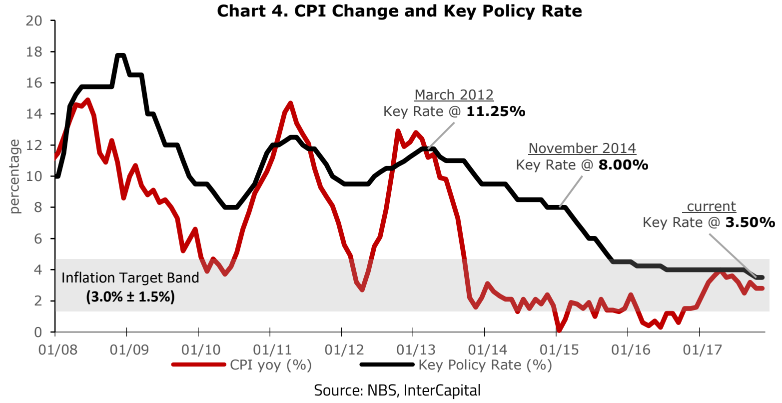
Serbian exports sector is well diversified across the board and hence resilient to disruptions in single industry.

Monetary and Fiscal Policy: Strong Dinar Underpins Serbian Monetary Policy Conundrum; Fiscal Picture in Check

MONETARY POLICY. If Serbia was already a member of the EU, then in the first eleven months the HICP change would have been **the third highest in the pool** – with an average value of **3.33%** (this is a YoY change), only Lithuania (3.71% YoY) and Estonia (3.63% YoY) have recorded higher HICP changes (according to Eurostat). The primary reason for relatively high Serbian inflation rate could be traced to **higher electricity prices** caused by rising electricity tariffs by 3.8% in October last year. Should the energy prices be removed from calculation, the CPI would average 2.7% YoY in period January-November (NBS, table 3.7.). This figure is also quite close to our baseline forecast of annual CPI change next year in size of 3.0%, where imported inflation from the eurozone and constant rise in wages would bring about higher consumer prices. Major source of upside risk for our inflation forecast stem from energy prices which might be susceptible to violent bursts of volatility due to geopolitical tensions in the Middle East. Events like these are hard to predict, but are nevertheless in the cards. Void of unexpected commodity trading regime changes, expected inflation would be poised right at the middle of the CPI target band (3.0%±1.5%).

Hiking electricity tariffs (among other things) placed Serbia at the very top of European countries according to CPI growth rate in 2017.

Chart 4. CPI Change and Key Policy Rate



Source: NBS, InterCapital

This year's dinar strength has prompted multiple FX interventions by the NBS to spur bank lending and to curb too much of a dinar appreciation. he move was unanticipated by financial analysts who were on their toes about news when the interest rates might go up. The direction of interest rates is not telegraphed to the markets as is the case across the Atlantic for instance. In our baseline view, benchmark one-week REPO rate would gradually go up next year, so one interest rate hike (from 3.50% to 3.75%) looks rather likely. Serbian economy still manages to print consistent CA deficits which are full covered by FDI inflows (as depicted on Chart 3.), so the risks for the sudden depreciation of dinar versus euro looked contained. However, should FX inflows continue to drive the dinar strength, we would not eliminate the possibility of another NBS one-week REPO cut next year, especially as ECB looks rather dovish at the prospects of phasing out QE and charting the path for a gradual interest rate rise.

Strong dinar is one of the reasons why it's difficult to predict where the benchmark interest rate might go next. However, the international monetary setup is more aligned with raising interest rates, then debasing them even further.

FISCAL POLICY. Serbian **fiscal blueprint** has definitely gone through a **period of major overhaul** since the IMF stepped in back in February 2015 and managed to report a general government **surplus** in size of **2.53% GDP** during the first nine months of 2017 (82b RSD in absolute terms versus a nominal GDP in size of 3,241b RSD; all figures are disseminated from the NBS, tables 4.1. for fiscal figures and 3.1. for gross domestic product at market prices).

Let's put Serbia next to EU countries to see how this goes: when our IC Macro Outlook was compiled, only the H1 data was available for all of the countries within the European Union, so for comparison purpose let's mention that in the **first six months of 2017**, **Serbian public surplus amounted to 2.13% GDP** (44.3b RSD versus a GDP at current prices in size of 2,081.8b RSD). This is definitely a stark contrast to -6.60% GDP recorded in the last year prior to IMF giving Serbia a financial health check (2014), but still looks somewhat unremarkable once compared to EU28 countries. If Serbia was a full member of the EU, in first six months of the current year there would have been ten countries with higher budget surplus as a share of GDP.

Serbia recorded a 2.13% GDP budget surplus in the first semester of 2017.

This sharp drop in public deficit came about in larger part through higher revenues, although **keeping expenditures in check also contributed**. Looking at the trailing twelve month data for October 2017, revenues were higher by +7.54% YoY, while public expenditures were roughly at the same level as exactly one year before. It's interesting to note that since end-2014, public revenues have swollen by +20.0%, while public expenditures have dropped by -2.57%, which is certainly a testament to the efforts of incumbent government to put through a plan to consolidate public finance. IMF notes that since end-2014 more than 25k public employees were removed from aggregate public payroll, although in the meantime some 11k were added back through fixed term and contractual hiring, offsetting part of the rightsizing gains.

How did budget surplus come into being? The public wage bill was consistently cut and a rise in revenues from higher GDP did the rest of the job.

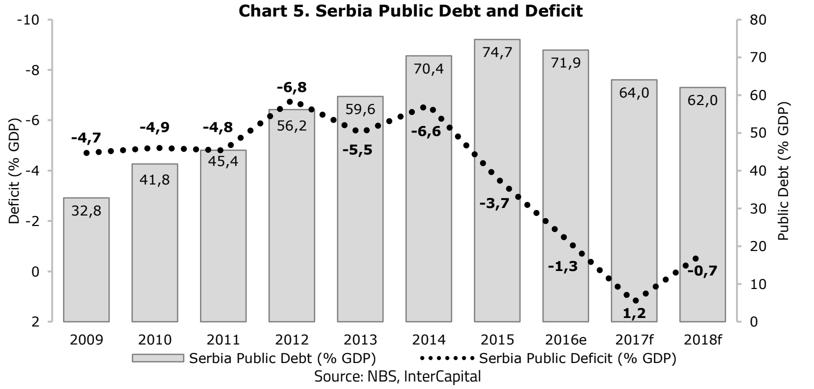
According to the most recent data disclosed by Serbian Public Debt Administration, by **end-October 2017 Serbian public debt** dropped to **64.9% GDP** (from 71.9% GDP at end-2016). The high portion of FX-denominated public debt is a striking feature: 41% of public debt is EUR-denominated, while 31% is USD denominated; only 22.2% of public debt is in RSD bonds and loans (all figures relate to general government). It's also worth noting that 80% of public liabilities pay a fixed interest rate and 14.6% of public debt is tied to EURIBOR, meaning that so far higher short-term interest rate in the USA have not caused higher interest expenditures on public debt. It's also worth noting that at end-2016 average annual interest rate paid by the government to service the public debt amounted to 4.25%.

Next year the Serbian Ministry of Finance plans a general consolidated government deficit in size of **-0.7% GDP**, which is both **credible** and **achievable**. The plan involves a **5%-10% increase of public wages** and since the rightsizing would be continued, **public expenditures** for employees would increase by roughly **+7.5%**. **Pensions** are also planned to rise - first through linear increase by **+2.5%**, and second through rolling back some of the measures introduced back in 2014 when public debt crisis loomed. Considering revenue collection, government plans a +3.5% YoY GDP growth next year, which is also realistic, especially if we reckon that due to drought and inefficiencies at Serbian electric power producer EPS the GDP growth dropped to merely +2.0% YoY; the relatively low base would allow for even more optimistic expectation and +3.5% YoY GDP growth could therefore be deemed as conservative. The major possible headwind for deficit forecast are circumstances surrounding the SOEs – with some 50k employees, **rightsizing and privatizations have been implemented at a glacial pace**. Meanwhile, loss-making public enterprises have been indirectly funded by more profitable SOEs – take fertilizer producer Azotara and chemical company MSK for example, which are implicitly funded by Srbijagas through avoiding to pay due gas bills. In November the state owned drug maker Galenika was sold to Aelius for 16 million EUR, which is only one of two successful cases of privatization (the other successful case was the last year's sale of Zelezara Smederevo).

Even with rising pensions and public wages, a 0.7% GDP deficit next year looks realistic and achievable. It could go even further in the direction of budget surplus should GDP growth surprise on the upside.

Before closing the fiscal policy chapter, it's worth noting that by **mid-December both S&P Global Ratings and Fitch lifted Serbian LT sovereign credit rating by one notch to BB** with a stable outlook. The move has been anticipated by financial markets for quite some time, indicating through Serbian CDS contracting to an all-time low.

Chart 5. Serbia Public Debt and Deficit



Source: NBS, InterCapital

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