Monthly Economic Overview
Bosnia & Herzegovina
No.2

Highlights

- ✓ The Executive Board of the IMF completed the first review of B&H economic performance under the EFF and allocated EUR 74.6 mn to the local governments as budget support. According to our baseline scenario, it is highly unrealistic to expect that the EFF will be continued in 2018 as it is an Election year and any further reforms will be hard to be tackled and agreed between the key political players.

- ✓ Strongest growth of exports in 7 years (17.4% yoy) resulted in lowest trade deficit (in % of GDP) in modern B&H history (22.5% of GDP). Exports growth was broad-based with almost all categories in positive area and increasing export to all key markets (Germany, Italy, Croatia, Slovenia, Serbia, etc).

- ✓ Heavy-weight macroeconomic indicators have softened in final month of 2017 (industrial production, retail trade and inflation) but the cumulative data for the whole year are mostly in line with our positive expectations.

- ✓ Banking sector of B&H ends year on a right foot with accelerating loans (7.1% yoy) and deposits (10.8% yoy) dynamics. Active interest rates continued with the declining path in 2017 – a trend observed since 2012.

- ✓ As for the 2018 we see no reason to change our key macroeconomic target rates so we still expect real GDP expansion of around 3.0% yoy, driven mostly by exports of goods and services (8% yoy), private consumption (1.7% yoy) and by gross capital formation (8% yoy).

Credit rating of B&H

Credit rating	S&P		Moody's	
	Rating	Outlook	Rating	Outlook
LT	B	Stable	B3	Stable
Date of last change	September-17		February-18	
Activity	Confirmed		Confirmed	

Source: Central Bank of B&H, Raiffeisen BANK dd BiH

Key macroeconomic figures of Bosnia and Herzegovina

	2012	2013	2014	2015	2016	2017e	2018f	2019f	2020f
Nominal GDP (EUR bn)	13.4	13.7	14.0	14.6	15.3	16.1	**17.0**	18.0	19.0
Real GDP (% yoy)	-0.8	2.3	1.2	3.1	3.1	2.5	**2.8**	3.0	2.5
GDP per capita (EUR)	3,452	3,531	3,614	3,784	3,967	4,179	**4,421**	4,698	4,967
GDP per capita (EUR at PPP)	6,900	7,200	7,300	7,500	7,900	8,300	**8,800**	9,400	9,700
Household consumption (real, % yoy)	-0.7	0.0	1.9	1.8	1.7	1.9	**1.7**	1.7	1.8
Gross fixed capital formation (real, % yoy)	4.0	-3.0	8.2	2.9	10.8	5.8	**8.0**	9.5	8.9
Industrial output (% yoy)	-5.2	6.7	0.1	2.6	4.3	3.1	**4.8**	5.0	4.5
Producer prices (avg, % yoy)	1.3	-2.2	-0.2	0.6	-2.3	3.0	**2.5**	2.3	2.3
Consumer prices (avg, % yoy)	2.1	-0.1	-0.9	-1.0	-1.1	1.3	**1.8**	2.0	2.0
Average gross industrial wages (% yoy)	2.2	-0.5	0.3	0.0	0.9	1.4	**5.1**	6.1	4.0
Unemployment rate (avg, %)	28.0	27.5	27.5	27.7	25.4	20.5	**18.0**	16.0	15.0
General budget balance (% of GDP)	-2.0	-2.2	-2.0	0.7	1.2	1.0	**-0.5**	0.5	0.5
Public debt (% of GDP)	39.9	38.9	42.1	41.8	40.4	40.8	**40.4**	37.5	35.7
Trade balance (% of GDP)	-28.2	-25.4	-27.5	-24.0	-22.6	-22.5	**-22.8**	-23.3	-22.5
Current account balance (% of GDP)	-8.6	-5.3	-7.4	-5.7	-5.1	-5.0	**-5.9**	-6.4	-6.3
Net foreign direct investment (% of GDP)	1.9	1.3	2.9	1.7	1.6	2.2	**2.7**	3.3	3.9
Official FX reserves (EUR bn)	3.3	3.6	4.0	4.4	4.9	5.4	**5.5**	5.8	6.1
Gross foreign debt (% of GDP)	52.1	52.1	51.7	53.4	54.4	54.8	**54.2**	53.1	51.8
EUR/BAM (avg)	1.96	1.96	1.96	1.96	1.96	1.96	**1.96**	1.96	1.96
USD/BAM (avg)	1.52	1.47	1.47	1.76	1.77	1.73	**1.55**	1.47	1.44

Source: Agency for Statistics of B&H, Central Bank of B&H, Raiffeisen BANK dd BiH

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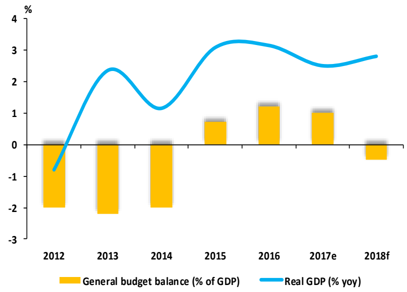
Key macroeconomic and banking sector indicators of Bosnia and Herzegovina

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017e	2018f
GDP and real economy											
Nominal GDP (EUR bn)	13.0	12.7	13.0	13.4	13.4	13.7	14.0	14.6	15.3	16.1	17.0
Real GDP (% yoy)	5.4	-3.0	0.9	1.0	-0.8	2.3	1.2	3.1	3.1	2.5	2.8
Nominal GDP per capita (EUR)	3,336	3,248	3,328	3,448	3,452	3,531	3,614	3,784	3,967	4,179	4,421
Industrial output (real, % yoy)	7.3	-3.3	1.6	5.6	-5.2	6.7	0.1	2.6	4.3	3.1	4.8
Retail trade index (real, % yoy)	n.a.	n.a.	n.a.	n.a.	n.a.	4.5	1.8	7.8	7.0	5.1	6.1
Household consumption (real, % yoy)	5.3	-4.5	0.1	-0.2	-0.7	0.0	1.9	1.8	1.7	1.9	1.7
Gross fixed capital formation (real, % yoy)	14.9	-28.3	-15.6	14.1	4.0	-3.0	8.2	2.9	10.8	5.8	8.0
Exports of goods and services (real, % yoy)	1.2	-3.2	13.9	4.6	0.1	7.8	4.2	6.8	9.5	10.1	8.0
Imports of goods and services (real, % yoy)	10.1	-14.3	2.5	2.9	0.7	-0.2	7.7	0.7	7.0	7.2	6.0
Balance of Payments											
C/A balance (EUR bn)	-1.8	-0.8	-0.8	-1.3	-1.2	-0.7	-1.0	-0.8	-0.8	-0.8	-1.0
C/A balance (in % of GDP)	-13.8	-6.4	-6.0	-9.5	-8.6	-5.3	-7.4	-5.7	-5.1	-5.0	-5.9
Secondary income (EUR bn)	2.0	1.7	1.8	1.8	1.9	1.9	2.0	1.8	1.8	1.8	1.9
Secondary income (in % of GDP)	15.0	13.5	13.9	13.5	14.0	13.8	14.5	12.5	11.9	11.2	11.9
Net inflow of FDI (EUR bn)	0.7	0.2	0.3	0.3	0.3	0.2	0.4	0.2	0.2	0.4	0.5
Net inflow of FDI (in % of GDP)	5.2	1.4	2.1	2.6	1.9	1.3	2.9	1.7	1.6	2.2	2.7
Export of goods (EUR bn)	3.4	2.8	3.6	4.2	4.0	4.3	4.4	4.6	4.8	5.7	6.1
Import of goods (EUR bn)	8.3	6.3	7.0	7.9	7.8	7.8	8.3	8.1	8.3	9.3	10.0
Trade balance (EUR bn)	-4.9	-3.5	-3.3	-3.7	-3.8	-3.5	-3.8	-3.5	-3.4	-3.6	-3.9
Trade balance (in % of GDP)	-37.5	-27.5	-25.7	-27.8	-28.2	-25.4	-27.5	-24.0	-22.6	-22.5	-22.8
Foreign reserves (EUR bn)	3.2	3.2	3.3	3.3	3.3	3.6	4.0	4.4	4.9	5.4	5.5
Prices, wages, unemplyoment											
Consumer prices (avg, % yoy)	7.4	-0.4	2.1	3.7	2.1	-0.1	-0.9	-1.0	-1.1	1.3	1.8
Producer prices (avg, % yoy)	8.6	-3.2	0.9	3.8	1.3	-2.2	-0.2	0.6	-2.3	3.0	2.5
Unemployment rate (avg, %)	23.4	24.1	27.2	27.6	28.0	27.5	27.5	27.7	25.4	20.5	18.0
Average monthly gross wages (EUR)	569.2	615.3	622.0	649.7	659.7	660.2	659.3	659.2	665.0	673.9	708.1
Average gross wages (LCY, % yoy)	16.7	8.1	1.1	4.4	1.5	0.1	-0.1	0.0	0.9	1.3	5.1
Fiscal position											
General budget balance (% of GDP)	-2.2	-4.4	-2.5	-1.3	-2.0	-2.2	-2.0	0.7	1.2	1.0	-0.5
Public debt (% of GDP)	29.0	33.4	37.4	38.0	39.9	38.9	42.1	41.8	40.4	37.5	35.7
Public debt (EUR bn)	3.8	4.2	4.9	5.1	5.3	5.3	5.9	6.1	6.2	6.0	6.1
External debt (EUR bn)	2.2	2.7	3.2	3.4	3.6	3.8	4.2	4.3	4.4	4.2	4.2
Internal debt (EUR bn)	1.6	1.6	1.6	1.7	1.7	1.5	1.7	1.8	1.8	1.9	1.9
Banking sector indicators											
Total Assets (EUR mn)	10.6	10.6	10.6	11.0	11.2	11.8	12.3	12.8	13.3	14.3	15.3
Total Assets (in % of GDP)	81.3	83.2	81.9	81.9	83.6	86.1	87.9	87.3	87.3	89.2	90.4
Total loans (EUR mn)	7.2	7.0	7.2	7.6	8.0	8.2	8.4	8.6	8.8	9.3	9.9
Total deposits (EUR mn)	6.1	6.2	6.4	6.6	6.8	7.3	7.9	8.5	9.1	10.1	10.9
Non-performing Loans (%) - NPL	3.1	5.9	11.4	11.8	13.5	15.1	14.2	13.7	11.8	10.8	9.8
Return on Assets (%) - ROA	0.4	0.1	-0.6	0.7	0.7	-0.1	0.8	0.3	1.1	1.7	1.5
Return on Equity (%) - ROE	4.2	0.8	-5.5	5.8	5.1	-0.5	5.4	2.0	7.3	11.7	10.6

Source: Agency for Statistics of B&H, Central Bank of B&H, Raiffeisen BANK dd BiH

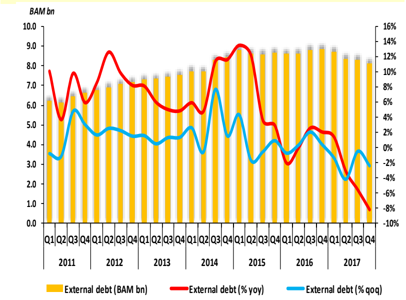
Budgets timely adopted but continuation of the IMF arrangement in 2018 highly unlikely

Budget balance (in % of GDP)



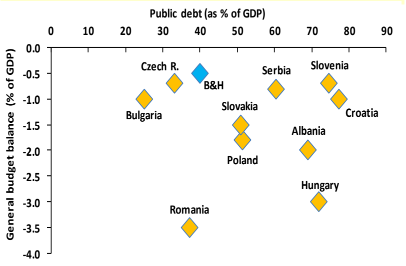
Source: Central Bank of B&H, Raiffeisen BANK dd BiH

External debt of B&H



Source: Central Bank of B&H, Raiffeisen BANK dd BiH

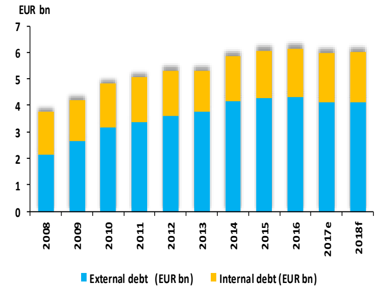
Key fiscal figures for B&H



Source: Central Bank of B&H, Raiffeisen BANK dd BiH

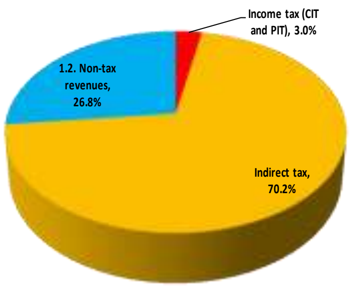
Discussion related to the IMF first positive review of the Extended Fund Facility (EFF), three year programme which was approved to Bosnia and Herzegovina (B&H)back in September 2016 in amount of SDR 443.042 mn (EUR 553.3 mn), was in the spotlight in the country during February. Political open confrontations in the State and FB&H Government and long debate over amendments of the Excise Tax Law (declined five times in the State Parliament) was major obstacle for continuation of the arrangement during 2017 - year in which B&H have not received any of the IMF EFF's tranches nor support of other European creditors (EBRD and EIB) aimed for continuation of the main infrastructural investments on Corridor Vc in B&H. Nevertheless, end of the year brought some positive turnaround related to decision making in B&H institutions driven again largely by strong international community pressure. Firstly, in mid-December the amendments on the Excise Tax Law were adopted where excises on oil and oil derivatives and products were hiked by 15 pfennig per litter, followed by timely adoption of the State and Budget of Republic of Srpska (RS). At the end after long-debate, in Jan-18 finally also the Budget for 2018 Federation of B&H (FB&H) was adopted fulfilling by this the key preconditions for the first positive review and release of the second tranche of the IMF programme. Consequently, the Executive Board of the IMF approved the first review under the EFF a second tranche in amount of SDR 63.4 mn (EUR 74.6 mn) became available to the local entity budgets as of mid-February, bringing the total funds disbursed to SDR 126.8 mn (EUR 149.3 mn). However, although the preconditions for continuation of the IMF arrangement were met and amending Letter of Intent was signed and sent to Washington, according to our baseline scenario continuation of the EFF programme is highly unlikely in 2018 which is the General Election Year. Key political players have already started with early pre-election campaigns and orient their attention toward the Election agenda and more populist oriented measures in 2018. That is the reason why we expect substantial slowing down of the reform processes and adoption of the key reform laws and other conditions set by the IMF which will again lead to the programme being "off the track" until the new governments are in place after the General Elections. However, even without the IMF 2018, the Budgets should be sustainable for 2018 as the entity ministries of finance turned again focus of financing more to the local debt market. In FB&H total budget framework for 2018 was adopted in amount of BAM 2.89 bn which is increase by 5% yoy. Out of the total Budgeted revenues, receipts and financing, total budget revenues amount to 78.7% or BAM 2.23 bn of the Budget while Receipts from financing amount to BAM 613 mn or 21.3% of the Budget. Same as in previous years, Tax revenues are planned to report solid growth by 6% up to BAM 1.66 bn where again strongest growth is expected from Direct taxes which are expected to grow by 19% up to BAM 67.5 mn, although the fundamental backbone of the Budget are Indirect taxes which are planned to grow by 5% yoy up to BAM 1.59 bn or 55.3% of total Budget framework. Nontax revenues are planned in total amount of BAM 607 mn which is planned increase by 21% yoy. It should be emphasised that the robust growth of Direct taxes and Nontax revenues in 2017 and for 2018 are generally achieved and planned thanks to very active work of the Tax inspection and other Federal inspections which brought many companies and workers to official economy and broadened the tax base in FB&H. Total expenditures are planned in amount of BAM 1.75 bn, out of which Current expenditures amount to BAM 1.37 bn or 47.6% of total Budget, although the planned level of current expenditures are kept slightly below 2017 level.

Public debt structure (EUR bn)



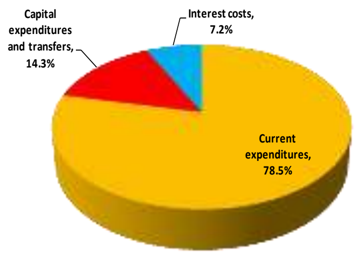
Source: Ministry of Finance of B&H, Raiffeisen BANK dd BiH

FB&H revenues structure



Source: FB&H Ministry of Finacne , Raiffeisen BANK dd BiH

FB&H expenditures structure



Source: FB&H Ministry of Finance, Raiffeisen BANK dd BiH

Capital expenditures and transfers are planned for the first time in amount higher than 5% of total Budget, or in amount of BAM 249.9 mn which is increase by 330% yoy and represent 8.7% of total Budget. The planned capital expenditures are mostly investments in reconstruction of the regional roads and road infrastructure in FBiH, which is one of the Election points of this year Budget.

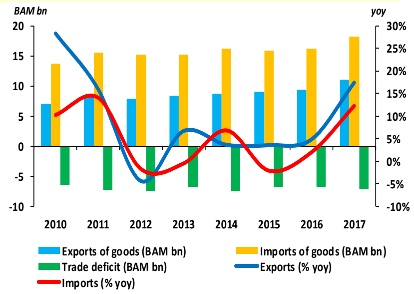
Interest payments for the external and internal public debt amount only to 4.3% of the Budget or BAM 124.9 mn which is decline by 16% yoy. This is result of declining level of overall public debt in FB&H and very low interest rate which B&H has on external and internal debt funds.
By this FB&H Budget for 2018 has the primary surplus of BAM 523.7 mn which is increase by 29% yoy or 28% of the planned Budget.

Below the line in financing part of the Budget overall Debt obligations for 2018 amount to still substantial 38.7% or BAM 1.1 mn of the Budget for 2018. However, as already mentioned the overall repayment burden and debt level is on downward path as the repayment obligations are by 2.1% yoy lower. External debt obligations are still higher than internal amounting to BAM 570 mn vs. 480 mn, while obligations for issued guaranties of FBIH amount to BAM 66 mn. Hence, the overall debt payment obligations for 2018 triggered planned additional debt raising and financing in amount of BAM 613 mn for 2018 which is 21.3% yoy increase. Out of that amount BAM 150 mn is planned in bond issues, BAM 360 mn in T-bills issues, while selling of financial assets is planned in amount of BAM 60 mn (more details on planned debt capital market issues in local currency please see chapter on capital market developments). External loan amount in the first version of the Budget is planned in amount of only BAM 43 mn which is the World Bank Budget support loan. However, taking into account the recent development related to the IMF and planned inflow of the second tranche we expect Amending Budget as of end Q1 2018 which will be changed mostly in financing part.

Hence, same will happen with the RS's Budget framework for 2018 which is planned in amount of BAM 3.3 bn (total budget revenues and receipts from financing). Therefore, the financing part which is planned in amount of BAM 563.4 mn for 2018 is RS which is also planned without the second tranche of the IMF will also survive substantial changes in Q1 2018. Total planned local debt issues are planned in initial Budget version in amount of BAM 406.7 mn (BAM 100 mn of 5Y bond were already issued in the time of writing of this report) while external loans are planned in amount of BAM 156.8 mn. For the repayments of the due debt total amount of BAM 759.9 are planned for external and internal debt (principal + interest).

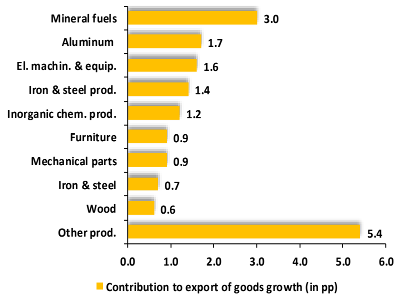
As already mentioned, the budgets for FB&H and RS are viable and missing funds for financing financial obligations could be met in planned amount in LC debt market in 2018. Local banks are still the majority investors in entity debt instruments as local banks are still struggling with the excess liquidity and LC placements. However, as the local banking agencies stipulate that the exposure to non-collateralized long-term debt can be only up to 5% of core capital this provides longer-term limits to banking sector and investments in local debt instruments. Therefore, this alternative way of financing is viable only for a short period of time as the market is still shallow and mostly relying on local banks. Hence, in 2019, after the Elections and setting up the new governments we believe that the B&H institution will again approach the IMF as this is the only viable alternative way of long-term financing for financing for the time-being.

Trade balance (in BAM mn)



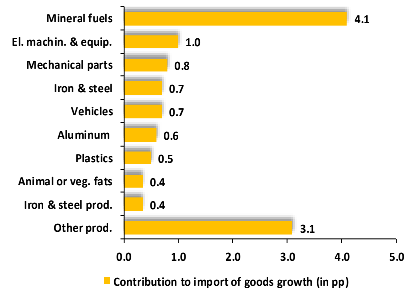
Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH

Export contribution by prod.



Source: Agency for Statistics of B&H Raiffeisen BANK dd BiH

Import contribution by prod.



Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH

Lowest trade deficit reported in modern B&H history

B&H exports of goods extended its double-digit run in Dec-17 (10.7% yoy), capping the strongest year since 2010. In full year period, B&H exported BAM 11.05 bn (17.4% yoy), while cumulative value of imports stood at BAM 18.13 bn (12.2% yoy). Consequently, export to import coverage has reached a historical peak of 61%, while total trade deficit came up to BAM 7.08 bn in 2017, increasing by 5.0% (or BAM 337.7 mn) compared to the year earlier. Even though, **the trade deficit widened in nominal terms, in comparison to GDP it fell to lowest level in modern B&H history (22.4% of GDP).**

Remarkable performance of export of goods in 2017 can be highlighted in several key points:

- Double digit yoy growth was recorded for every single month of the year, except for June.
- Out of 22 exports categories only 2 registered % yoy decline in 2017.
- 13 exports categories recorded strong expansion with double digit growth including largest categories such as base metals, machinery, mineral products etc.
- Exports to almost all major markets recorded a new high (Germany, Croatia, Austria, Slovenia, Serbia etc).
- Sharp rebound in export growth of mineral products as world prices improved.

A more detailed breakdown of figures in 2017 shows that 2/3 of export of goods growth was driven by 9 products from 6 exports categories. More precisely, iron & steel, aluminium products and iron and steel products (part of the base metals category) contributed by 3.8 pp, mechanical parts and el. machinery & equipment (part of the machinery & equipment category) by 2.5 pp, mineral fuels (par of mineral products category) by 3.0 pp, inorganic chemical products (part of chemical products category) by 1.2 pp, furniture (part of miscellanies category) by 0.9 pp and wood (part of wood products) by 0.6 pp. (see chart). All in all, the largest contributors to exports growth remained, more or less, the same as in years before, **but the main positive achievement which should be underlined once again is that exports growth was broad-based with almost all categories in positive area.**

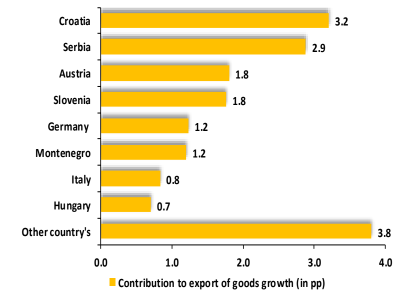
Import of goods in 2017 recorded strongest growth since 2011 (12.2% yoy) and in nominal terms the highest value in B&H modern history. Imports growth was also broad-based with only one category in negative area. However, dominant driver of the imports growth refers to one category (mineral fuels) which contributed 4.1 pp of registered growth or 1/3 of reported increased. Mineral fuels are the only product which contributed to more than 1 pp to the overall growth which is mostly result of the increasing world prices. B&H also imported a high value of iron, steel and aluminium (which are part of base metals category) contributing together by 1.3 pp, mechanical parts and equipment (part of machinery category) contributing together by 1.8 pp and vehicles (cars) contributing by 0.7 pp.

Despite the fact that exports is growing much stronger than imports for three concesutive years, B&H reports trade surplus in just 5 categories: wood and wood products (BAM 525 mn), headwear & footwear (BAM 370 mn), ammunition (BAM 179 mn), miscellaneous (BAM 807 mn), and base metals (BAM 20 mn) – first time since 2015.

The EU remains the most important B&H trade partner

According to the last official ranking by the OEC (Observatory of Economic Complexity), **B&H is 74th largest exporter in the world (out of 120 countries)**. From a continental perspective, 94.6% of B&H exports by value are delivered to European countries while 2.0% are sold to Asian and Australian importers. B&H ships another 1.3% worth of goods to North Africa with 0.7% going to Africa countries. Looking more detailed within the figures, **the European Union (EU) remained B&H top export destination for goods.** In 2017, total value of export delivered to the EU member states amounted BAM 7.87 bn (71.2% of total exports) which is increase by 16.8% compared to 2016 and contributed 12 pp to the overall growth of exports. The most important market within the EU are more or less unchanged compared to previous year with Germany as the top major export market (14.4% of total exports), followed by Croatia (11.6% of total exports), Italy (10.9% of total exports) and Slovenia (8.8% of total exports). Outside the EU, the largest export markets for B&H are Serbia (9.9% of total exports) and Turkey (3.9% of total exports). If we look markets by contribution to overall growth the most important ones are Croatia (contribution by 3.2 pp), Serbia (contribution by 2.9 pp) and Austria (contribution by 1.8 pp). Unfortunately, we still do not have detailed statistics on which products are exported to which markets, but it is important to emphasize that strong increase was recorded in exports to all above mentioned markets in 2017.

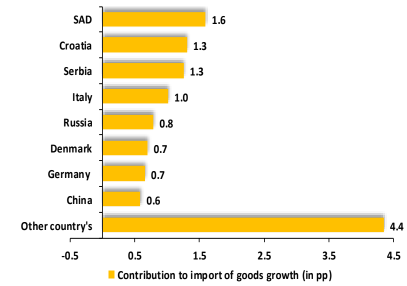
Export contribution by market



Source: Agency for Statistics of B&H , Raiffeisen BANK dd BiH

The main source of imports to B&H in 2017 was also the EU with total value of BAM 11.07 bn or 62% of total import of goods. Import from the European Union has increased 10.7% yoy contributing by 6.6 pp to overall growth of imports. Within the EU the main markets for B&H imports are Germany (11.6% of total imports), Italy (11.4% of total imports), Croatia (10% of total imports) and Slovenia (5.0% of total imports). Accordingly, these four countries are crucial for the B&H trade performance and their economy must be closely watched when forecasting B&H trade dynamics in forthcoming period. Outside the EU, the largest import by value came from Serbia (11.2% of total imports), China (6.5% of total imports) and Russia (4.7% of total imports). Nevertheless, the largest contribution to the import of goods growth in 2017 surprisingly was the US. Imports from the US went up sharply in 2017 by 78.4% yoy reaching value of BAM 584.9 mn, which accounts to 3.2% of total imports but in 2017 this increase contributed by 1.6 pp, respectively.

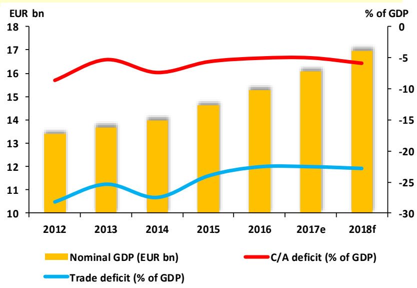
Import contribution by market



Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH

In terms of the trade surplus/deficit by markets, it should be noted that B&H is reporting notable surplus in trade with just few countries such as Austria (BAM 280 mn) or Montenegro (BAM 261.9 mn). Furthermore, for the first time in history B&H reported surplus in trade with Slovenia in 2017 in amount of BAM 60.7 mn. The largest trade deficit B&H has in trade with country's not members of the EU: China (BAM 1.2 bn) and Serbia (BAM 936.3 mn). As for the key EU partners, the deficit is largest in trade with Italy (BM 853 mn), followed by Croatia (BAM 545 mn) and Germany (BAM 508 mn).

Trade and C/A balance (f)

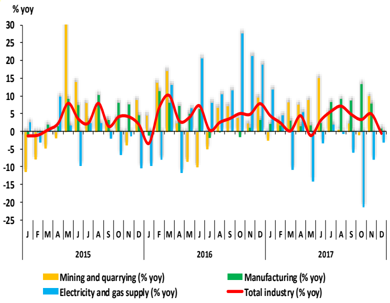


Source: Central Bank of B&H, Agency for Statistics of B&H Raiffeisen BANK dd BiH

As for the 2018 we expect continuation of the positive trade performance on the both sides of the trade balance sheet (exports and imports of goods). Exports performance should be driven by the expected economic increase in all our key trade partners (Germany, Croatia, Serbia) while imports of goods continued with positive trend seen in previous years but still bellows the growth of exports. Therefore, **our target rates for exports and imports of goods stands at 7.9% yoy and 7.5% yoy, respectively with trade deficit target rate settled at 22.8% of GDP.**

Macro indicators have softened in Dec-17 but the growth remain solid for the whole year

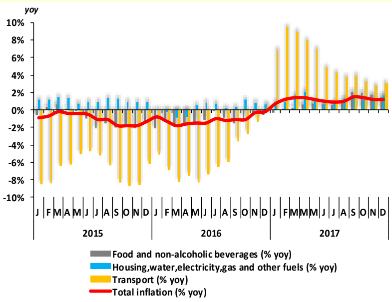
Industrial production



Source: Agency for Statistics of B&H Raiffeisen BANK dd BiH

B&H industrial production, a bellwether of economic activity, declined by 0.6% yoy in Dec-17, following six consecutive monthly increases. The biggest drag in Dec-17 was electricity supply, which dropped 3.1% yoy, while mining and manufacturing have posted just tepid growth of 0.6% yoy and 1.0% yoy, respectively. Still, over a longer period B&H industry has performed quite strongly. Over 12 months of 2017, the industrial production output increased by 3.1% yoy (4.3% yoy in 2016), on the back of export-oriented manufacturing (5.3% yoy) and mining (4.8% yoy), while electricity supply declined by 3.9% yoy over the same period due to very bad meteorological situation. Industrial output is considered a vital indicator for the economy as it is seen as a preliminary gauge for GDP growth. One of the reasons why we expect softer real GDP growth in 2017 compared to 2016 (2.5% yoy vs 3.1% yoy in 2016) emerges from slower industrial production growth, as industry produces 18% of national GDP and holds 18% in terms of total employees.

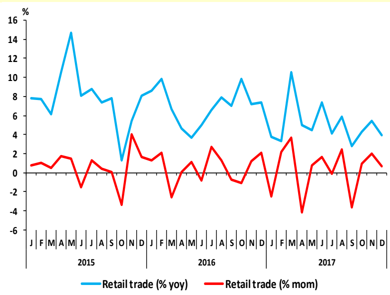
Inflation



Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH

Inflation rate was unchanged in Dec-17 from the previous month reading of 1.2% yoy. Inflation rate reached its 2017 peak in Sep-17 of 1.5% yoy after which it began to fall gradually in final quarter of 2017. Inflation has eased recently due to slower growth in transport prices which is result of higher base last year. **Consequently, the consumer prices in 2017 went up by 1.3% yoy (totally in line with our expectations), thus marking the first positive inflation rate since 2012**. On annual level, the rise in inflation in 2017 was driven by imported factors via prices of food (1.0% yoy), fuel (5.6% yoy) and to some extent housing prices (1.7% yoy) rather than a broad based recovery of the private consumption. The inflation trend to expect is one of a gradual increasing path, especially from second month of 2018 when the new Law on Excise duties will come into force, pushing the prices of transport and food further up. Thus, our target inflation projection for 2018 is slightly higher than in 2017 and stands at 1.8%% yoy.

Retail trade index



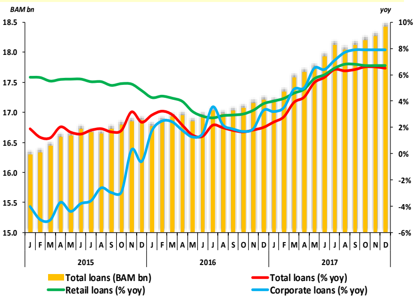
Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH

Retail trade index eased to 3.9% yoy in last month of 2017, the lowest monthly growth since Sep-17. Nevertheless, 2017 was a period of quite solid growth in retail trade which undoubtedly envisages a positive contribution of the private consumption to the overall GDP performance. Increase in retail trade was definitely not the result of the improving purchasing power through strengthen of the labor market. In Dec-17 the average net salary totaled BAM 862, representing a nominal increase of timid 1.8% compared to same month in 2016. Unemployment rate which according to the latest ILO results stands at 20.5% is mostly result of shrinking labour force and "brain drain" phenomena visible in past two years, rather than more distinct economic dynamics. **Therefore, increase of the retail trade by 5.1% yoy in 2017 is driven by the inflow of remittances and the increasing retail lending by domestic banks.**

Positive spill-over effect on the overall economy from the very good tourist season and **tourism sector** is also one of the main economics marks in 2017. With 1,317 thds arrivals (13.7% yoy) and 2,677 thds nights (12.3% yoy), B&H in 2017 reported its best tourist season in the post war period. Concerning the structure of foreign tourist nights, most of them were realized by tourists from Croatia (11.8%), Serbia (8.1%), Turkey (7.3%), Italy (5.7%), Slovenia (5.3%) and UAE (5.3%). **Tourism is becoming a rising contributor the B&H economy and its upward momentum is expected to be continued in the forthcoming years.**

Banking sector of B&H ends year on a right foot with accelerating loans and deposits dynamics

Loans performance

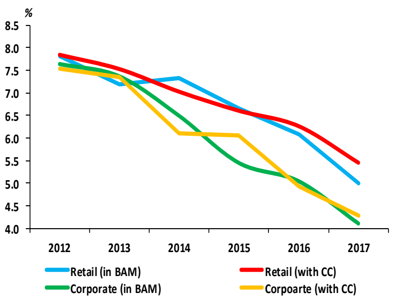


Source: Central Bank of B&H, Raiffeisen BANK dd BiH

The banking sector of B&H went through sizable consolidation process in period 2015-2016, with two cases of small players liquidation (in RS entity) and consolidation of four smaller private owned banks in FB&H through the M&A process (firstly, Privredna and BOR banka merged into Privredna banka followed by Moja banka and IK banka merging into ASA banka). Consequently, from 26 banks at the beginning of 2015 the number of banks declined to 23 at the end of 2016, lowest number of banks in B&H modern history. **In 2017 the consolidation process has stopped, while the overall banking sector experienced year marked by stability, increasing level of capitalization and liquidity, declining NPL levels and stronger growth of assets, loans and profitability.** Even though, all banking sector figures for the whole 2017 are still not published, the available banking sector figures as of Dec-17 points to best year in terms of banking sector performance since global financial crisis back in 2008.

First banking sector figures available for the whole period of 12 months in 2017 are related to overall credit and deposits dynamics. The nominal loan growth rate reached 7.1% yoy in Dec-17 (up to BAM 18.42 bn) thus showing promising revival of banking sector activity. 2017 has become the year of noticeable corporate loan growth and revival of demand for financing. Explicitly, corporate loan growth has been accelerating since the beginning of 2016, reaching peak of 8.0% yoy as of Dec-17 up to BAM 8.72 bn (47.3% of total loans). Retail loans growth was also robust with 6.7% yoy although with slightly slower pace than corporate amounting to BAM 8.61 bn (46.8% of total loans). Credit growth in retail sector is one of the major drivers behind estimated growth of private consumption of 1.9% yoy.

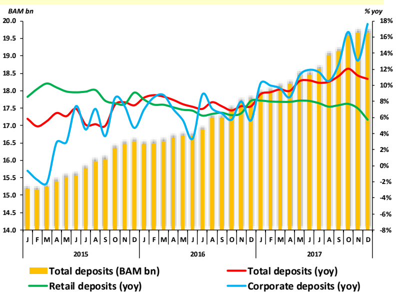
Interest rates on loans



Source: Central Bank of B&H , Raiffeisen BANK dd BiH

It must be pointed out that the interest rates on both key categories continued with the declining path in 2017 – a trend observed since 2012. Explicitly, average interest rate on corporate loans in domestic currency decreased by 94 bp compared end of 2016 (from 5.0% to 4.1%), while the average interest rate on corporate loans with a currency clause went down by 64 bp (from 4.9% to 4.3%). An even stronger decline in average interest rates was recorded in the retail sector, where average interest rates on loans in domestic currency and loans with a currency clause dropped by 107 bp (from 6.1% to 5.0%), and by 81 bp (from 6.3% to 5.5%). **As we are projecting a relatively supportive macroeconomic environment for 2018, the lending activity is expected to stay at current solid level of expansion over the next 12 months.** Furthermore, taking into account the global dynamics in the banking market (low Euribor rates by the end of the year), as well as macroeconomic developments in B&H (slight recovery of the labour market, increase in business activities by companies), we expect that low interest rate environment will be continued until end of 2018.

Deposits dynamics



Source: Central Bank of B&H , Raiffeisen BANK dd BiH

At the same time, 2017 has become the first year since 2007 in which total deposits recorded double-digit growth. Precisely, total deposits posted 10.8% yoy (up to BAM 19.67 bn) driven by citizens' savings (5.7% yoy) and corporate deposits (17.6% yoy). Compared to end of 2016, the average passive interest rates of B&H banking sector registered a decline in retail segment by 24 bp (from 0.9% to 0.7%), and in corporate segment by 37 bp (from 0.9% to 0.5%). Thus, it also should be underlined that 2017 was the second straight year characterized by declining L/D ratio which has settled at 93.7% as of Dec-17.

Downward turnover trend on the B&H capital market marked 2017

Total turnover on the Sarajevo Stock Exchange (SASE) in 2017 amounted to BAM 532.6 mn which is lower by 29.5% compared to 2016. On the Primary market were held 15 public issues of bonds and T-bills in the total amount of BAM 308.6 mn, which mostly affected total turnover decrease.

Instead of planned BAM 390 mn in 2017, the Ministry of Finance FB&H (FMF) issued total of BAM 289.8 mn of debt instruments through SASE, of which BAM 29.9 mn were 5y bonds and BAM 259.8 mn were T-bills with different maturities (3,6,9 and 12 months).

Due to satisfactory level of liquidity in Q3 2017, need for financial funds was reduced, so all planned auctions in this period was cancelled. However, by the end of the year FMF decided to offer long terms issues, more precisely **5y bonds in the amount of BAM 30 mn with average ytm of 1.20% which is the lowest average yield on this particular instrument issued on SASE.** As for short term instruments, the last T-bills auction on SASE was held on 12 December when total of BAM 20 mn 6m T-bills was auctioned with bid to cover ratio near 4. **The average ytm was 0.045% for 6M Tbills which is also the lowest average yield on this particular instrument issued on SASE.** Partially due to the introduction of a negative interest rate of -0.2% on the amount of funds exceeding the required reserve at CBBH, partially due to excessive bank liquidity, average yields on debt instruments in 2017 were again significantly lower.

On the other hand, total recoded turnover on the Banja Luka Stock Exchange (BLSE) amounted to BAM 486.8 mn which is lower by 22.1% compared to 2016. Total of 17 auctions of T-bills and bonds issued by the Government of Republic of Srpska amounted to BAM 366.5 mn, which is lower by 21.6% compared to 2016. Within 9 T-bills auctions with maturities 6 to 12 months, the RS Government collected BAM 143.15 mn instead of planned BAM 131 mn. **Yields on T-bills in RS were higher than in Federation of B&H amounting 0.3% for 6m T-bills and 1% for 12m T-bills.** The Government of RS collected BAM 223.34 mn through bond issues with maturity 3,5,7 and 10 years with corresponding yields: 2.74% for 3y bonds, 2.5 - 3.49% on 5y bonds, 3.5 - 3.78% on 7y bonds and 4.0 – 4.34% on 10y bonds.

FMF has published the indicative security (Bonds and T-bills) issuance calendar for 2018, which would include BAM 360 mn of T-bills with different maturities and BAM 150 mn of bonds with maturities 5y, 7y and 10y of which BAM 20 mn would be issued with 10y maturity. Furthermore, the Government is planning approximately BAM 120 mn of financial claims selling through the local market.

As for BLSE market, Government of RS has not published official issuance calendar for 2018 like in previous years, but nevertheless they started auctioning from the beginning of the year. **Accordingly, in January were issued 6m T-bills worth BAM 20 mn with average ytm of 0.30% and 5y bond issue in the amount of BAM 100 mn with bid to cover ratio 1.5 and average ytm of 2.89%.**

FB&H - Prim. issuances 2017

Security type	Issue date	Maturity date	Amount (BAM)
Federation of Bosnia and Herzegovina (FB&H)			
3M T-bills	11.04.2017	12.07.2017	19,986,543
3M T-bills	25.04.2017	26.07.2017	29,986,805
3M T-bills	09.05.2017	09.08.2017	29,986,049
6M T-bills	23.05.2017	22.11.2017	19,974,076
6M T-bills	06.06.2017	06.12.2017	29,962,071
6M T-bills	13.06.2017	13.12.2017	29,960,306
3M T-bills	11.07.2017	11.10.2017	cancelled
3M T-bills	01.08.2017	01.11.2017	cancelled
3M T-bills	22.08.2017	22.11.2017	cancelled
3M T-bills	26.09.2017	27.12.2017	cancelled
9M T-bills	17.10.2017	18.07.2018	19,991,923
12M T-bills	07.11.2017	07.11.2018	19,994,308
9M T-bills	14.11.2017	15.08.2018	19,998,540
12M T-bills	28.11.2017	28.11.2018	19,996,600
6M -bills	12.12.2017	13.06.2018	19,995,508
5Y Bonds	27.12.2017	28.12.2022	29,999,154
Total amount issued in 2017:			289,831,882

Source: Ministry of Finance of FB&H, Raiffeisen BANK dd BiH

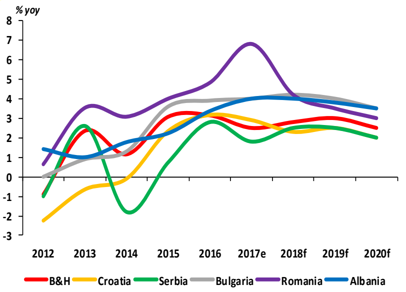
FB&H - Prim. issuances 2018

Security type	Issue date	Maturity date	Amount planned (BAM)
Federation of Bosnia and Herzegovina (FB&H)			
6M T-bills	10.04.2018	10.10.2018	30,000,000
6M T-bills	24.04.2018	24.10.2018	30,000,000
3M T-bills	08.05.2018	08.08.2018	30,000,000
7Y Bonds	15.05.2018	16.05.2025	20,000,000
6M T-bills	29.05.2018	28.11.2018	30,000,000
5Y Bonds	05.06.2018	06.06.2023	20,000,000
6M T-bills	26.06.2018	26.12.2018	20,000,000
3M T-bills	03.07.2018	03.10.2018	30,000,000
3M T-bills	28.08.2018	28.11.2018	30,000,000
5Y Bonds	04.09.2018	05.09.2023	30,000,000
10Y Bonds	11.09.2018	12.09.2028	20,000,000
3M T-bills	18.09.2018	19.12.2018	30,000,000
3M T-bills	25.09.2018	26.12.2018	30,000,000
7Y Bonds	02.10.2018	03.10.2025	30,000,000
9M T-bills	16.10.2018	17.07.2019	20,000,000
9M T-bills	13.11.2018	14.08.2019	30,000,000
12M T-bills	27.11.2018	27.11.2019	30,000,000
5Y Bonds	04.12.2018	05.12.2023	30,000,000
12M T-bills	11.12.2018	11.12.2019	20,000,000
Total planned amount in 2018:			510,000,000

Source: Ministry of Finance of FB&H, Raiffeisen BANK dd BiH

Economic outlook overshadowed by political developments in 2018

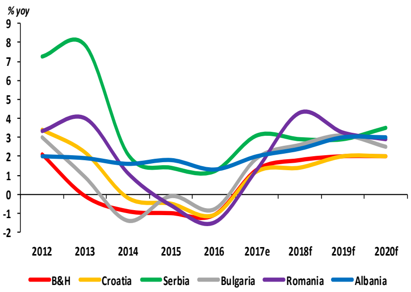
Real GDP - % yoy (f)



Source: Agency for Statistics of B&H, RBI/Raiffeisen RESEARCH

Even though the first macroeconomic figures for Jan-18 still have not been published by the major statistics institution (Central Bank of B&H and State Agency for Statistics), this year has started as we anticipated in terms of other relevant political and macroeconomic events. This is primarily true for the IMF agreement as we earlier announced that B&H will receive the second tranche in amount of EUR 150 mn already during Q1 2018. We have also anticipated that the EFF will not be continued in 2018 as it is an Election year and any further reforms will be hard to implement. Current political situation support such announcements as we already see large political conflicts within the local governments especially on cantonal levels in FB&H. It also should be mentioned that the **IMF downgrade the real GDP target rate for this year to 3.2% yoy (from 3.5% yoy) due to lack of reforms and "brain drain" phenomena which is expected to be continued in this year.**

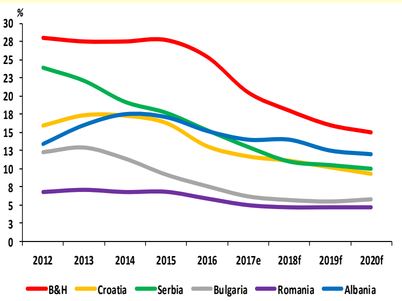
Inflation - % yoy (f)



Source: Agency for Statistics of B&H, RBI/Raiffeisen RESEARCH

Similar opportunities and threats for the B&H economy have also be underlined in latest report on B&H economy by the Moody's Investors Service which affirmed the credit rating of B&H, as B3 with the Stable Outlook. In support to the affirmed credit rating, the analysts of the Moody's have emphasized resilient economic growth of B&H, although structural challenges, including very high unemployment, have had negative effects on the economic strength. Analysts said that B&H has been moderately indebted country with relatively low interests, and that this has contributed to its fiscal strength. According to the last available data, total value of external debt of B&H came down to EUR 4.17 bn (-8.2% yoy) which accounts for 25.9% of estimated GDP for 2017. Furthermore, total public debt of the country is expected to be around 38% of the GDP in next three years (on average) ranking B&H as moderately indebted country. The Stable Outlook is based on expectation that B&H will continue to meet the conditions for the external financing, especially the one by the IMF, which would provide the needed financial and technical assistance for the gradual implementation of the Reform Agenda. **Moody's predicts real GDP expansion of 3.7% yoy in 2018 which is the most optimistic scenario from all major international financial institutions (EBRD forecasts real GDP growth of 3.0%, the IMF of 3.2% yoy and World Bank of 3.2% yoy).** S&P credit rating for B&H stands at B (with stable outlook) which is expected to be confirmed in Mar-18. It is not reasonable to assume that the credit rating could be revised upwards in the mid-term period for B&H.

Unemployment rate (f)



Source: Agency for Statistics of B&H, RBI/Raiffeisen RESEARCH

As for the 2018 we did not change our key macroeconomic target rates so wee still expect that B&H economy will achieve real GDP expansion of around 3.0% yoy, driven mostly by exports of goods and services (8% yoy), private consumption (1.7% yoy) and by gross fixed capital formation (8% yoy). Inflation is expected to be boosted again to more healthy levels being at 1.8% yoy in 2018, mostly thanks to supply side factors such are higher imported prices of oil and food. Unemployment rate is expected to further decline to 18% (once again dominantly driven by the "brain drain" phenomena). Solid growth of private consumption 1.7% yoy (driven by revival in credit growth activity and record inflow of remittances) along with infrastructural investments should push the imports of goods and services up to 6.0% yoy while we also expect the C/A deficit to widen up to 5.9% of GDP in 2018. **In next monthly report, releases of the first tier Jan-18 macroeconomic data indices are expected, and we assume to see firm start for the first month with accelerating trend in Q1 2018.**

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