# Monthly Economic Overview Bosnia & Herzegovina

No.1

## Highlights

- ✓ First reading on third-quarter GDP showed that B&H economy maintained a brisk pace of growth in the July – September period, with annual rate of 2.9% yoy. The economy is being powered by a strong reading in manufacturing (7.5% yoy) and wholesale/retail trade (6.9% yoy), thus contribution to around 2/3 of reported increase.
- ✓ The C/A deficit has narrowed by 4.5% yoy to BAM 1.06 bn, equal to around 3.4% of GDP estimated for 2017. B&H attracted BAM 553 mn in net inflows of FDI, up by 64.6% yoy from Q1-Q3 in 2016, however still accounting to timid 1.8% of estimated GDP for 2017.
- ✓ As shown by the official data, the banking sector of B&H (which numbers 25 active banks), reported a record net profit of BAM 318.4 mn during Q1-Q3 period. The performance with regards to NPL ratio is particularly positive in B&H banking market. The overall NPL ratio declined to its lowest level in 7 years, of 10.8%.
- ✓ Several positive political decisions took the central stage during the first month of 2018 despite still-present crisis between the ruling parties at the State and FB&H level. Budgets for 2018 were adopted for the Federation B&H entity and for the State Institutions (one of the key conditions set by the IMF) while political agreement on the European Commission's enlargement questionnaire was also reached.

### 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-17 | |
| 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) | -0.9 | 2.4 | 1.2 | 3.1 | 3.1 | 2.5 | **2.8** | 3.0 | 2.5 |
| GDP per capita (EUR) | 3,448 | 3,526 | 3,606 | 3,780 | 3,968 | 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 | 3.6 | **4.8** | 5.0 | 4.5 |
| Producer prices (avg, % yoy) | 1.3 | -2.2 | -0.2 | 0.6 | -2.3 | 2.8 | **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 | **40.0** | 41.5 | 42.5 |
| Trade balance (% of GDP) | -28.2 | -25.4 | -27.5 | -24.0 | -22.5 | -22.4 | **-22.1** | -21.4 | -21.4 |
| Current account balance (% of GDP) | -9.1 | -5.3 | -7.5 | -5.5 | -4.4 | -5.0 | **-5.9** | -6.4 | -6.3 |
| Net foreign direct investment (% of GDP) | 1.9 | 1.4 | 2.6 | 1.4 | 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 | 4.8 | **5.0** | 5.3 | 5.6 |
| Gross foreign debt (% of GDP) | 52.2 | 52.2 | 51.8 | 53.4 | 54.3 | 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 | 1.72 | **1.63** | 1.53 | 1.44 |

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

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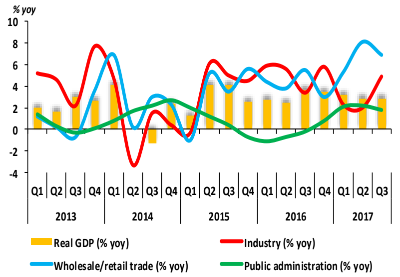
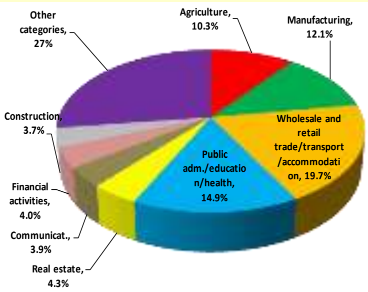
## B&H economy grew at a surprisingly brisk pace in the third quarter (2.9% yoy)

### Real GDP dynamics



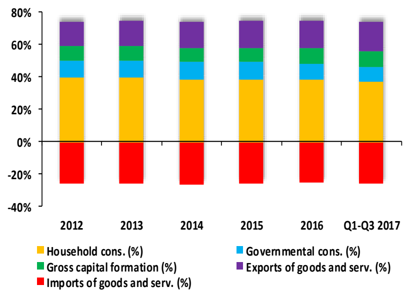

*Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH*

### GDP structure in Q3




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

### GDP expenditure structure



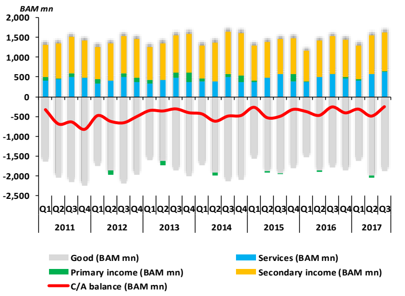

*Source: Agency for Statistics of B&H, Raiffeisen BANK dd BiH*

First reading on third-quarter GDP showed that B&H economy maintained a brisk pace of growth in the July – September period, with an annual rate of 2.9% yoy. **The economy is being powered by a strong reading in manufacturing (7.5% yoy) and wholesale/retail trade (6.9% yoy), thus contribution to around 2/3 of reported increase.** These two GDP components have traditionally been the key drivers of the BH economic growth, as the only two categories holding double-digit share within GDP structure. Both components contracted in the aftermath of the global financial crisis back in 2009, but managed to recover amid positive external developments which spurred export-oriented manufacturing while resilience of sales is more a result of stable inflows of workers remittances, and less of increasing employment. All in all, 12% of B&H GDP stems from manufacturing and around 13.5% from the wholesale/retail trade component. **Negative contribution to GDP growth in Q3 came from the agricultural sector (-3.8% yoy)** and from category which gathers professional, scientific, administrative and support service activities (-3.7% yoy). These two categories were the only ones which delivered negative figures also in the previous quarter. While professional, etc activities component does not play significant role in the overall economic dynamics (accounts to around 3.0% of the GDP) agriculture is regarded as a strategic industry in B&H and is the beneficiary of government subsidies. After being in positive area during 2015-2016, the agriculture has now become the weakest link in the country's growth.

The Agency for Statistics has also revised the figures from the first two quarters. The economy was previously reported to have grown at a 2.9% yoy in Q1 and 1.7% yoy in Q2 period. According to the revised data, the real GDP for Q1 was raised to 3.2% yoy while for Q2 2017 the economy was unexpectedly revised strongly upwards by 120bp up to 2.9% yoy. The larger revision in Q2 from the earlier GDP publication dominantly reflects upwards revision in total industry and in construction sector which from negative snapped back into positive area (from negative 1.1% yoy to positive 1.2% yoy). Unexpectedly strong report on economic growth for Q1-Q3 period suggests that B&H economy is closer to 3% annual growth rate for 2017 than to our target rate of 2.5% yoy. **However, having in mind that these figures are preliminary data which will be subject of additional revision, we will not change our 2017 target rate for the time being.**

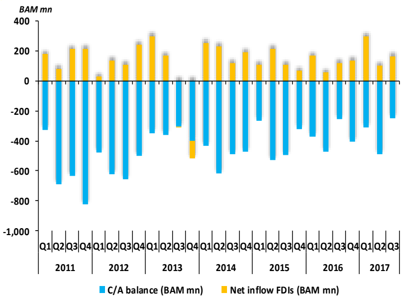
The economic recovery since the 2009 recession is now in its eighth year (with the exception of 2012 when economy declined slightly by 0.8% yoy in real terms) and showing little signs of fatigue even though the pace of growth is still far below the pre-crisis levels. Nevertheless, we have to bear in mind that B&H is export-led economy and that country is largely exposed and depends to external economic shocks and movements. Therefore, the medium-term outlook for the B&H is positive but limited to economic growth in range between 3.0% and 3.5% yoy respectively. In order to push the economic growth above the mid-term average of 3.0% yoy, B&H would finally need to exploit its considerable economic potential in the field of gross public investments in energy and infrastructure sector. Materialization of such scenario would assume peaceful environment in political landscape which however is unlikely at least not before the General Elections in October 2018. Having in mind that main risk but also main opportunity for B&H economy emerges from the political stability and outcome of the general elections, we will keep a close eye on political developments in the forthcoming period.

### C/A structure



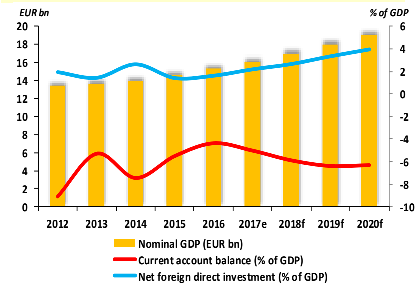

*Source: Central Bank of B&H*
*Raiffeisen BANK dd BiH*

### C/A and FDI balance




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

### C/A and FDI in % of GDP (f)




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

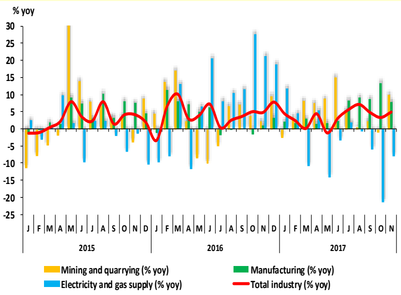
## Positive developments in BoP – record value of exports of goods, travel services and remittances

B&H current account (C/A) deficit has narrowed significantly in first three quarters of 2017 according to the preliminary figures released by the Central bank of B&H (CBBH). Contraction of the C/A deficit was particularly strong in the third quarter of 2017, when the size of the C/A gap narrowed to BAM 252.7 mn – lowest quarterly reading since data are available (Q1 2007). The C/A gap narrowed in Q3 dominantly as B&H posted its best quarterly performance on service account since 2007. **Explicitly, service exports reached historical peak of BAM 995.7 mn in the third quarter of 2017, out of which 57% refers to travel services.** Along with surplus on the primary and secondary income account, the rising trade deficit was somewhat outweighed, which consequently brought down the C/A deficit at historical low.

Since the beginning of the year, the C/A deficit has narrowed by 4.5% yoy to BAM 1.06 bn, equal to around 3.4% of GDP estimated for 2017. Looking historically, this has been the lowest C/A deficit for the Q1-Q3 period since 2013. While in 2013 tightening of the C/A gap reflected lower trade deficit, in 2017 services and secondary income account played the crucial role in the positive C/A dynamics. The B&H trade deficit in goods, without services, was BAM 5.5 bn (5.7% yoy), i.e. B&H exported BAM 6.6 bn (18.5% yoy) and imported BAM 12.1 bn in goods (12.3% yoy). It should be noted that nominal value of goods, exported and imported, represents the highest Q1-Q3 prints since data are available. At the same time, the surplus on the service account came up by 10.8% yoy to BAM 1.6 bn – value not seen since Q1-Q3 2008. **Exports of services, which peaked all-time high of BAM 2.36 bn, represent the brightest spot within the C/A structure.** Expansion of exported services is mostly driven by the travel services which are on an expansion course since 2011 and currently accounts to almost 50% of all services exported. Services imported are also on the upward trend but with pace of growth much below the one on the export side. Explicitly, value of services brought in grew by 5.1% yoy to BAM 743 mn, out of which 36% refers to transport and 33% to travel services. All in all, the surplus on the service account is covering almost 30% of the trade deficit in 2017 – highest ratio since 2007. **Secondary income is still the largest surplus category within C/A structure, as the inflow of remittances totalled BAM 2.8 bn an it currently holds around 9.0% of estimated GDP.** The net inflow of remittances from abroad is five times higher than the net inflow of foreign direct investment in the same period, and their importance for the life standard of B&H citizens is fundamental.

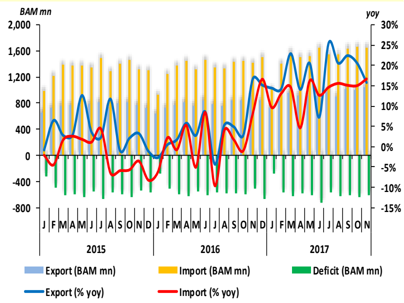
Capital and Financial account of the Balance of Payments (BoP), **showed that B&H attracted BAM 553 mn in net inflows of FDI, up by 64.6% yoy from Q1-Q3 in 2016, however still accounting to timid 1.8% of estimated GDP for 2017.** Net inflow of other investments fell to BAM 935 mn (-15.7% yoy), which is the lowest value in the last 4 years, while the portfolio investments recorded a net outflow of BAM 155 mn. However, adding the surplus on the capital account (BAM 260 mn) and the net error and default account (BAM 216 mn), the overall BoP in the first three quarters of 2017 was in surplus area of BAM 750 mn (reserve assets). **Having in mind that dynamics of the key BoP categories are largely in line with our expectations, our key forecasts for 2017 remain unchanged: the current account deficit at 5.0% of GDP and the net inflow of the FDI of 2.2%.**

### Industrial production



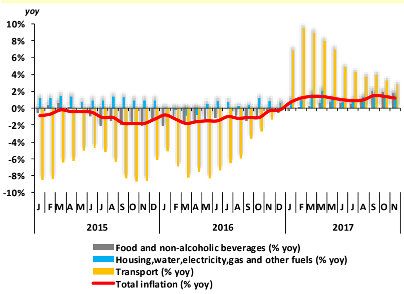

*Source: Agency for Statistics of B&H Raiffeisen BANK dd BiH*

### Trade balance




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

### Inflation




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

## Industry and exports steady pillars of B&H economy

**Industrial production** in B&H increased by 6.7% yoy in November 2017, according to latest data published by the State Agency for Statistics. The industrial production has reported moderate growth this year (with an exception of May 2017), driven by mining and manufacturing. **More precisely, during January-November 2017, industrial production increased by 3.5% yoy as a result of the 5.2% yoy increase in mining and 5.6% yoy growth in manufacturing.** On the other hand, production and supply of electricity and heat, gas, and air conditioning declined over the mentioned period by 4.0% yoy. All in all, the industrial production, which makes around 18.0% of GDP, is heading towards our annual target rate of 3.6% yoy in 2017, moderately lower compared to 4.3% yoy registered in 2016. Slower pace of industrial growth is one of the main presumption why we reckon on lower full-year GDP reading in 2017 compared to 2016 (2.5% target rate compared to 3.1% yoy in 2016).

**Trade balance** of the B&H economy continues to post an impressive performance with double digit growth on both sides of the balance. In November 2017, the exports of goods advanced by 15.8% yoy, while imports of goods increased by 16.7% yoy. Only in one month of 2017, the exports of goods were in the single digit area (July 2017) while the imports of goods reported growth below 10% in January and April of 2017. **Since beginning of the year, B&H exported goods worth BAM 10.13 bn (18.0% yoy) which record value ever, compared to BAM 16.64 bn worth of imports (13.5% yoy).** Consequently, the trade deficit in 11 months of 2017 came up BAM 6.51 bn, which represents an increase of 7.2% yoy in nominal terms while in correspondence to GDP the trade deficit declined to 20.7% respectively. After we receive the full year data, we will provide the detailed analysis of the trade performance of B&H in 2017.

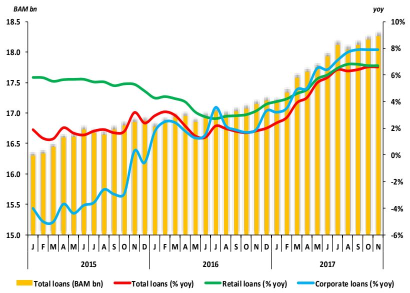
**Inflation rate** eased to 1.2% yoy in November 2017, thus marking the lowest CPI reading in three months. The inflation rate was reduced dominantly on lower increases in the prices of food and non-alcoholic beverages (1.8% yoy down from 2.0% in month before) and transport (2.9% yoy, down from 3.3% yoy in October 2017). The November figure left the cumulative average inflation at 1.2% yoy; slightly lower than our target rate of 1.3% yoy. **Hence, in 2018 we expect the inflation rate to fluctuate between 1.5% yoy and 2.0% under the assumption that the oil price will increase on the global market and that Excise tax low will come into force already in Q1 2018.**

**Labour market statistics** showed just marginal sings of strengthening with average net wages at level of BAM 857 in November 2017, representing a nominal increase of 1.8% compared to same month in 2016. **Despite the weak wage growth, the retail trade is continuously advancing with the retail trade index rose a better-than-expected 5.2% yoy in November 2017 – highest in three months.** In 11 months of 2017 the retail trade index went up by 5.2% yoy, clearly pointing to positive private consumption in 2017. Nevertheless, the fragile labour market statistics clearly points to the fact that domestic consumption and life standard of B&H citizens is basically driven by the inflow of remittances and the increasing retail loans by the B&H banking sector.

## Positive signs of robust revival in credit growth and demand for financing along with decline with NPLs

Broad-based stabilisation of the banking sector figures, supported by a reasonably solid macroeconomic environment coloured most of the 2017. **Profitability, capitalization, NPLs ratio, deposits growth, lending activity, all demonstrate improving dynamics in course of previous year.** As shown by the official data, the banking sector of B&H (which numbers 25 active banks), reported record net profit of BAM 318.4 mn during Q1-Q3 period. **Achieved bottom line result proved to be the highest recorded Q1-Q3 net profit in history of B&H banking sector and by 48.1% up from the same period in previous year**. Only two small banks suffered losses in mentioned period (of BAM 3.6 mn), while 23 banks achieved net profit of BAM 322 mn. Rising profitability was equally driven by the rising revenues on one side (5.8% yoy) and expenditure cuts on the other (-4.0% yoy). Consequently, the return on equity (ROE) was 11.7%, up from the 8.4% seen in Q3 2016, while the return on assets came up to 1.7% from 1.2% in Q3 2016.

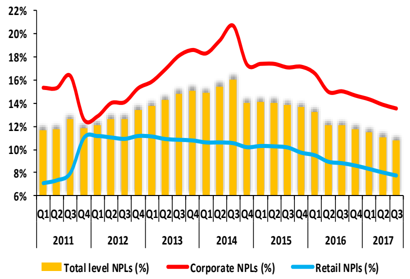
### Loans performance




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

The performance with regards to NPL ratio is particularly positive in B&H banking market. **The overall NPL ratio declined to its lowest level in 7 years, of 10.8%.** The progress has been notable on both sides of the loans: the corporate NPL went down to 13.5% (lowest since Q3 2010) while the retail NPL declined to 7.7% (lowest since Q3 2011). Even though we expect that positive trend in NPLs will be continued in period ahead we cannot expect that the B&H banks will manage to push both areas to the single-digits as corporate credit risks will continue to dominate the banking sector. As a reminder, the last time when both categories (retail and corporate NPLs) were in single digit area was Q1 of 2010. On the capitalisation side, the capital adequacy of B&H banking sector is much above the regulatory threshold of 12.0% (15.6% as of Q3 2017) pointing to indisputable sector's stability.

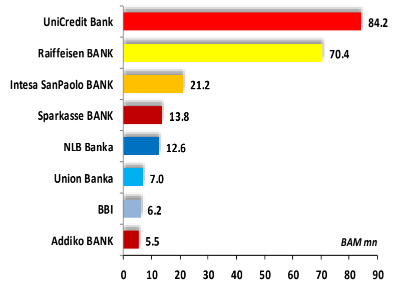
### NPL statistics




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

The available banking sector indicators for final quarter of 2017 confirmed our positive expectations mirrored in good and stable growth of the key fundamentals. **In November 2017, both corporate and retail category demonstrated stable robust dynamics with a 7.9% yoy growth rate for the corporate lending and 6.7% yoy growth on the retail lending side.** On the deposits side, the citizens savings increased by 7.1% yoy while corporate deposits went up more robustly by 13.1% due to lower base level. Accordingly, cumulative loan base surged by 6.5% yoy up to BAM 18.26 bn, while cumulative deposits growth rate outpaced the one in lending for the 57th straight month, rising by 11.2% yoy up to BAM 19.66 bn. So, the loans to deposits ratio continued to hover below the parity level for the 16th straight months, settling at 92.9% as of November 2017.

### Profitability of FB&H banks

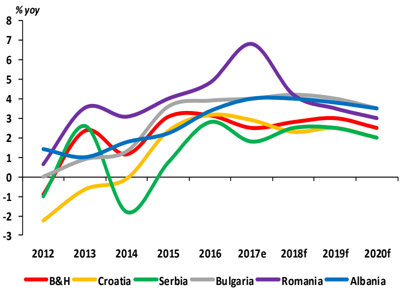



*Source: FB&H Agency for Bank Supervision , Raiffeisen BANK dd BiH*

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. The key risk to the positive dynamics to sustain is primarily the political landscape which represents the main drag on the overall economy and thitherto the banking activity. So far, B&H proved to be quite resilient to any political turmoil and crisis, however political uncertainty is for sure one of the key obstacles for more prominent revival of banking sector dynamics and improving risk perception for the market. As long as the political stability remains elusive, the progress in lending will be limited at single digit values.

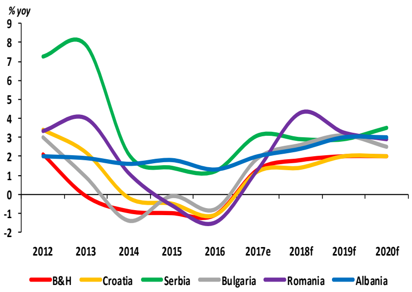
## Elusive political stability remains still main headwind to the economy

**Real GDP - % yoy (f)**



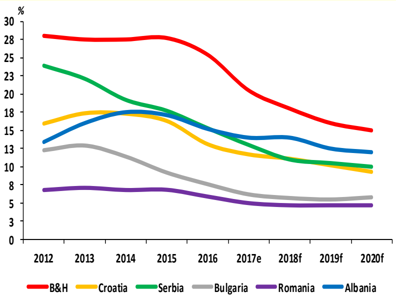

*Source: Agency for Statistics of B&H, RBI/Raiffeisen RESEARCH*

**Inflation - % yoy (f)**




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

**Unemployment rate (f)**




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

Several positive political decisions took the central stage during first month of 2018 despite still-present crisis between the ruling parties at the State and FB&H level. **The Chairman of the State Council of Ministers and the two entities' Prime Ministers (PM) reached a political agreement on the European Commission's enlargement questionnaire.** "Over the next few days, we expect to have completed all the answers in the EU Questionnaire, following which they will enter the verification and technical preparation procedures" the State PM said, while the State Presidency has issued an order to the Council of Ministers to submit the answers to the EU legislative body as soon as possible. As a reminder, on 9 December 2016, the European Commission handed over the Questionnaire to B&H authorities with 3,242 questions, answers to which will enable preparation of its Opinion on the B&H membership application.

The House of Representatives of FB&H entity adopted the 2018 budget in the amount of BAM 2.88 bn which is by BAM 150 mn higher amount compared to 2017 budget framework. It includes financing via long-term bonds in the amount of BAM 150 mn, by T-bills in the amount of BAM 360 mn and by selling of claims in amount of BAM 60 mn. As the budget still has not been published in the Official Gazette, the more detailed analysis of the budget revenues/costs will be provided in our next monthly economic report for both – FB&H and RS level. At the same time, the House of Representatives of the State Parliament adopted the budget of state institutions and international obligations for 2018 in the amount of BAM 1.95 bn, i.e. BAM 950 mn for the financing of State Institutions and BAM 1 bn for the external debt servicing. **Accordingly, all central-level governments in the country have adopted the 2018 Budget bills, which was one of key preconditions set by the International Monetary Fund (IMF).** The remaining conditions needed to be implemented by the political authorities are initiating of the due diligence of two FB&H state-owned telecom companies (BH Telecom and HT Mostar) and adoption of the Law on Deposit Insurance. If B&H authorities implement remaining conditions, the second tranche of the Extended Fund Facility (EFF) will be disbursed in the amount of EUR 76 mn (SDR 63.4 mn).

**According to our baseline scenario, we can expect release of the second tranche by the IMF within the EFF during Q1 2018, but it is highly unrealistic to expect continuation of the Program in 2018 as it is an election year.** Albeit it was announced that along with the IMF funds, additional funding in 2018 will become available from the EBRD and EIB for the Corridor Vc robust speeding up of public investments is not our baseline scenario for 2018 (as most of the announced investments in highway construction are in its early stage of progress). Therefore, we forecast that the real GDP will expand modestly by 2.8% yoy in 2018 on the back of the stable growth in private consumption (1.7% yoy), exports of goods and servicing (8.0% yoy) and moderate growth of gross investment (8.0% yoy). Positive inflation rates will continue to make a comeback (1.8% expected CPI rate in 2018), driven by supply side factors such are higher imported prices of oil (transport prices) and food and beverages. Unemployment rate is expected to further decline to 18% mostly as a result of shrinking labour force and "brain drain" phenomena visible in the past two years, rather than more distinct economic dynamics. The main risk for our baseline scenario emerges from the political stability and outcome of the General elections in October 2018.

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