More promising growth outlook, reforms still the main challenge

After the flood-related economic slowdown in 2014, the data reveals a stronger footprint thus far in 2015, suggesting GDP expansion in the region of around 2.5% in 2015. Improving export performance supports the trade balance, although the CA deficit remains one of the highest in the region. On the fiscal front, we expect the deficit to remain broadly contained (around 2% of GDP), with a stabilizing public debt trajectory, but the main challenges lie on the reforms front.

Economy	2014	2015	2016
Real GDP growth (%)	1.1	2.5	3.2
Unemployment (%)	27.5	26.8	25.5
CPI (%), average	-0.9	0.5	1.8
Budget balance (% GDP)	-2.1	-2.0	-1.9
Public debt (% of GDP)	42.8	43.5	43.3
Current account (% GDP)	-7.7	-7.3	-7.2

Source: Erste Group Research

Ratings	Current	Outlook
Moody's	B3	stable
S&P	B	stable

Source: Erste Group Research

General	2014
Population (in mn)	3.8
GDP/Capita EUR	3,625

Source: Erste Group Research

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Note:
**Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.*

- The 2015 economic outlook seems more encouraging, with the main upsides coming from robust and stable household consumption and better performance from the export sector. Investments have the potential to support the growth momentum, but political instability is increasing uncertainty. Public consumption should continue to fall, thus mildly weighing on the total growth figure.
- The inflation trajectory is expected to be mostly shaped by the low base effect, fading effects of low food prices and accelerating economic activity, so we expect to see the FY figure moving back to green territory towards YE15. However, disinflationary pressures in the first half of the year will keep the average figure around the modest 0% region.
- More favorable export performance is easing pressure on the trade balance figures, but the narrow export base, import-oriented structure of the economy and low value-added export products will keep the figure well above 20% of GDP in the mid run. Furthermore, the CA will also be shaped by remittances and foreign wage inflows, so we see the figure standing at around 7% of GDP. The FDI footprint is still weak, with some potential coming from investments in energy, tourism and infrastructure sectors, but structural weakness and the slow reform pace remain bottlenecks to unlock this potential.
- The monetary outlook in 2H15 should be marked by the gradual stabilization of corporate lending and stable household lending profile, and also shaped by milder growth in government lending. We also expect milder improvements of financial stability indicators, although NPLs could still remain on a mild upward trend in the mid run.
- The fiscal position is expected to remain relatively stable, with one of the lowest deficit and public debt levels in the CESEE region. However, the main challenges for policy makers lie on the structural reforms front, where the Stabilization and Accession Agreement should play a supportive and binding role

Real Economy

After slowdown in 2014, growth accelerated in 1Q15, supported by domestic and external demand

Political instability (riots, disruption of transport, discouragement of investments, etc.) and massive floods last year resulted in the slowdown of the B&H economy to 1.1% y/y vs. the 2.5% y/y recorded in 2013. A detailed breakdown by production approach reveals that the slowdown was mainly the result of falls in the energy, mining and agriculture sectors, while manufacturing maintained its supportive role. Also, net exports deteriorated, as exports slowed from near 7% y/y in 2013 to just above 3% in 2014, while imports moved from negative territory in 2013 to near 7% y/y in 2014. Despite the economic slowdown, labor market statistics show that the unemployment rate remained on the same level as in 2013, at 27.5%, which is still the highest in the SEE region. However, the first estimate of 1Q15 GDP shows that growth accelerated to 2.1% y/y, mostly supported by robust performance from retail trade and construction.

More recent short-term indicators suggest that we can expect more robust growth in the 2Q15 rate, as we could see acceleration on all fronts. Industrial production accelerated to an average of 5.2% y/y from the -0.7% y/y recorded in 1Q15, reflecting the low base effect in the mining sector, but also supported by robust manufacturing performance. Retail trade retained its strong supportive role, with the annual growth rate rising from 7.2% to above 11% in the second quarter, driven by the stronger consumption of non-food products. As for external trade, we could also see acceleration on the exports side (6.6% y/y vs. 2.2% y/y) while imports started to cool down, with the fading effects of last year's flood-related damages playing a key role. That said, we could see the 2Q15 growth figure moving to above 3% y/y vs. -1% y/y in the same quarter last year.

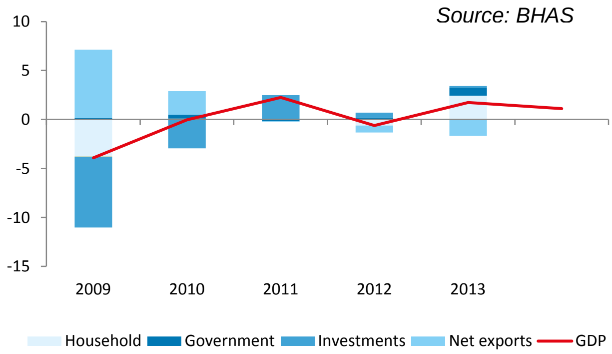
Positive trends expected to continue and we see FY growth figure moving around 2.5%

Looking ahead, in 2H15 we expect a continuation of positive trends, with the main upsides coming from strong retail performance (supported by remittances) and positive developments in the industrial sector, with spillovers to the export side, supported by a more promising EU growth outlook. Also, several investment projects in infrastructure (corridor 5c), energy (Una Kostela and Vranduk hydro plants) and the tourism sector (Buroj Ozon), should back investment activity, at least in the medium run (although short-term implementation risks remain elevated). As for the public sector, we expect a decline in public consumption, as political instability (government formed only in May 2015) postponed some of the fiscal consolidation and structural reform measures, backed by the IMF stand-by arrangement. With all of this in mind, we see the growth figure at around 2.5%, although with downside risks down the road, still coming primarily from politically-related uncertainties.

Inflation still in red but we see upside factors moving the FY figure to 0%

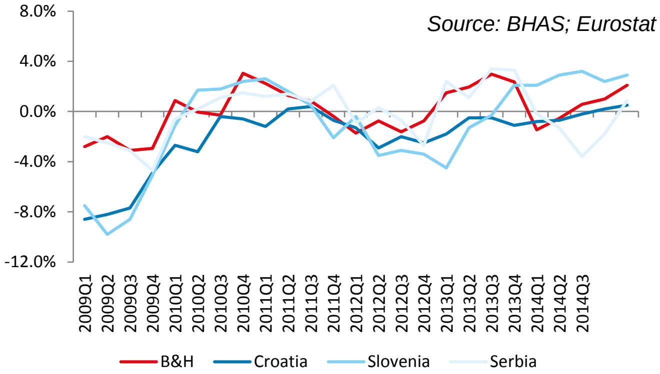
Despite stronger economic activity, inflation remained in negative territory in 1H15, with the figure hovering around -0.4% y/y in 1H15. However, looking ahead, we expect the headline figure to move back to positive territory, with the main upsides coming from the low base effect, fading effects of low food prices, and more vivid demand-side pressure amid somewhat intensified investment activity and more favorable movements on the labor market. These factors should outweigh weak cost-side pressures (primarily falling oil prices), so we expect FY inflation to land at around 0%.

GDP growth mostly driven by domestic demand
Real GDP growth and contributions*

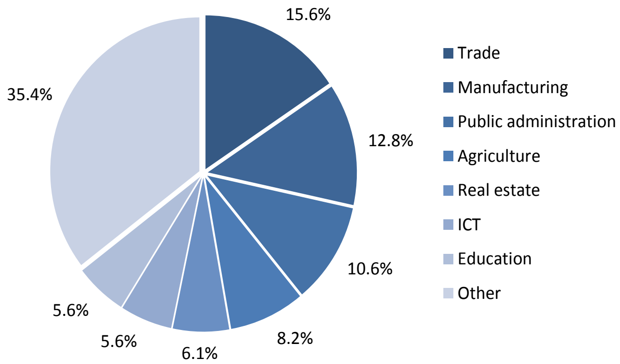


*data on GDP by expenditure approach for 2014 is not available

Solid GDP performance compared to peers
Quarterly GDP (y/y figure)

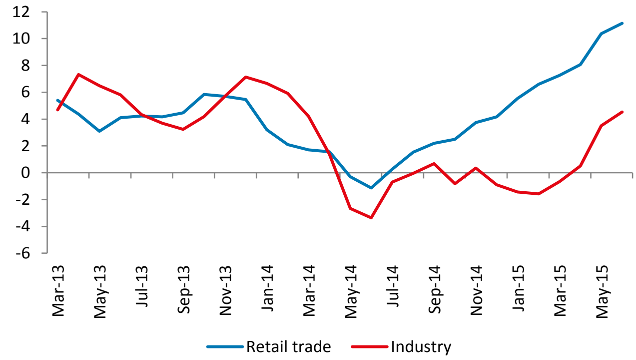


Relatively diversified structure of the economy
Shares of NACE categories in GVA (%) in 2014



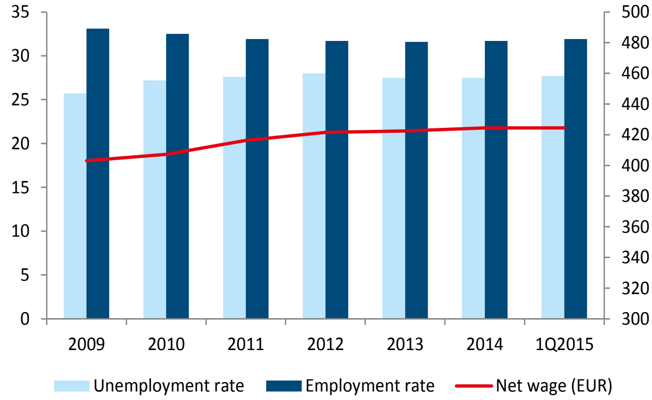
Source: BHAS

Strong retail accompanied by recovery in industry
Industrial production and retail trade (y/y)



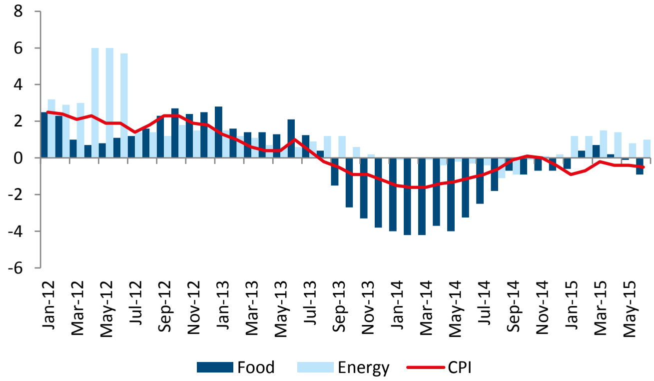
Source: BHAS

Stagnation on the labor market
Unemployment, employment (%) and net wages (EUR)



Source: BHAS

Disinflationary pressures still present
CPI, food prices and energy prices (y/y)



Source: BHAS

External Balance

C/A deficit compression stopped in 2014, owing to flood-related disruptions in trade balance

After stabilization in 2013, the external position of B&H slightly deteriorated during 2014, courtesy of flood-related damages and a slowdown in economic activity. The YE figures show that the C/A deficit rose from -5.5% of GDP in 2013 to -7.7% of GDP in 2014, mostly reflecting the exacerbation of the trade deficit, which increased from -27.8% of GDP to -30.1% of GDP in the same period. With regard to the trade deficit, it is important to note that such high levels reflect the structural weaknesses of the B&H economy, which is highly import-oriented and has a relatively narrow export base, dominated by low value-added products, so improvements on that front are a mid-term story, requiring various structural reforms and the restructuring of the economy. As for financing, despite various disruptions, FDI inflows accelerated above 3% of GDP, pushing C/A coverage to nearly 40%. Looking at the structure, the mining, petroleum and metal production sectors absorbed around 40% of investments, with most flows originating from Russia and Great Britain.

The first quarter of 2015 brought signs of stabilization, with more favorable export performance and weaker imports pushing the trade balance below 30% of GDP and C/A deficit towards 7% of GDP. Income accounts maintained their supportive role, with primary income mostly reflecting growing wage inflows, while secondary income was traditionally shaped by strong inflows of remittances. On the financing side, FDI inflows were 60% lower compared to the same period last year, with volatility being boosted by political uncertainties and unfavorable weather conditions.

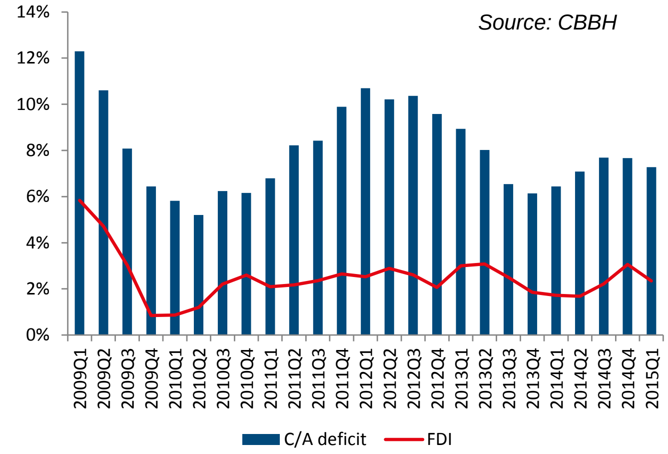
Rest of year: we expect gradual improvements on external front

For the rest of the year, we expect more favorable movements on the external front, supported by the acceleration of exports, which should outweigh upward pressures on the imports side resulting from intensified investment activity and a stable household consumption profile. As for income accounts, we expect similar developments as in recent years, with a secondary income surplus (remittances and social transfers) maintaining its important supportive role. We expect the CA deficit to remain at around 7% in the next two years and the FDI footprint could strengthen, moving above 3% of GDP, pending the successful realization of the abovementioned projects in the energy and tourist sectors. Also, SAA, which is effective from June 1, could also be supportive for foreign investments. However, the broadening of the export base, improvement of business climate (FDI stimulation) and sectoral restructuring (towards the production of higher value-added products) are big mid-term challenges ahead, important for reshaping the weak B&H international trade position.

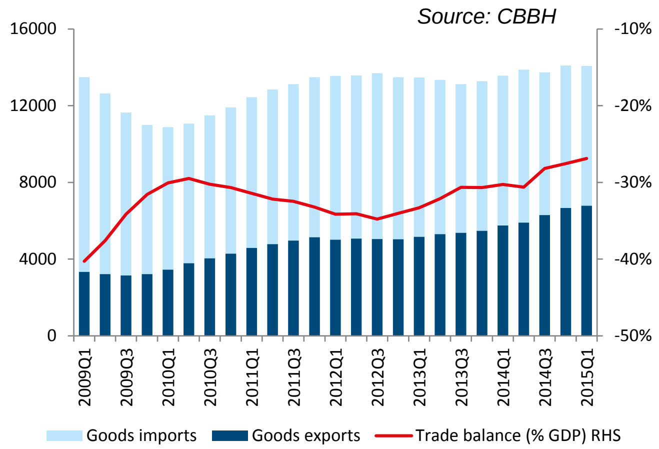
External debt still on bottom of scale in CESEE region

The external debt trajectory was mostly shaped by continuous banking sector deleveraging and rising exposure of the public sector to IFI creditors. Similar developments are expected in the following years, with the headline figure moving around 55% of GDP, which puts B&H near the bottom of the scale among its SEE peers. International reserves are steadily rising and stand at around 30% of GDP, which covers around six months of imports, with no major risks ahead.

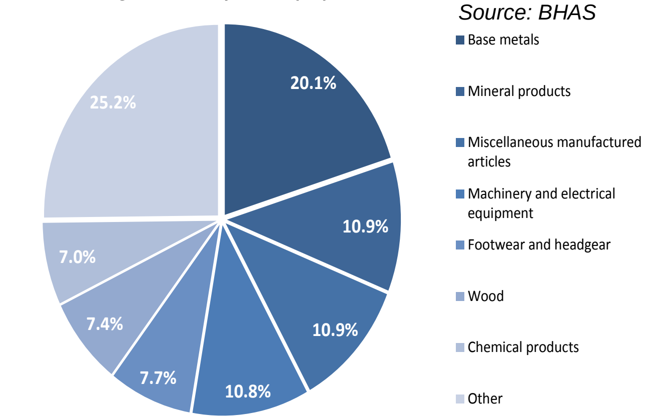
Although narrowing, CAD still on demanding level
C/A deficit and FDI flows (4Q trailing, % GDP)



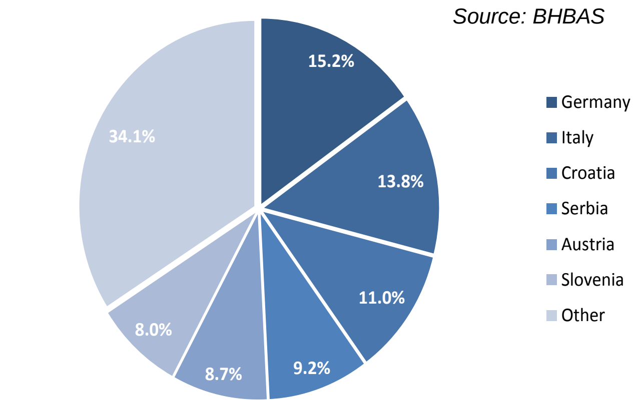
Trade balance gap still on troubling level
Trade balance (4Q trailing, BAM mn and % GDP)



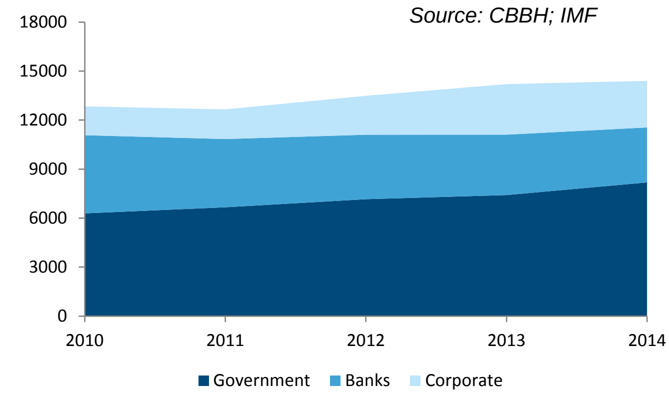
Low value added products dominating export base
Share of goods exports (%)



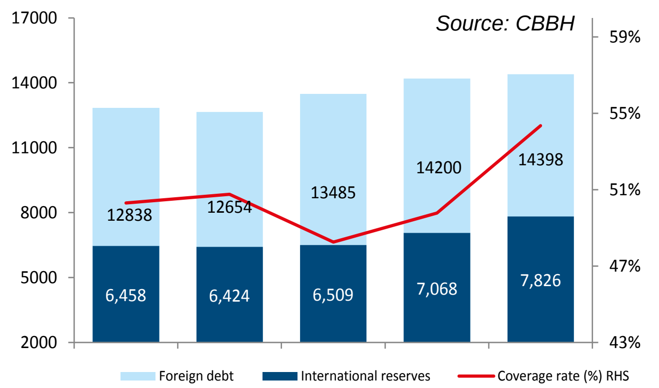
Main export markets – Germany, Italy and Croatia
Share of total exports by countries (%)



Rising share of public debt in external debt
External debt by sector (BAM mn)*



Coverage of foreign debt by FX reserves on rise
Foreign debt and international reserves (BAM mn)



*share of corporate debt estimated from the IMF data on total external debt

Monetary Sector

Monetary sector recorded positive developments in 1H15, supported by growth of both deposits and loans

In the first half of 2015, the monetary sector recorded positive developments, as the growth of all monetary aggregates and total lending activity were higher compared to the same period last year. Monetary aggregate M2 grew by a robust 9% y/y, resulting from the positive contribution of all money supply components (with LCY deposits playing a dominating role), while total bank claims on domestic sectors kept up a steady 3-4% y/y growth rate. A closer look at the CBBH balance sheet reveals no major surprises, with continuous growth of international reserves on the assets side and accelerating growth of government deposits on the liabilities side (coming from IFI loans).

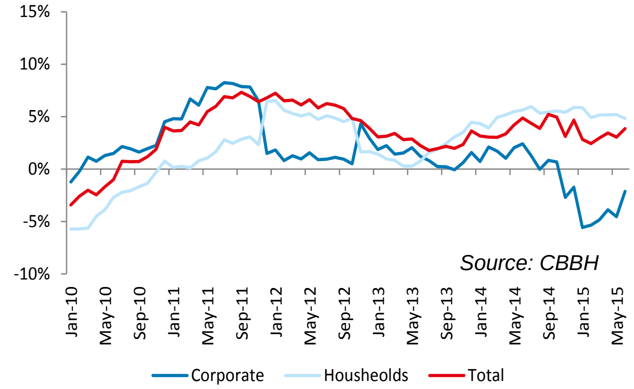
When talking about lending activity in the banking sector, the abovementioned aggregate growth of 3-4% blurs the whole story, which is notably different compared to the first six months of 2014. The biggest change comes from the slippage of lending to private corporations to an average of -4.4% y/y vs. near 2% y/y growth in the same period last year. Such developments can be seen as a result of corporate deleveraging and the discouragement of investment activity resulting from the political instability. Also, due to a freeze in IMF liquidity loans, lending to the government sector increased to above 30% y/y, an almost 20bp higher growth rate comparing to 1H14. On the other hand, we saw no major changes in the household sector, as lending accelerated to 5.9% y/y, which is slightly above the 5.3% y/y growth recorded last year. Details on household lending shows that the positive growth was solely a result of an above 7% y/y rise of consumer loans (comprising 60% of total household loans) as all other loan categories recorded a decline. As for the liability side of banks' balance sheets, we saw an increase of deposits in all sectors, with a robust average of 9.4% y/y growth of deposits in the household sector (supported by remittance inflows) and 7.5% y/y growth in the corporate sector. The government sector also increased its deposits, mostly on the cantonal level, primarily as a result of the abovementioned IFI funds, thus putting the total deposit growth figure at 9.4% y/y. The loan-to-deposit ratio returned above 110% in June 2015, after slipping to its lowest level since 2008 at YE14.

Although well-capitalized, banking sector under pressure from rising NPLs and weaker profitability

The financial stability of the banking sector slightly deteriorated, as financial soundness indicators show that capital adequacy fell to 16.2% in 1Q15 from 16.3% in 4Q14, although still standing well above the 12% regulatory minimum. The biggest threat to the stability of banking sector is still the share of non-performing loans in total loans, which rose to 14.2% from 14%. However, at the same time the NPL coverage ratio hiked above 70%. Profitability is also weaker than in 2014, as ROAA and ROAE slipped to 0.4% and 2.8% from FY14 0.5% and 4.2%, respectively. However, developments in the banking sector should be viewed partially as the result of the restructuring process during 2014 (bankruptcy of Bobar bank, sale of loan portfolio in two banks, etc.).

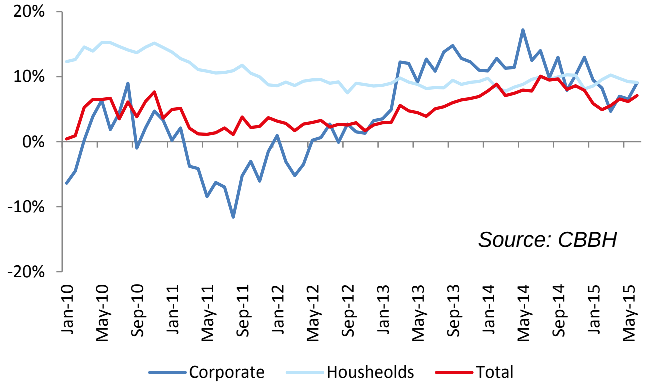
Looking forward, we expect lending activity to stabilize in the private sector for 2015, as hopefully lasting political stability, robust consumer demand and more favorable exports dynamics could gradually stimulate corporate lending. Thus we could see additional improvements from stability indicators, although NPLs are still putting strong pressure on banking balance sheets.

Household loans keeping total loans in green
Bank loans to institutional sectors (y/y growth, %)



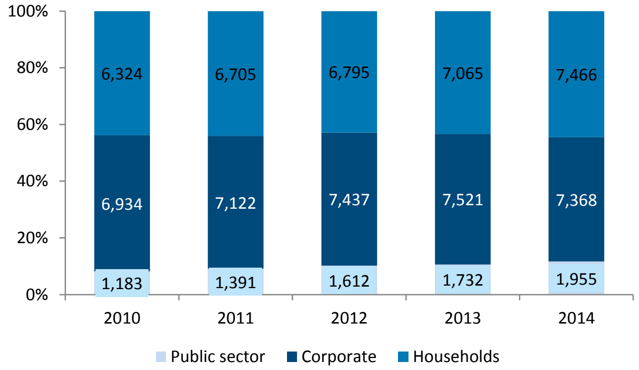
Source: CBBH

Stable rise of deposits in the banking sector
Bank deposits by institutional sectors (y/y growth, %)



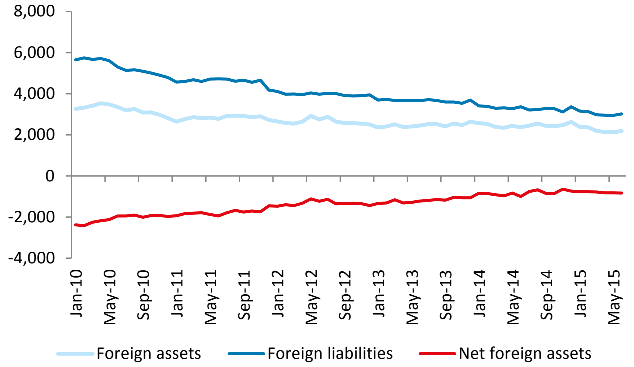
Source: CBBH

Increasing share of household loans
Total loans by institutional sector (BAM mn; %)



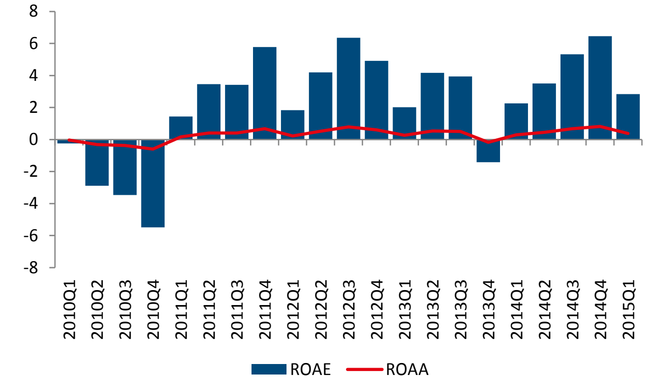
Source: CBBH

Reduced exposure to external financing
Bank foreign assets and liabilities (BAM mn)



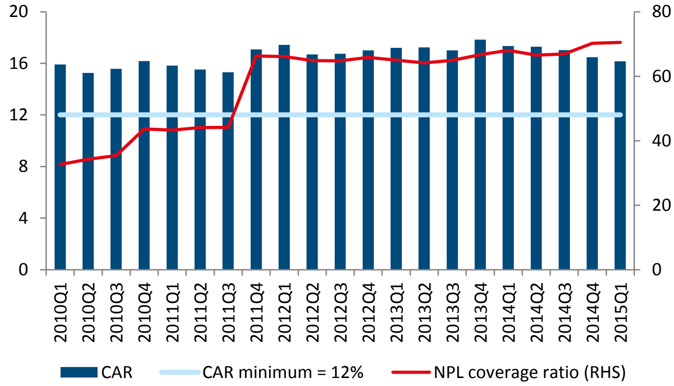
Source: CBBH

Weaker profitability in 1Q15 – effects of restructuring?
Return on assets (ROAA) and equity (ROAE) (%)



Source: CBBH

CAR somewhat weaker but better NPL coverag
NPL coverage ratio and CAR (%)



Source: CBCH

Fiscal Policy

Political instability halted IMF loan disbursement before expiration of SBA in June – negotiations on new SBA ahead

Political instability and the late formation of the government postponed the implementation of the reform programs that were the prerequisite for the continuation of the IMF stand-by arrangement signed in 2012. As a result, the Fund decided to halt the disbursement of the remaining funds before the official end of the arrangement in June, which caused some liquidity problems and shifted the government's funding profile towards local banks. After the formation of the government, the authorities continued talks with the IMF on the possibility of a new arrangement and we could see an agreement by the end of the year; however, the IMF's conditions regarding reforms, especially on the labor market and public administration, are highly unlikely to change, so we expect hard negotiations ahead. Besides the hurdles with the IMF, political instability was also postponed and slowed the budgetary process, so only Republika Srpska adopted the 2015 budget according to plan, while the budget of FBiH was adopted only in the middle of May.

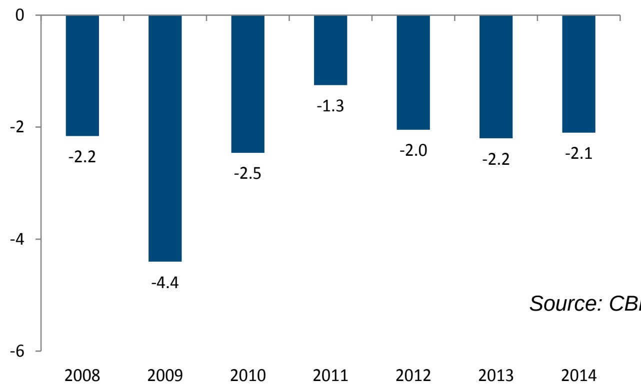
First six months of 2015: consolidated expenditures outpaced revenue inflows

As for the recent fiscal developments, we still lack details on general government budget performance. However, data on the realization of the consolidated budget of B&H institutions, entities and treasury single account in the first half of the year show robust performance of tax revenues (+6% y/y), while total revenues were broadly flat (0.6% y/y), reflecting a strong decline in non-tax revenues. On the other hand, total expenditures rose by 3.2% y/y, mainly driven by a rise in current expenditures. A more detailed look at the main categories shows that the biggest annual rise was recorded on interest expenditures (14%), transfers (9.7%), wages (2.2%) and social benefits (2.2%), while consumption of goods and services and subsidies fell by 12.1% y/y and 41.1% y/y, respectively. Also, capital expenditures fell by 9.7% y/y. Such developments on the expenditure side indicate that the authorities are trying to pursue a consolidation program based on cuts in material and capital expenditures, while keeping socially- and politically-sensitive items intact. Given the composition of the budget, such a policy stance resulted in the compression of the consolidated surplus by 18%. All that said, we see the nominal value of total general government deficit (also including extra-budgetary funds, municipal and cantonal authorities and roads and highway funds) standing at approx. the same level as in 2014, which puts the deficit figure at around 2% of GDP, based on our growth forecast. Translating this into public debt, we see the figure rising from 42.8% in 2014 to around 43.5% in 2015.

Fiscal position in the mid run will depend heavily on the structural reforms

Despite the relatively stable fiscal position (one of the lowest fiscal deficit and public debt levels in the CESEE region), we see many challenges ahead, mostly coming from the reforms agenda, which is a prerequisite not only for a new SBA loan but also an integral part of B&H EU path. In that sense, we see the adoption of the 2015-18 reforms agenda as a step in the right direction, but given the scope and complexity of the reforms outlined, especially those related to the labor market, public enterprises and rule of law, we see many challenges ahead. Lasting delay on the reforms side would imply a deteriorating fiscal profile, given the mounting pressures on expenditure and constrained support on the revenues side amid a suffering growth pattern.

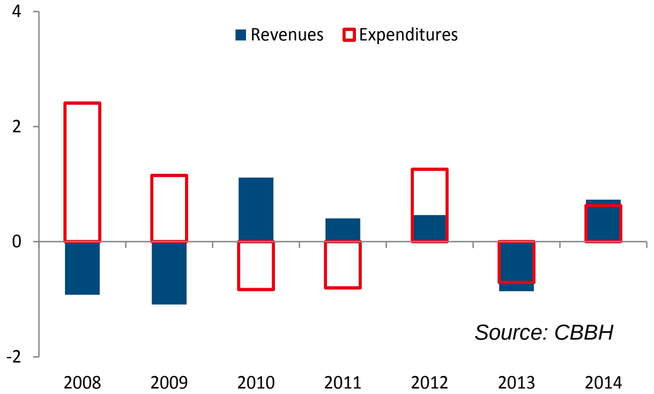
Mild compression of fiscal deficit in 2014…
General government fiscal balance (%of GDP)*



Source: CBBH

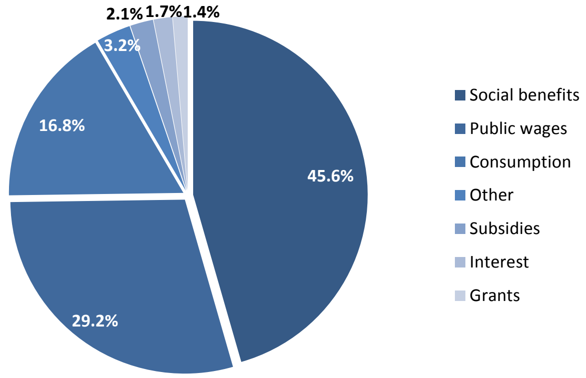
*GDP based on production approach (higher compared to expenditure approach)

…owing to robust revenues performance
Change of revenue and expenditure shares in GDP



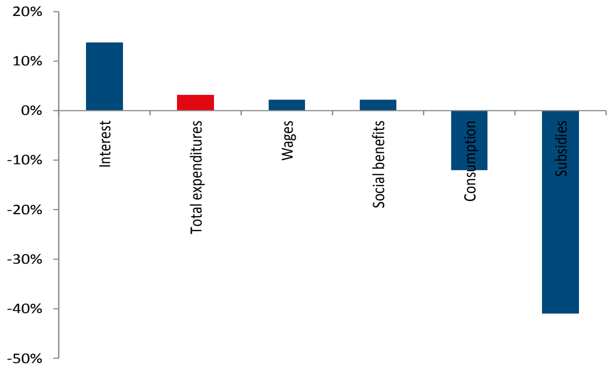
Source: CBBH

Wages and social benefits comprising 75% of budget
Categories of central budget expenditures (% of total)



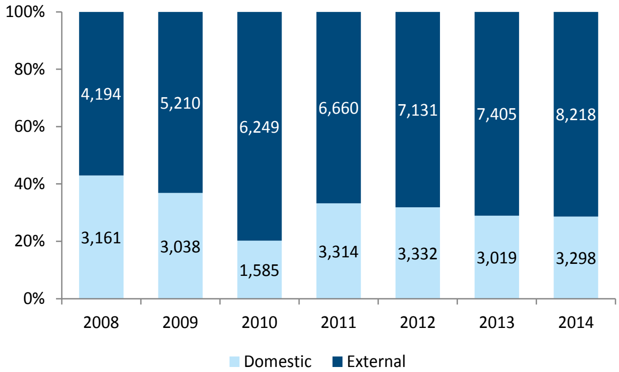
Source: CBBH

Total expenditures on rise, cuts on material items
Main categories of expenditures (y/y)



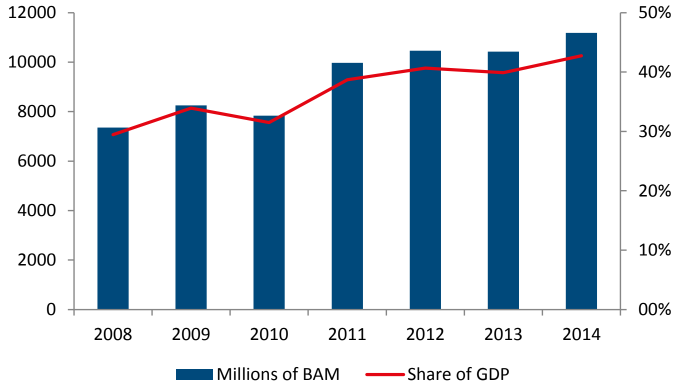
Source: ITA

External debt dominating public debt figure
Domestic and external public debt (BAM mn, %)



Source: MoF

Public debt breaking level of 40% of GDP
Public debt (BAM mn and % of GDP)



Source: MoF; Erste Group Research

Politics

Government formed six months after elections; first tensions in ruling coalition already surfaced in June

After the general elections in October 2014, the implementation of the results and forming of governments lasted for months. Ultimately, the election results were fully implemented on March 31, when the parliamentary assembly at the state level appointed a new council of ministers, with the majority comprised of Party of Democratic Action (SDA), Alliance for Change (SDS, PDP, NDP), a coalition led by the Croatian Democratic Union (HDZBIH), all center-right, and Democratic Front (center-left). On the same day, the parliamentary assembly of the entity Federation of Bosnia and Herzegovina (FBiH) appointed its government, supported by SDA, HDZ and DF, while the government of the entity Republika Srpska (RS) was already formed earlier, led by the Alliance of Independent Social Democrats (SNSD) and its partners.

However, soon thereafter, the first tensions arose between the coalition partners in FBiH, resulting in the Democratic Front leaving the government and joining the opposition in June. The government was thus left with no majority support. The two remaining partners, SDA and HDZ, then entered coalition talks with several smaller parties, which could result in a very tight majority of 50 out of 100. For the time being, there are no signs that this reshuffling should lead to majority changes at the state level, but such a scenario could not be ruled out entirely, considering the differences between the parties and statements from political leaders on the issue. In such a changing political environment, progress in the area of reforms was limited in the past several months.

Stabilization and Accession Agreement with EU, effective since June 1, 2015, could be supportive for reforms agenda

All parliamentary parties have declared their support for the country’s path towards the EU and even signed a written commitment to unlocking the process on all government levels (state, entities, cantons). The new initiative of the EU, aimed at reviving BiH accession, resulted in the enforcement of the country’s Stabilization and Accession Agreement on June 1, which requires Bosnia and Herzegovina to make many reforms in order to advance towards the EU, including economic, social, administrative and rule of law measures. Recently, the three government levels (state, FBiH, RS) adopted the Reform Agenda, which includes a comprehensive list of reforms that BiH is required to make during harmonization process. New labor laws in FBiH was one of them, voting on which showed that the reforms may be challenging to carry out, especially without a firm majority supporting the government. Therefore, EU-required reforms and seeking stable majority may remain the two main political topics in the upcoming period.

Forecasts

Annual	2009	2010	2011	2012	2013	2014	2015f	2016f
Nominal GDP (BAM mn)	24,307	24,879	25,772	25,734	26,282	26,934	27,607	28,822
Population (mn)	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
GDP per capita (EUR)	3271.4	3348.3	3468.6	3463.5	3537.2	3624.9	3715.6	3879.0
Real GDP (growth y/y %)	-2.7	0.8	1.0	-1.2	2.5	1.1	2.5	3.2
Private consumption (growth y/y %)	-4.6	0.1	15.8	3.5	-3.0	1.8	3.5	4.5
Fixed capital formation (growth y/y %)	-28.8	-15.9	15.8	3.5	-3.0	4.0	5.0	7.0
Nominal gross wages (EUR)	613.8	620.9	652.0	655.6	658.7	672.3	679.0	689.2
Gross wages growth (%)	8.6	1.2	5.0	0.5	0.5	0.4	1.0	1.5
CPI (y/y, average %)	-0.4	2.1	3.7	2.1	-0.1	-0.9	0.0	1.2
CPI (y/y, year end %)	1.5	0.7	2.8	1.8	-1.2	-0.4	0.5	2.5
Unemployment (%)	25.7	27.2	27.6	28.0	27.5	27.5	26.8	25.5
Exports fob (EUR mn)	2828.1	3628.8	4205.0	4018.7	4285.9	4733.0	5017.0	5368.2
Imports cif (EUR mn)	6317.0	6961.7	7937.8	7798.5	7756.0	7943.0	8260.7	8673.8
Trade balance (% of GDP)	-31.6	-30.7	-33.2	-34.0	-30.7	-31.0	-27.0	-26.0
Current account balance (% of GDP)	-6.4	-6.2	-9.9	-9.6	-6.1	-7.7	-7.3	-7.2
FDI inflow (% of GDP)	0.9	2.6	2.7	2.1	1.9	2.2	2.9	3.5
General government budget balance (% of GDP)	-4.4	-2.5	-1.3	-2.0	-2.2	-2.1	-2.0	-1.9
Public debt (% of GDP)	33.9	31.5	38.7	40.7	39.9	42.8	43.7	43.8
Foreign debt to GDP (%)	53.5	51.6	49.1	52.2	50.8	54.2	53.9	53.3
EUR/BAM	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
USD/BAM	1.4	1.5	1.4	1.5	1.5	1.5	1.8	1.8

Source: Erste Group Research

Note:
**Information on past performance is not a reliable indicator for future performance. Forecasts are not a reliable indicator for future performance.*

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