Adria Region Macro Quarterly 2Q 2023

Better Activity Profile, Inflation Still Weighs

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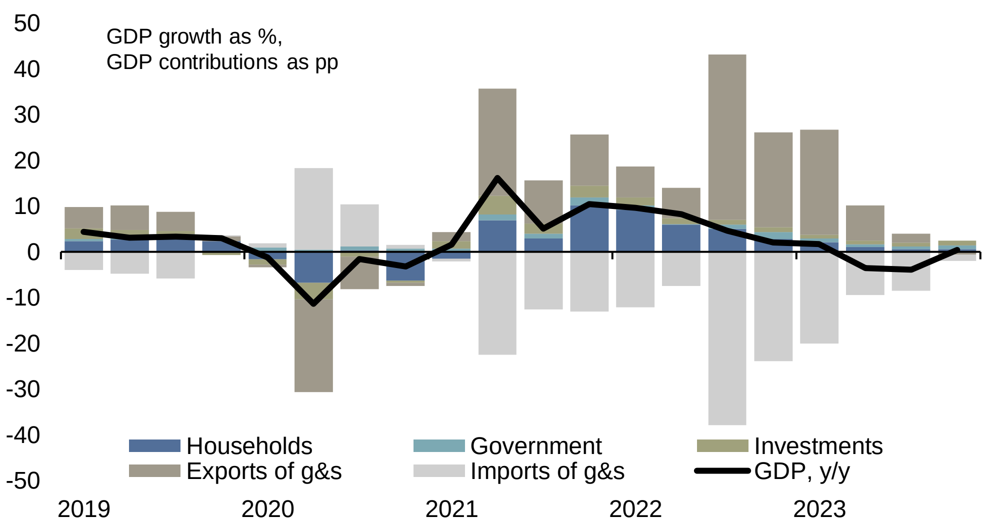
Slovenia

Bloomberg Adria

	2019	2020	2021	2022	2023F	2024F
GDP real growth (%)	3.5	-4.3	8.2	5.4	0.1	3.5
GDP current prices (EUR mln)	48,533	47,021	52,208	58,989	64,051	69,039
GDP per capita (EUR)	23,233	22,361	24,770	27,975	30,396	32,764
CPI (%, annual average)	1.7	-0.3	2.1	9.3	8.5	4.1
CPI (%, end-of-year)	2.0	-1.2	5.1	10.8	6.8	2.6
Unemployment rate (%, ILO)	4.5	5.0	4.8	4.2*	4.2	4.0
Employment growth (% annual average)	2.5	-0.6	1.3	2.4	1.1	2.0
Imports of goods (EUR mln)	30,701	27,289	34,373	40,650	42,617	44,274
Exports of goods (EUR mln)	31,999	29,622	35,255	41,693	43,711	45,411
EUR/USD (average)	1.12	1.14	1.18	1.05	1.09	1.12
EUR/USD (end-of-year)	1.12	1.22	1.14	1.07	1.11	1.14
3M Euribor (average)	-0.36	-0.43	-0.55	0.35	3.13	2.50
10Y EUR swap rate (average)	0.26	-0.14	0.05	1.93	3.27	2.74

*estimate

Slovenia, GDP growth & contributions



Source: statistics office, Bloomberg Adria analytics

Economic activity

- As the overall economic environment for Slovenia's main trading partners presents a somewhat better picture than previously anticipated, **we revised our real GDP growth for 2023 upwards, i.e., to a stagnation (+0.1%) yoy.** We see positive risks in the domain of i) government expenditure via measures to mitigate energy-related social crisis that also played a part in 4Q2022 and thus helped to bypass technical recession, and ii) investments growth overwhelmingly backed by ample EU funding, more precise through national Recovery and Resilience Plan. Net export contribution is seen positive for the whole year. Private consumption is seen significantly slower vs 2022, amid falling real disposable incomes, which are influenced by a combined high inflation and costlier consumer crediting. On the other hand, (un)employment prospects remain strong, which will drive nominal wage growth - private sector wages are seen rising amidst lack of labour supply, while public sector ones will increase due to gov't hikes in the sector. **For 2024 we see real GDP growth accelerating to +3.5% yoy**, on the back of sharper pace of exporting and personal consumption first and foremost.

Inflation

- **In 2023 we expect average inflation rate at 8.5% yoy** or lower versus 2022 outcome of 9.3% yoy, given the weaker consumer demand prospects, monetary tightening effects, weaker GDP growth and gov't support via energy price caps for households. Stronger inflation bounding is seen contested by low unemployment rate, price slack on the producers' side (most notably due to still unresolved supply chain bottlenecks) and relatively high food prices in contrast to global trend (although making the lowest share in the total inflation basket among region's peers, i.e., ca 16% or almost half the rate seen in North Macedonia).
- We see **average inflation rate in 2024 to soften to 4.1% yoy**, as the monetary tightening effects fully materialise, while also base effect kicks in on a stronger footing than the year before.

Slovenia

Monetary and fiscal policy

- We see the **ECB hiking deposit rate to 3.5% and refi rate to 4.0%** in the rest of 1H 2023, which means additional 100 basis point rate hikes ahead. The reason for more aggressive monetary tightening than anticipated until recently lies in the latest surprises in the Eurozone core inflation, which rose to 5.6% yoy in February-2023 (vs 5.3% in January-2023). Such developments in the core inflation reflect persistently strong domestic demand, especially amid milder winter which allowed for downside corrections in the key energy costs and alleviated cost pressures from the general spending fundamentals. We think that domestic demand will adjust downward eventually, allowing for the ECB to stop hiking rates as core inflation falls. Another element to watch for is how much the Fed hikes – if the ECB fails to match the magnitude in the Fed's tightening and EUR/USD drops as a result, there would an extra push upward to the Eurozone inflation via higher import costs. Also, the focus is switched away from the quantitative tightening, but it is an important element in the whole monetary policy spectre going forward.
- Fiscal policy changes for 2023 include top income (above 74,000 EUR) tax bracket hike to 50% (from 45%), taxation of rental income to 25% (from 15%) and a windfall tax. Public sector wage hikes and costlier refinancing due to rising interest rates will weigh-in on the budget, and as such, gov't expenditure will be around highest on record, as the gov't also will try to shield the economy against rising living costs (aid package is worth ca 1.2 bnEUR). Bottom line is that the fiscal gap will be somewhat above 5% of GDP, which given a strong investors' demand for Slovenian bonds in the primary markets seems still relatively fine. The government's best accomplishment is an ongoing strong record of managing refinancing needs, with 2 bnEUR bond sales this year pushing the government cash buffer to 11% of GDP, which covers the public refinancing needs at least through mid-2024.

FX and interest rates

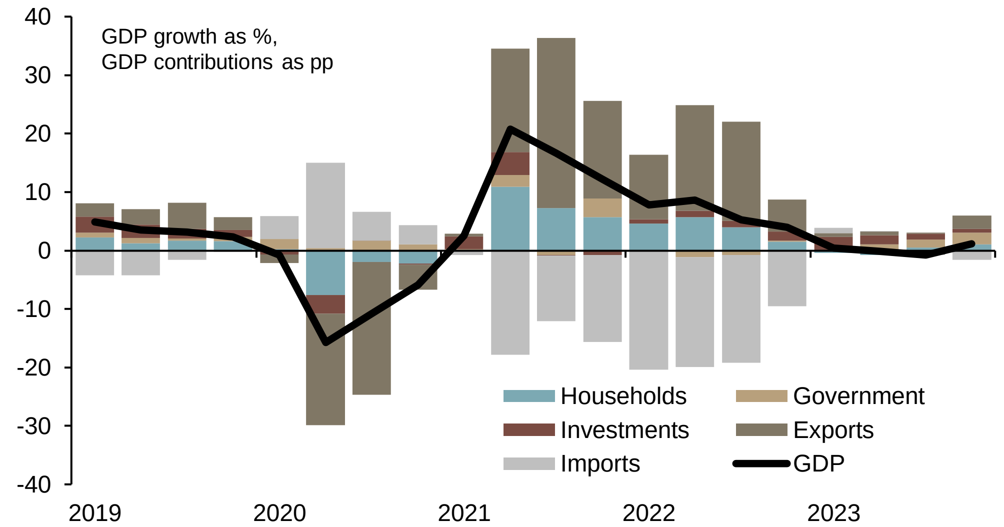
- EUR/USD is likely to rise slowly in the upcoming months, with swings in the global risk appetite to shape a relatively volatile profile in the upwardly oriented range. Indeed, on the monetary policy front, even with peaks to the central banks' policy rates looming large ahead, the ECB's moves are likely to support a stronger euro on the account of interest rate differential. The euro was traditionally benefiting more from the improving macro outlook, which means that once the focus is switched from inflation to growth fundamentals the euro will find more support. Risks against a stronger euro are concentrated into potentially stronger than expected global inflation profile if perhaps China reopening proves swifter than anticipated, or geopolitical risks deteriorate further.
- On interest rates outlook, we forecast the **3M Euribor rising slightly beyond 3.5%** in the next couple of months and see the **6M Euribor around 3.75%** on the back of the ECB's policy rate hikes. Rates will remain at those levels at least until early 2024, after which we see a downside potential however still highly dependent on growth fundamentals – policy rate cuts and resultantly reduction in Euribor rates would be allowed only in case of GDP profile weak enough to vote for policy accommodation. In times between, excess liquidity in the EMU is indeed falling, however the local banking systems remain liquid enough to support the new loan generation. We also think that, faced with gradually weakening demand for loans, this will curb upside pressures to interest rates on new loans going forward. On the long term rates, we see upside pressures there as well, along with a general increase in cost of money and deterioration in credit quality globally in 2023. Still, better rated issuers such as Slovenia will be less affected and we do not see spreads widening for Slovenian bonds.

Croatia

	2019	2020	2021	2022	2023F	2024F
GDP real growth (%)	3.4	-8.6	13.1	6.3	0.1	2.6
GDP current prices (EUR mln)	55,677	50,461	58,287	67,385	72,758	77,108
GDP per capita (EUR)	13,696	12,467	15,026	17,484	18,879	20,007
CPI (%, annual average)	0.8	0.0	2.7	10.7	8.4	3.9
CPI (%, end-of-year)	1.3	-0.3	5.2	12.7	5.9	2.7
Unemployment rate (%, ILO)	6.7	7.6	7.7	7.0*	7.0	6.8
Employment growth (% annual average)	2.3	-1.2	2.2	2.5	1.2	2.0
Imports of goods (EUR mln)	23,312	20,856	26,254	38,437	40,417	42,110
Exports of goods (EUR mln)	12,817	12,013	15,609	21,624	22,788	23,786
EUR/USD (average)	1.12	1.14	1.18	1.05	1.09	1.12
EUR/USD (end-of-year)	1.12	1.22	1.14	1.07	1.11	1.14
3M Euribor (average)	-0.36	-0.43	-0.55	0.35	3.13	2.50
10Y EUR swap rate (average)	0.26	-0.14	0.05	1.93	3.27	2.74

*estimate

Croatia, GDP growth and contributions



Source: statistics office, Bloomberg Adria analytics

Economic activity

- Milder winter, which in many ways transferred to qoq growth of real GDP in 4Q (thus averting technical recession), along with strong labour market (employment above pre-GFC levels), healthy investments (gross fixed capital formation gained pace for the fourth straight quarter in 4Q) and exporting activity, poised us to **revise our previous forecast of 2023 real GDP growth to a stagnation (+0.1%) vs 2022 level** (at 6.3%, i.e. fourth best in EU27 and the most in Adria region). In 2023 we expect growth to be supported by investment prospects (boosted by Schengen and EA entry, adding to contain transportation and financial costs) and government expenditure via wide-range of subsidies to the economy (something that positively materialised in the 4Q and is announced to continue in 2Q2023). Meanwhile, personal consumption and exporting will take a hit, with the former impacted by high inflation environment, lower remittances and higher financing costs, and the latter due to weaker foreign demand prospects (an outlier being export of services, as tourism season is seen in the same line as in 2022). **Our 2024 call is now higher (at +2.6%)**, bearing in mind three elections in that year (with pronounced government expenditure expected).

Inflation

- As inflation pressures from food/energy are easing (global energy crisis mostly averted due to supply reallocation and good weather prospects), focus is shifting to „core" elements as domestic demand remains resilient (poor demographics drive wage bargaining power to employees' side). Even though the focus at the start of 2023 was on the price movements due to EA entry, results proved that price surges (due to price roundups, for example) were largely absent (mom increase in January was in line with 20Y+ average for that month) and social cohesion was mostly intact for that matter. All told, we see **average inflation rate in 2023 slowing to (still high) 8.4% yoy (from 10.7% in 2022)**, with lower numbers seen in the 2H2023, as core inflation rate maintains a lag to overall spending fundamentals and monetary actions fully materialise. **For 2024 we see average inflation rate at 3.9%.**

Croatia

Monetary and fiscal policy

- We see the **ECB hiking deposit rate to 3.5% and refi rate to 4.0%** in the rest of 1H 2023, which means additional 100 basis point rate hikes ahead. The reason for more aggressive monetary tightening than anticipated until recently lies in the latest surprises in the Eurozone core inflation, which rose to 5.6% yoy in February-2023 (vs 5.3% in January-2023). Such developments in the core inflation reflect persistently strong domestic demand, especially amid milder winter which allowed for downside corrections in the key energy costs and alleviated cost pressures from the spending fundamentals. We think that domestic demand will adjust downward eventually, allowing for the ECB to stop hiking rates as core inflation falls. Another element to watch for is how much the Fed hikes – if the ECB fails to match the magnitude in the Fed's tightening and EUR/USD drops as a result, there would an extra push upward to the Eurozone inflation via higher import costs. Also, the focus is switched away from the quantitative tightening, but it is an important element in the whole monetary policy spectre going forward.
- **Govt's tax intake in 2023** will be widely **impacted by slower economic and inflation environment**, while the focus is to some extent on special windfall tax, although its impact remains questionable as low amount is to be collected according to our view. Additionally, government in 1Q2023 introduced its maiden „national bond", which we see as a mean of cheaper gov't borrowing in times of globally increasing financing costs. Nevertheless, the 1.85 bnEUR-heavy issue is seen as a success (some 1.3 bnEUR raised only from retail, with >43ths citizens involved), with more bond issuance(s) likely in the near term at least to cover for **this year's public refinancing needs of 10%/GDP while the current cash buffer stands at 8%/GDP**. Adding to the previous, government's budget in 2023 is seen seriously tested with broad-based public sector's wage hikes and the fact that **2024 is branded as a „Super-election" year** (national and European parliamentary and presidential elections) and thus stronger expenditure is expected in the 2H2023.

FX and interest rates

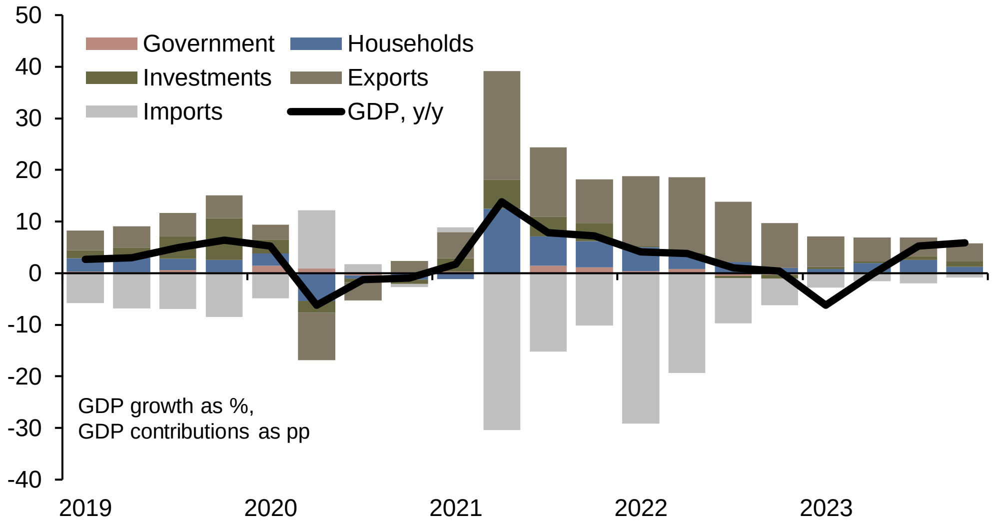
- EUR/USD is likely to rise slowly in the upcoming months, with swings in the global risk appetite to shape a relatively volatile profile in the upwardly oriented range. Indeed, on the monetary policy front, even with peaks to the central banks' policy rates looming large ahead, the ECB's moves are likely to support a stronger euro on the account of interest rate differential. The euro was traditionally benefiting more from the improving macro outlook, which means that once the focus is switched from inflation to growth fundamentals the euro will find more support. Risks against a stronger euro are concentrated into potentially stronger than expected global inflation profile if perhaps China reopening proves swifter than anticipated, or geopolitical risks deteriorate further.
- We forecast the **3M Euribor rising slightly beyond 3.5%** in the next couple of months and the **6M Euribor around 3.75%** on the back of the ECB's policy rate hikes. Rates will remain there at least until early 2024, after which we see a downside potential however still dependent on growth fundamentals – policy rate cuts and resultantly reduction in Euribor rates would be allowed only in case of GDP profile weak enough to vote for a policy change. In times between, excess liquidity in the EMU is indeed falling, however the local banking system is liquid enough to support the new loan generation. We also think that, similarly as in some other areas in the region, faced with gradually weakening demand for loans, ample unused liquidity in the system will curb upside pressures to interest rates on new loans going forward. This is especially pronounced as before the EMU entry banks have seen a sizeable liquidity release from the reduction of mandatory reserves. On the long term rates, we see upside pressures there as well, along with a general increase in cost of money and deterioration in credit quality globally in 2023. Still, region-wise we see Croatian spreads underperforming that of Slovenia given the latter sovereign's better refinancing position.

Serbia

	2019	2020	2021	2022	2023F	2024F
GDP real growth (%)	4.3	-0.9	7.5	2.3	1.3	3.5
GDP current prices (EUR mln)	46,003	46,815	53,329	60,365	68,152	74,139
GDP per capita (EUR)	6,624	6,786	7,803	8,833	9,972	10,848
CPI (%, annual average)	1.9	1.8	4.0	11.7	11.4	4.6
CPI (%, end-of-year)	2.1	1.3	7.9	14.6	6.4	4.2
Unemployment rate (%, ILO)	10.5	9.1	11.1	9.4*	8.9	8.6
Employment growth (% annual average)	2.0	1.9	2.6	1.6	1.2	1.4
Imports of goods (EUR mln)	22,103	21,347	26,802	35,982	38,676	40,363
Exports of goods (EUR mln)	16,506	16,353	21,224	27,177	30,178	32,184
EUR/RSD (average)	117.86	117.58	117.57	117.46	117.68	117.88
EUR/RSD (end-of-year)	117.59	117.57	117.58	117.32	117.80	118.00
6M Belibor (average)	2.65	1.37	1.08	2.69	6.09	5.50
5Y RSD govt rate (average)	3.51	2.77	2.63	6.04	8.50	8.00

*estimate

Serbia, GDP growth & contributions



Source: statistics office, Bloomberg Adria analytics

Economic activity

- **In 2023 we expect real GDP growth to slow to 1.3%,** with negative rates materialising in 1H2023 due to higher base effects. Domestic consumption will grow slower, bitten by high inflation and costlier borrowing, with sticky labour market still on the supporting side. Investments will bring some upside to the overall economic growth, although we are talking about slippery territory as bulk of investments come from EU and China, making their path quite vague and in the shadow of political moves. Positive contribution is expected from investment in infrastructure projects planed in 2023. Monetary policy decisions will bite on GDP in terms of consumption and investment spending (domestic and abroad), as interest rates are expected to increase further. We see a slowdown in foreign demand reducing exports (and consequently imports). Negative risks for 2023 arise from geopolitics, notably ties with Russia and handling the EU prospects.
- In 2024 we see 3.5% GDP growth, as foreign and domestic demand starts to recover, and the fight with inflation starts to ease, giving more stable outlook for the future business environment. Positive risks in the mid-term come from resolution of the conflict in Ukraine and possible faster growth in China spilling over to global demand.

Inflation

- HICP **inflation** rate is expected to top during 1Q2023, and to follow downward path in 2023 and 2024. On average **in 2023 we see only slightly lower rate compared with 2022**, as inflation rates showed more resistance than initially expected. Tightened financing conditions (supported by both NBS's and ECB's policy), in line with deteriorating real wages will pull domestic spending wiping out part of the demand pressures on inflation. Commodity prices under 2022 level, and inherited high base from the last year will support inflation downward path.
- Even though inflation will slow down, let's recall that we are still talking about two-digit levels in 2023, on average, which is still far out of NBS's targeted range. Only in 2024 we see inflation 4.6% on average, going down to the upper targeted bound of 4.5%.

Serbia

Monetary and fiscal policy

- According to our latest view, we see Serbian central bank to continue lifting the key policy rate, even a step more than previously expected. We see the **NBS sending the key policy rate of 5.75% to 6.50%.** As headline and core inflation are showing stubbornness, monetary policy will continue to fight. We see further direct effects of the ECB restrictive monetary policy, as the financial system is highly euroized and exposed to Euribor rates. High euroization poses high FX risk for the private non-financial sector, although in recent years tamed as EUR/RSD exchange rate has been relatively stable, due to depreciation/appreciation pressures balanced with central banks interventions (backed up by accumulated FX reserves). Bearing in mind all above, we expect that monetary policy, in line with economic slowdown, delivers results in curbing inflation in 2023, even though the transmission mechanism is significantly challenged by bulk of fixed rate loans, and strong banking sector liquidity. Lower volatility on the global markets presents an issue less for the monetary policy, so the focus will stay on curbing inflation.

- **Fiscal figures** will be hit by weakening economic activity trends this year. Although persistently strong inflation would be a positive factor for the gov't tax intake, still in this year we expect the backfire effects of past cost increases to weigh on private sector spending and affect tax receipts. Fiscal deficit will deteriorate in such environment and we estimate the gross public refinancing needs (budget gap + maturing debt) to come at around 10%/GDP this year. Coverage of the latter is still not fully met, with the cash buffer currently standing around 9%/GDP. We expect the government financing to rely on a combination of off-market and market borrowing, with the costs higher than a year before. The off-market part is strongly supported by the UAE loan (1 bnEUR) and IMF deal (2.4 bnEUR) offering better conditions than the current market does. All in all, we expect public debt to stay bellow 60%, which offers scope for further debt raising. Following on that, the price will stay elevated as it depends on global markets dynamic and challenges the government capability to manage the maturity and currency structure of the debt.

FX and interest rates

- We expect the **EUR/RSD to trade in a narrow range** i.e. stay in a dirty float regime going forward, with the recent government borrowing abroad vouching for a solid foreign capital flows to support the dinar stability. That said, we do see deteriorated foreign goods trade dynamics to create negative pressures onto the RSD stability, however the mentioned government foreign borrowing has increased the foreign FX reserves to record highs and the central bank has enough to use it in defence of the RSD stability.

- **Interest rates will be higher going forward** amid further policy tightening by the NBS, but also the ECB creating an imported policy transmission effects via high euroization of the local banking system. Different to other countries in the region, the local banking system is relatively poorer in terms of unused liquidity, which means that the room to offset the tightening monetary policy effects onto interest rates is relatively tighter. Still, we expect demand for loans by the private sector to weaken as part of the overall economic activity. On long term rates, in times of market stress we expect Serbian yields to rise more than for better rated issuers in the region, however in the near term the general view is for less market fluctuation than in 2022, hence suggesting somewhat more stable profile for Serbian long term yields than in the last year.

Bosnia and Herzegovina

Bloomberg Adria

	2019	2020	2021	2022	2023F	2024F
GDP real growth (%)	2.8	-3.3	7.1	3.5	1.7	2.0
GDP current prices (EUR mln)	18,682	18,118	20,353	24,018	26,677	28,639
GDP per capita (EUR)	5,351	5,214	5,857	6,912	7,677	8,241
CPI (%, annual average)	0.6	-1.1	2.0	14.0	9.2	5.3
CPI (%, end-of-year)	0.3	-1.6	6.3	14.8	7.4	4.1
Unemployment rate (%, ILO)		15.9	17.4	15.4*	15.0	14.5
Employment growth (% annual average)	2.3	-1.0	1.3	2.2	1.8	2.0
Imports of goods & services (EUR mln)	19,494	16,645	21,084	29,284	31,246	33,038
Exports of goods & services (EUR mln)	14,328	11,870	16,485	22,772	24,234	25,652
EUR/USD (average)	1.12	1.14	1.18	1.05	1.09	1.12
EUR/USD (end-of-year)	1.12	1.22	1.14	1.07	1.11	1.14
3M Euribor (average)	-0.36	-0.43	-0.55	0.35	3.13	2.50
10Y EUR swap rate (average)	0.26	-0.14	0.05	1.93	3.27	2.74

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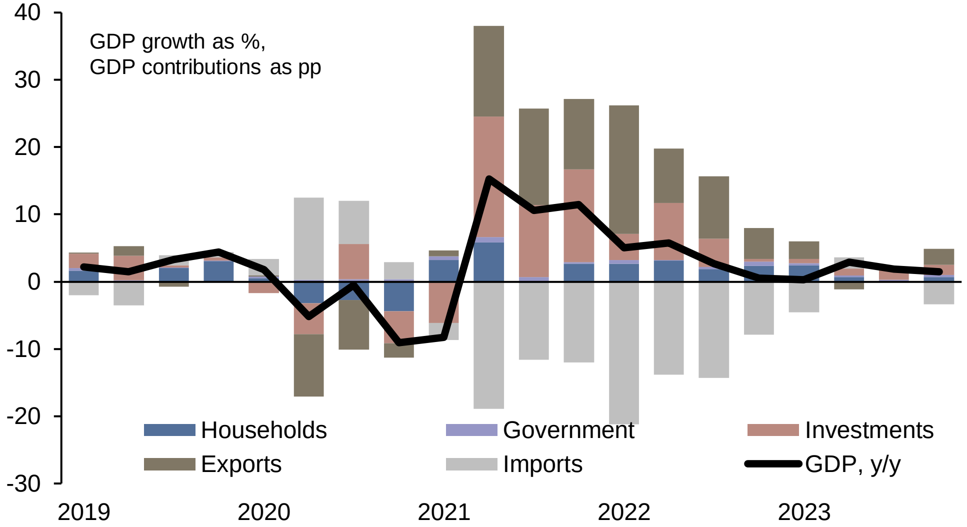
B-H, GDP growth & contributions



Source: statistics office, Bloomberg Adria analytics

Economic activity

- We are keeping our **GDP growth forecast for 2023 at 1.7%** as we think that prolongations to form the government on all levels have delayed some reforms and capital flows, however we still think that the named government forming will take place soon and support the improvement of growth prospects. This however cannot fully offset the negative influences of inflation onto private spending, which we see as slowing in growth this year mostly due to costlier energy and other non-discretionary spending categories. Although unemployment is rather high in international comparisons, the labour market is still too tight to allow for a more pronounced deterioration in spending trends. Investments are hit by higher interest rates and generally deteriorated investment prospects due to mid-term uncertainties. We see a potential of capex revamping on the back of EU capital flows and foreign investors attention amid still low labour costs.
- **In 2024, we see GDP growth advancing to 2.0% yoy**, with a better outlook for both net exports and investments, while gradually falling inflation would support household consumption.

Inflation

- We see **inflation rate** already peaked and started to head down, as we expect it to continue in 2023, posting on **average 9.2%**. As establishment of a governments (on entity and national levels) has been resolving slowly, measures to halt basic food prices were not implemented, which somewhat kept inflation elevated and especially painful for low-income households. Inflation slowed down on the back of energy prices dropping in recent months, with domestic demand still strong, as retail volumes show further growth according to January-2023 data. We expect the demand pressures to turn around and ease in the coming months, as in the environment of still high inflation, incomes are losing spending potential and supporting consumption with debt became costly.
- In 2024 we expect inflation to slowdown further at 5.3% on average, as prices start to reach their more sustainable new levels.

Bosnia and Herzegovina

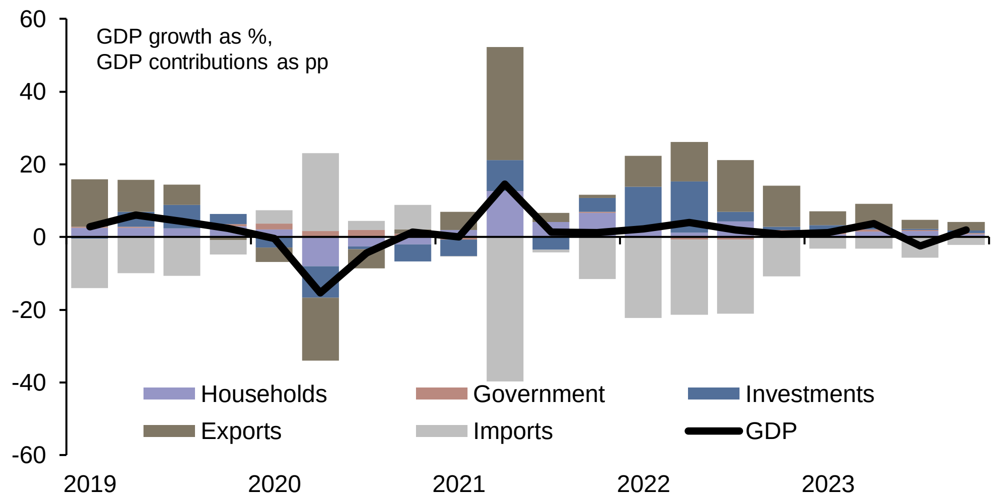
Monetary and fiscal policy	• We do not expect a change in the monetary policy setup, with the Central Bank of Bosnia and Herzegovina moving sticking to the Currency Board Arrangement (CBA). The stability of the EUR/BAM is perceived as resistant to the short term fluctuations, with the CBBH FX reserves at above 8 bnEUR i.e. up by 1% yoy. The 2023 will be highlighted by ongoing volatility in the global capital markets, which maintains a dose of uncertainty for the FX reserve stability going forward. However, the perception of the currency board stability will be intact thanks to imrpoved foreign capital flows after the B-H's political situation upgrades and gaining the EU candidacy status. • On public finances, formation of government on all levels after the last autumn elections was still not fully accomplished, and we expect widening government budget deficit once the formation is executed. The reason is that multiple public spending schemes are in the waiting for the official sign-offs. Deterioration in the core macro trends will create its own effect as well, especially the backfire of past living cost increases which will weigh on the private sector spending. The government's funding is not in very much bad situation, with the overall public financing needs this year estimated at just below 4%/GDP, while the current cash position of the central government stands at around 1.5%/GDP – the gap we see being met by the combination of off-market and on-market borrowing going forward, yet at a higher cost as a function of general increase in cost of money.
FX and interest rates	• The EUR/BAM stability will remain in place going forward, according to our view. • B&H's interest rates cannot escape the general trend of costlier borrowing to curb the inflation pressures. We nevertheless expect demand for loans by the private sector to weaken amid increased mid-term uncertainty, which will alleviate some upside pressures from the price of money. Come what may, credit quality of the banks' loan books is likely to deteriorate somewhat on the back of weakening economic activity, and incentives to cover for the credit losses would add to upside pressures to the interest rates.

North Macedonia

	2019	2020	2021	2022	2023F	2024F
GDP real growth (%)	3.9	-4.7	3.9	2.1	1.1	2.6
GDP current prices (EUR mln)	11,261	10,852	11,689	13,600	15,304	16,513
GDP per capita (EUR)	5,423	5,236	5,640	6,562	7,384	7,968
CPI (%, annual average)	0.7	1.2	3.4	14.0	11.3	5.2
CPI (%, end-of-year)	-0.2	3.1	4.9	17.8	7.7	3.7
Unemployment rate (%, ILO)	17.3	16.4	15.8*	14.5*	14.0	13.1
Employment growth (% annual average)	5.1	-0.3	0.0	0.5**	0.2**	1.0**
Imports of goods (EUR mln)	8,578	7,647	9,615	12,727	13,886	15,068
Exports of goods (EUR mln)	7,028	6,269	7,740	10,006	11,046	12,070
EUR/MKD (average)	61.51	61.67	61.63	61.62	61.60	61.60
EUR/MKD (end-of-year)	61.49	61.69	61.63	61.49	61.58	61.58

*estimate, **methodology change due to Census 2021

N. Macedonia, GDP growth & contribution



Source: statistics office, Bloomberg Adria analytics

Economic activity

- We are sticking to our previous view of slower **real GDP growth in 2023 at 1.1%**. Even though we expect private consumption to slowdown (especially in 1H2023) based on deteriorating wages and financial conditions for lending, and still high inflation rates, our view suggests light increase with positive contribution of remittances. Additional support we see in investments during 2023, providing some improvement in the labour market as the country experiences two-digit unemployment rates, so there is a scope for further employment.
- We see solid investments mostly in infrastructure, energy and utility facilities, backed up by the government, EBRD and EIB financing. Negative risks are coming from costlier funding taking a toll on private investment, although compensated with former mentioned. Government is planning to increase capital expenditure by ca 50% in comparison to 2022. We see budget plans doable bearing in mind that the support for public finances comes from IMF Precautionary and Liquidity Line and bond financing as the government succeed to issue the Eurobond, after a cancelation due to the government reshuffle in February-2023. Foreign trade will be driven mostly by foreign demand slowdown as it is tied to main trading partners economic growth seen as pale in 2023. Further in 2024 we expect the economy to grow 2.6% yoy on somewhat higher pace than 2023, dominantly driven by external demand picking up, spilling to other segments.

Inflation

- Headline **inflation rate** peaked in October 2022. North Macedonia experienced the highest inflation rates in the region, providing high base effects for 2023. We expect domestic demand to significantly slow down in 2023, as spending fundamentals have been deteriorating, with further pressures from monetary policies on financing consumption (bear in mind that outstanding loans for consumption are more than 60% of total household debt). Among the main drivers of inflation heading down we see prices of commodities, hoovering below 2022 levels. All in all, the inflation rate will **average 11.3% in 2023**, going for one-digit levels at the year end, and lending to 5.2% on average in 2024.

North Macedonia

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Monetary and fiscal policy

- Two digit inflation is going to push the **NBRNM to elevate interest rate levels even further**. North Macedonia (same as Serbia) has high euroization in the financial system, so it digests effects of the ECB's monetary policy, too. We expect the policy rate to reach 6% in 1H2023, aside from high inflation, encouraged by NBRNM's determination to maintain the EUR/MKD exchange rate stability. High FX reserves give the central bank some stability in terms of managing monetary policy in case of external negative events. We expect the transmission to demand to fasten, as January-2023 data show a spike in interest rates for households and companies, in line with general economic slowdown in 2023.
- **Government deficit** is expected to **widen in 2023**, as the economy slows down, although we see some positive signs compared with previous year, as interventions on the energy prices will ease vs 2022, and the country is dependent on energy imports. Apart from bond issuances, the government financing currently relies on external financing via World bank (100 mEUR) and IMF (530 mEUR), which enables lower costs compared with current market pricings. This year's gross public refinancing needs are estimated at a relatively high ~12%/GDP, with the current cash buffer (incl. the latest 500 mEUR bond issue) of around 7%/GDP covering only part of the total needs. The named supranational borrowing ensures the biggest part of funding gap, however it must be mentioned that the overall position is tight and realization of downside risks to GDP growth would put additional pressure on budget maintenance without any notable spending cuts.

FX and interest rates

- The **EUR/MKD will remain in a relatively narrow area** at least through 2023, with the NBRNM managing to keep the FX rate in the so-called dirty float regime as the weakening foreign demand effects into the stability of FX reserves are (partly) offset by the IMF-approved Stand-By arrangement.
- Interest rates are going further higher in 2023, according to our view, on the account of monetary tightening against the persistently strong inflation. The important element going forward is the deterioration in credit quality, coming on the heels of weakening economic activity trends. This means that private sector will be paying even higher interest rates on loans raised in the local banking system, and this not only due to the ECB's tightening effects onto Euribor, but also the effects of the NBRNM tightening.

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Disclosures Appendix

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