

Regional analysis Inflation report

Inflation slowing only modestly in 2023

Authors:

Andrej Knez, Chief Markets Analyst

Ivan Odrčić, Lead Financial Markets Analyst

Marina Petrov, Senior Markets Analyst

Highlights – Inflation

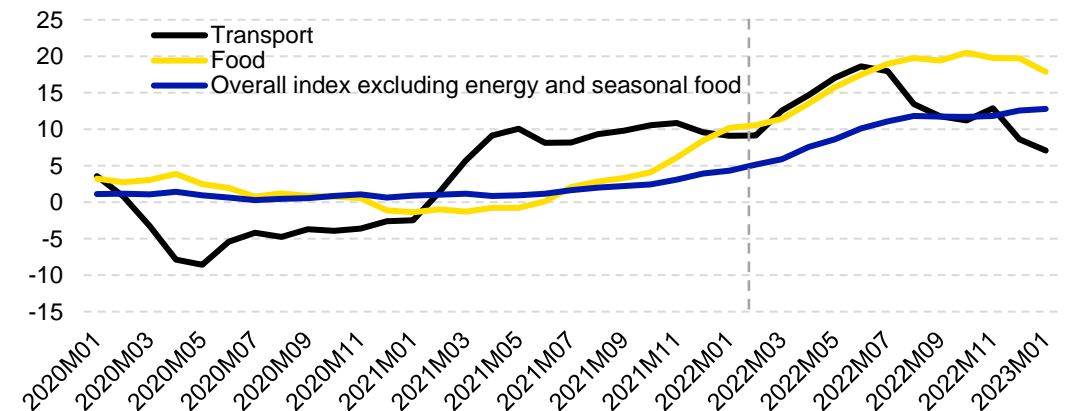
Headline inflation is slowing down in most of Adria region, with only Serbia being an outlier in the recent months as headline inflation pressures seem to have built up further. On a global view, inflation pressures coming from energy and food categories are easing, especially energy costs with relatively warm winter which in case of Europe meant less usage of gas and electricity. More so on Europe trends, energy supply reallocation away from Russia was quite successful, likewise adding to energy cost easing. The focus then in shifted onto core inflation elements to reflect the phase of the ongoing inflation pressure, especially as domestic demand proved to be much stronger than assumed before. Further elements are highlighted below. We are also examining the future path of inflation in the rest of 2023 as suggested by our quantitative models.

Croatia was recently in focus as the eurozone entry propelled an increased social attention that there were sizeable, unfounded price hikes at the key retailers. However, **January-2023 has produced a 0.3% mom rise in prices** according to the Eurostat’s HICP methodology (i.e. 0.0% mom according to national methodology), which is **quite close to a 20Y+ average** change for the first month of the year. Food prices did increase, but this was still at the same pace as in the years before on average. More importantly this time around is that our preferred core inflation gauge (HICP’s excl. energy and seasonal food category) is on a sturdy rise and suggests there is enough demand in the domestic private sector to allow for further price upside corrections with the previous energy and food price hikes. In total, **headline HICP inflation came in at 12.5% yoy**, being down from 12.7% yoy in December (and an average rate of 12.7% yoy for the 2H22), which also **confirms that headline inflation has passed its peak** recorded at 13% yoy in November.

Sticking with Croatia, **producer prices** posted 20% yoy rise in December-2022, being **significantly slower** compared to mid-2022, when producer prices were increasing at yoy rates above 30%. We see **decreasing fuel prices** and slowdown in producer prices **signalling downward path in headline inflation** rates from the cost side of the prices. However, food price inflation is quite sticky (opposite to transport prices, which adjust much faster to energy costs), which is preventing a much steeper reduction in headline inflation rates.

	January mom % change, average 2001 - 2022	January-2023	
All-items HICP	0.2	0.3	🟡
Food and non-alcoholic beverages	1.6	1.4	🟢
Food	1.7	1.7	🟡
Bread and cereals	0.7	1.8	🔴
Meat	0.1	0.7	🔴
Fish and seafood	1.6	1.6	🟡
Milk, cheese and eggs	1.0	0.6	🟢
Oils and fats	2.0	0.8	🟢
Fruit	3.9	2.4	🟢
Vegetables	7.7	3.1	🟢
Sugar, jam, honey, chocolate and confectionery	1.1	3.4	🔴
Food products n.e.c.	0.7	2.3	🔴
Non-alcoholic beverages	0.7	0.2	🟢
Coffee, tea and cocoa	0.6	-0.3	🟢
Mineral waters, soft drinks, fruit and vegetable juices	0.8	0.5	🟢

Croatia - Core inflation, food and transport prices
(yoy change in prices)



Source: Eurostat

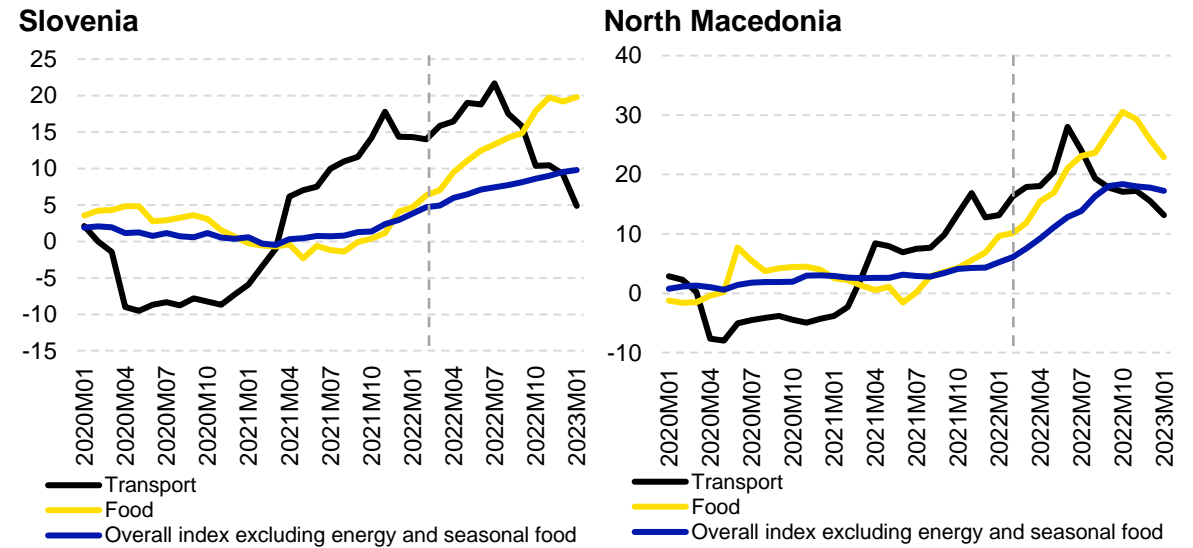
Highlights – Inflation

Slovenia also confirmed that **inflation passed its peak**, with HICP inflation rate falling to **9.9% in January-2023** (vs. 10.8% yoy in December), which is the first single-digit level since May-2022. Still, **food price inflation remains sticky**, producing a higher rate in early 2023 (19.8% yoy vs. 19% in 4Q22) and preventing a steeper slowdown in the headline inflation rate. More importantly, food prices rose by 2% mom, being completely outside of the headline move (-0.1% mom). Slovenia has the lowest share of food within HICP basket (16%) almost half of what is North Macedonia showing (36%), so Slovenian HICP is at a lesser extent sensitive to food prices – in other words, a bigger share of household spending on food would resultantly keep headline inflation even higher. When it comes to **energy, Government capped electricity prices** to below cost for micro, small and medium sized companies until June-2023, which will provide some certainty in this price area. Electricity for households and small business customers is also capped until August-2023. **Fuel prices** will experience upward price pressures coming from **Government considering adjusting margins** in accordance with inflation rates. Additional upward pressure to consumer prices is expected to reflect producer prices posting higher rates (23.3% yoy in December-2022). On the other side, we are still looking for demand to pass through the effects of ECBs monetary policy continuous tightening (core excl. energy and seasonal food accelerated to 9.8% yoy vs. 8.4% average in 2H22), economic slowdown and real wages decrease (-6% in 2022 on average) but challenged by low unemployment rate).

After peaking in October-2022 at **19.4% yoy**, headline **HICP** in **North Macedonia** slowed down to 16% yoy in January-2023. **Core inflation slipped to 17.2% yoy**, also calming after 18.1% average in 4Q22. The main drivers behind the headline move were food prices, dropping by 0.8% mom after a 2.3% mom drop in December-2022. Transport costs also went down by 1.9% mom in January driven by the drop in fuel prices mirroring global markets. Slowdown in food price inflation is partially driven by weakening demand, as wages dropped 5% in real terms yoy in 2H22 (dropping continuously from May-2022), and we can see significant deterioration in retail trade of food, beverages and tobacco.

Staying with North Macedonia, basic food staples margins have been capped in most of 2022 and prolonged to April 2023, as government intends to keep basic foods from surging with the market in order to somewhat discipline basic prices. The effect may not seem so significant when compared with headline inflation (inflation w/o administrated prices was +0.6 pp on average in 2022), but it certainly is significant from social aspect bearing in mind its share in lower-income households most hit by rising food prices (within the region N. Macedonia is bearing the largest share of food category in total HICP, amounting to 36%). In total, we see inflation further stabilizing given global price dynamic, high base effects and ongoing deterioration in consumption fundamentals.

Core inflation, food and transport prices
(yoy change in prices)



Source: Eurostat

Highlights – Inflation

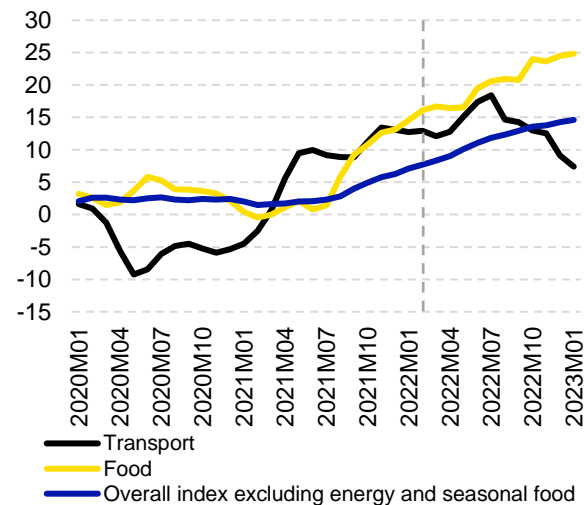
When it comes to **Serbia**, this is a **single country in the region displaying an acceleration in HICP yoy inflation** – the **yoy rate rose to 15.2% in January-2023** (vs. 14.6% yoy in December) to mark the highest HICP figure since at least mid-2000s. Additional upside pressures to yoy headline rate are coming from **costlier housing energy prices and costlier services**. On the other hand, we see transport energy prices calming now, but transmitting previous rises almost fully to core inflation. **Food price inflation is sticky** – domestic supply is limited by competitive pricing at exporting markets, which keeps prices for the local consumers elevated. There is ample supply of eggs, but abroad price pressures are spilling over, as the exports of eggs was increased 25% in 2022 in quantity, but 75% in value, showing surge in export price. The opposite situation we see with milk - milk imports increased cca 40% yoy in 2022 in quantity, and 75% in value, showing that domestic supply is not enough to fulfil demand (in 2022 Serbia became a net importer of milk after years of being net exporter).

Transport prices slowed down to 7.4% yoy (vs. 13.7% yoy in 2H22), posting **back-to-back negative mom rates**, as the drop in the global commodity market copied to the domestic market. We see this as a factor of inflation calming down during 2023. Relevant monetary policies stayed restrictive, with both ECB and NBS increasing rates further in 2023, and we expect some results to be seen in 2023. Pressures from the labour market were strong during 2022, as unemployment is dropping and real wages begun to drop only from October 2022, with a slow pace. Fiscal policy acted expansionary during post pandemic years, which somewhat supported domestic demand. We see further prices' trajectory to sum up measures undertaken in previous periods, and to absorb decrease in global energy prices and slowdown in global (in particular European) inflation rates as large amount of the inflation in Serbia is imported. Food prices will stabilize slowly driven by supply (and climate) conditions and supported by the sense that the fiscal policy is going to keep stimulating demand for basic food staples by increasing pensions and lump sum flows to the most vulnerable citizens (with high marginal spending propensity). In addition, capped prices of basic foods keep inflation rate cca 2 pp on average lower in 2022 compared with inflation rates w/o administrative prices.

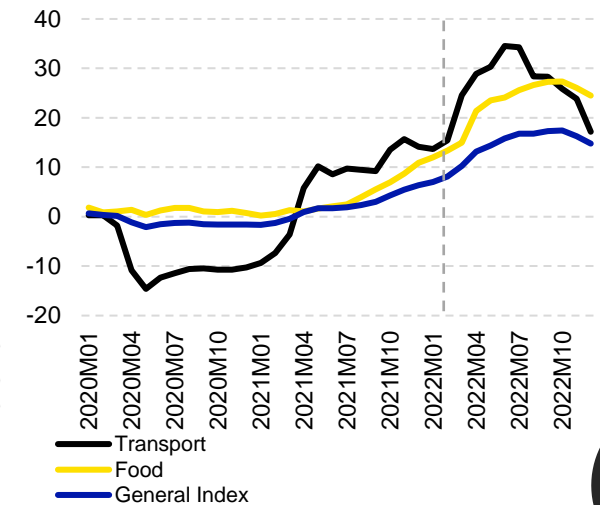
The **annual inflation rate in Bosnia and Herzegovina** slowed down to **14.8% in December-2022**, after peaking in October-2022 at 17.4%. Like in the rest of the region, food prices posted the highest inflation rate at 24.5% supporting overall rate. Mom change in prices dropped into a negative zone, recording 0.6% decrease. Transport prices posted the most significant decrease of 6.1% mom in December-2022, as fuel prices went down. Clothing and footwear prices were 3.7% lower in December-2022, compared with the previous month, representing weaker demand pressures. Rise in prices in Bosnia and Herzegovina are a significant burden to low-income households, as wages are falling in real terms, and there were no measures to halt prices of basic food staples in the moment of high food inflation. There are hints of further price increases during first months of 2023 (including slight rise in fuel retail prices) and announced tobacco prices increase from March-2023 (due to announced higher retail tobacco prices from BAT group).

Core inflation, food and transport prices (yoy change in prices)

Serbia



Bosnia and Herzegovina*



*For BH CPI indices used, as core inflation measure is not available, general index presented
Source: Eurostat and BH statistical office

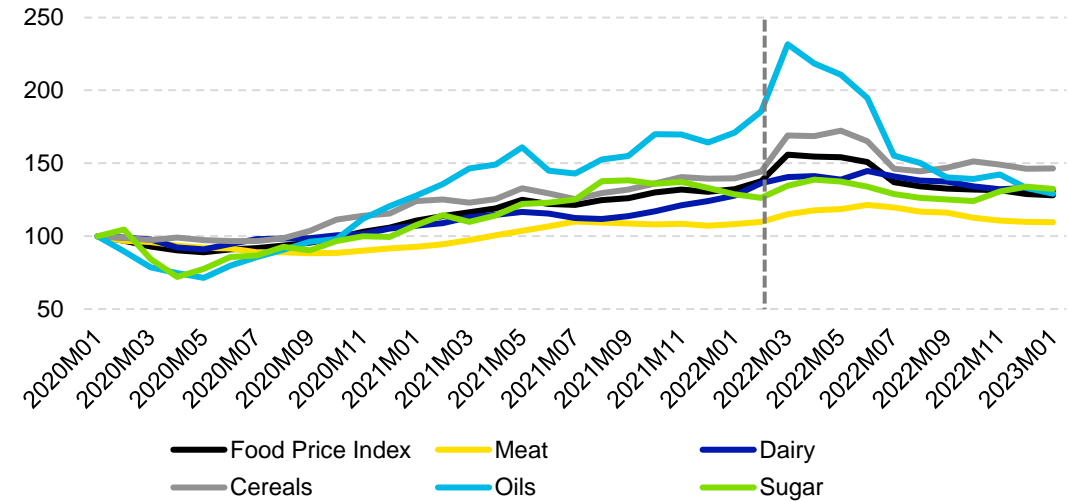
In this part we try to clear out how food prices in the region build up, trying to gauge many relevant aspects. As our analysis suggests, food price inflation is constantly higher than the headline rate, with some of them already having regulated caps on some prices.

Food prices on the global market are sliding down. Oil prices are back on their January-2021 level, while meat, dairy and cereals are back on their levels at the beginning of 2022, although still above 2021. Global food prices are not mirrored perfectly in the domestic prices (neither producers nor consumers), even though countries in the region show solid import-export flows.

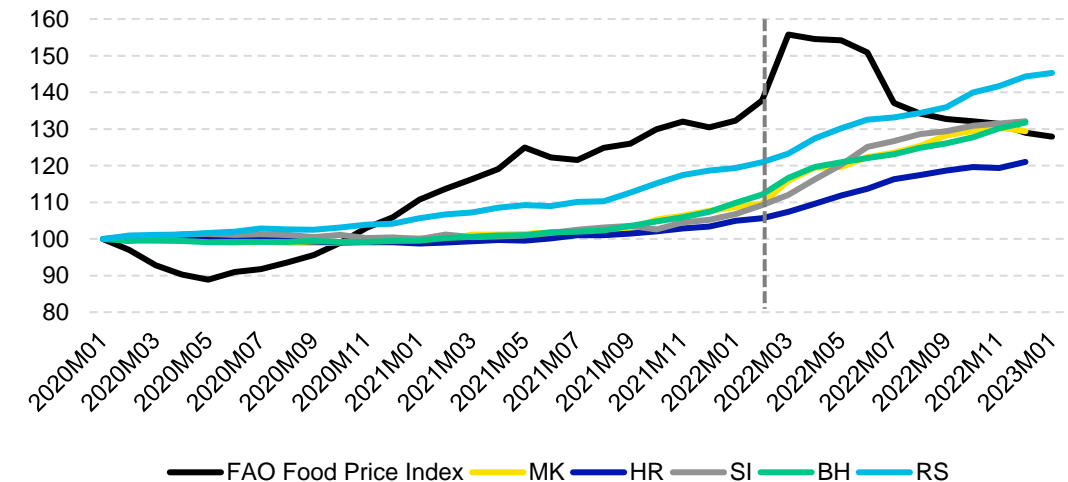
Domestic food prices rely on domestic production conditions (even some of them are also imported, like energy prices), and to a lesser extent to global food prices. Food prices in the past periods were impacted strongly by rising transport costs and more expensive agrochemicals, both necessary for agriculture, manufacture of food products and distribution to retail spots. This was influenced by Russia – Ukraine conflict, as they are major cereal and agrochemicals producers. Agriculture production in the region was also hit strongly by drought in 2022, reducing production and imposing upward pressures on prices.

Aside from that, avian influenza in Europe wiped out a significant volume of poultry and egg supply, threatening to keep spreading as many countries are still reporting cases of the flue. When it comes to our region, Slovenia and Croatia are recording cases of the flue in 2023, still only within the wild birds. Even though domestic food production is a major factor stabilizing domestic supply, higher prices caused by shortages over Europe tempt domestic producers to turn to exports in case domestic prices don't adjust (thus strong increases in, for example, egg prices in Croatia, along the fact that one of the major national producers closed production at the end-2022). Serbia, North Macedonia and Albania are part of the Open Balkan initiative within which they agreed to cooperate to bridge food crisis, among other issues. By signing the Agreement on food safety, members of the initiative agreed to allow free trade of a list of products within. This will somewhat stabilize food supply in this part of the Western Balkan, as members agreed to lift any bans on food export that were imposed in case of trade within the countries of the initiative.

FAO food price index
(index, January-2020 = 100)



PPIs in the Adria region, manufacture of food products
(index, January-2020 = 100)



As regards **inflation outlook**, in most of the region the turning point in the headline inflation took place in the recent months (with Serbia being the sole outlier). Much warmer winter and quite good energy supply reallocation to sources other than Russia allowed for less costlier energy. Still, core domestic demand is proving much more resilient to the overall economic slowdown and especially previous price hikes, as we examined details of spending fundamentals in our [recent report on retail trade](#). Simplified, this means that headline inflation will remain quite sticky and core inflation will keep producing upside pressures at least during 1H 2023 – bear in mind that core inflation also maintains a lag to overall spending fundamentals. As a result, **headline inflation rates will be slightly lower on average this year**, whereby the central bank inflation targets are not to be reached before 2025.

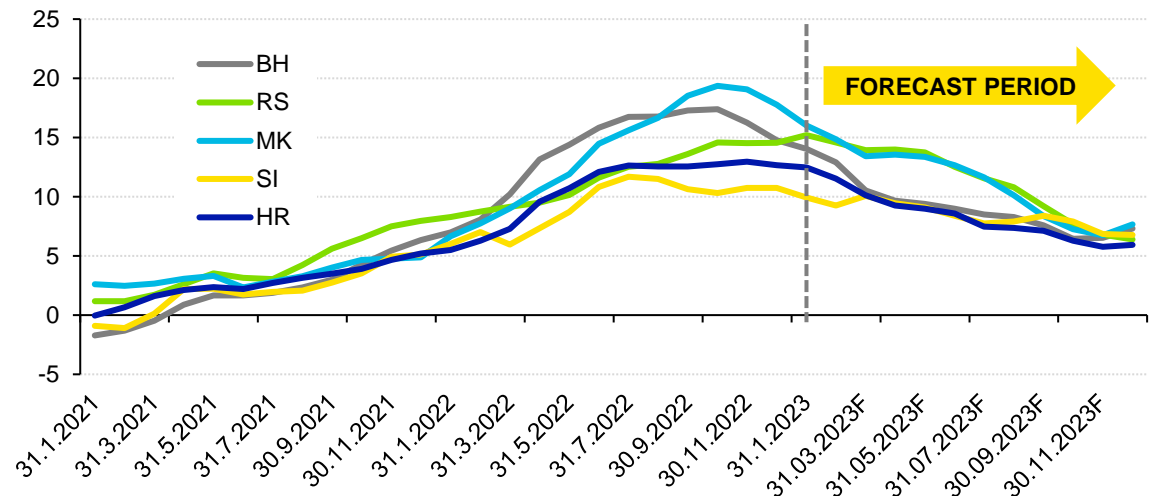
We see monetary policies keeping restrictive stance, as its transmission to the prices seems heavily challenged by strong labour markets and milder than expected economic weakening in the region and the main trading partners. Private sector interest rates are expected to rise further, damping credit activity and pulling down demand. Our expectations regarding relevant monetary institutions follow:

- 1) **ECB** – we see the **ECB hiking rates by 75bps** after upside surprises to the EA core inflation readings which increasingly fuels into a potential for additional 25bp rate hike somewhere in mid 2023. We see tightening cycle in terms of rising interest rates to close in 1H2023, but tightening policy to be continued in terms of quantitative tightening. In all, we see **Euribor 6M settling around 4.00%** as of mid-2023 until at least mid-2024.
- 2) **NBS** – we see the **NBS hiking rates by an extra 75bps till mid-2023 (in 25bp moves)**. We expect inflation to peak in 1Q2023, slowing down further supported by restrictive ECB and NBS policies. Inflation rates in 2023 will stay elevated, especially in 1H2023, making it harder for NBS to finish the restricting cycle (bearing in mind EUR/RSD rate is formally managed floating, but in fact is kept stable, which keeps NBS busy with looking at interest rate differentials). Global markets are more stable this year, alleviating the need for much more tightening by the NBS.

3) **NBRNM** – we see central bank **increasing interest rates by 75bps** in 1H2023, as inflation is still high. As the central bank targets EUR/MKD stability, we have shifted our view towards higher rates, bearing in mind that current reconstruction of Government and recent bond issuance fiasco act destabilizing and central bank may have to act more prudently to fulfil its goals (complementing FX interventions with interest rate rises).

Inflation forecasts			
Annual averages (%)	2022	2023	2024
Croatia	10.7	8.4	3.9
Slovenia	9.3	8.5	4.1
B-H	14.0	9.2	5.3
Serbia	11.7	11.4	5.1
N. Macedonia	13.9	11.3	5.2

Inflation forecasts (annual rates in %,)



Source: BBA analytics

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Bloomberg Adria Team Analytics

Andrej Knez, Chief Markets Analyst
andrej.knez@bloombergadria.com

Ivan Odrdic, Lead Financial Markets Analyst
ivan.odrcic@bloombergadria.com

Ratko Guduric, Senior Markets Analyst
ratko.guduric@bloombergadria.com

Jelena Zindovic, Senior Corporate Finance Analyst
jelena.zindovic@bloombergadria.com

Matteo Mosnja, Corporate Finance Analyst
matteo.mosnja@bloombergadria.com

Ilija Nestic, Corporate Finance Analyst
ilija.nestic@bloombergadria.com

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