SEE-6
Economic Outlook

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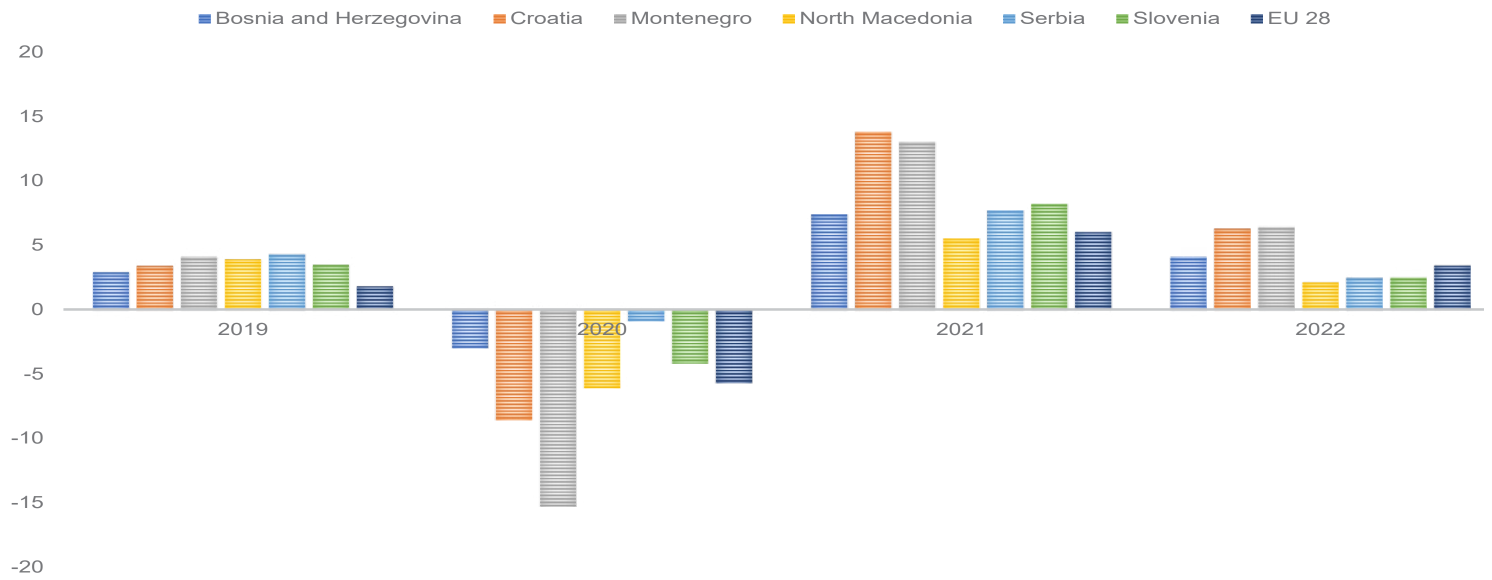
GDP GROTWH RATE – ANNUAL %



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BOSNIA AND HERZEGOVINA

B&H economy is slowing down, inflation pressure softens, with uncertain future prospects

The slowdown of economic activity continues in the first half of 2023

The slowdown of economic activity in the EU, with the present contraction in Germany, the main foreign trade partner in B&H, accompanied by the decrease of real household spending, impacted the trend of real economic activity in the country. The slowdown of economic activity from the end of 2022 continued in the first half of 2023. According to the available official data, in the first and second quarter of 2023, real economic activity grew by 1.7% and 1.2%, respectively, on year on year basis. The gross value-added increase resulted from growth of services, while production activities recorded annual decline or negligible growth rates. The strongest growth of real economic activity was recorded in wholesale and retail trade (8.0%) and hotels and catering (6.2%).

The decrease of economic activity in the EU and general demand for local products impacted a decline of industrial production for the fifth successive month as of June of 2023. The largest decline of economic activity and neg-

ative real growth rates at the annual level were recorded in manufacturing (-2.8%), construction (-1.6%), and production and supply of electric energy, gas, steam, and air conditioning (-1.6%), which also had the largest negative contribution to the growth of real gross added value. Contractions of the mentioned activities were mainly related to decreased domestic demand and decreased exports, mainly those of base metals.

From the expenditure perspective, the largest contribution to the real GDP growth was recorded in the case of gross investments – 12.4% increase on year on year basis. The exports of goods and services, which contributed the most to GDP growth in recent years, recorded the lowest growth rate in the first two quarters of 2023 (1.7%). This was mainly due to the decline of economic activity in the most important export markets (primarily Germany), but also to a decline in the export value of some important export groups of products: base metals, furniture, and electric energy. Strong inflation pressures in the first quarter of the current year, particularly in the categories of goods and services with the largest shares in the total household expenses, impacted a decline of real spending of households in the first quarter by 0.4% and its negative contribution to the growth of real GDP.

After the 2022 elections, all governments have now been formed, but domestic political tensions and limited policy coordination at the state level continue to hamper economic policy and reforms. Structural reforms are critical for improving the business environment, stimulating private-sector employment, and tackling corruption. Work on these reforms needs to resume as soon as possible.

Unemployment continues to decline

Employment exceeded its prepandemic level already in late 2021, and emigration trends have reportedly intensified, further straining the already tight labor market. Labor market data show a continuation of the trend of decreasing the number of registered unemployed persons in the first half of 2022. In June 2023, the lowest number of unemployed over the previous five years was recorded. At the end of June 2023, positive developments in the labour market indicated a decrease of the annual unemployment rate by 4.2%, while the number of unemployed decreased by almost 13 thousand. Change in the number of employees on a cumulative basis at the end of June showed almost 10 thousand newly employed persons compared to the end of the previous quarter. The highest growth of the number of employees was recorded in the construction. Although these data seem encouraging (using ILO methodology, the unemployment rate was 13.6% – a record low level), the key characteristic of B&H labor market remains the same – low activity of the working-age population and high unemployment among youth and the 50+ population. Unfavorable global economic circumstances, slowdown of economic growth in the EU, unfavorable demographic trends (profound external emigration of the working-age population), and insufficient and ineffective active labor market policies raise concerns about continuing positive trends.

The trend of average salary growth continued in the first half of 2023, partly as a result of the increased minimum wages but also as a result of increasing labor union pressure. The average net salary was around 12.5% higher in June 2023 compared to the same month of the previous year. With the weakening of inflationary pressures in the first half of the year, an increase in real wages by 7.5% was recorded, which partially contributed to the recovery of the real purchasing power of the population. The highest wages were recorded in the IT industry, real estate, and finance.

Inflation has been declining since Q4 2022

Average annual headline and core inflation reached 14 and 4.5 percent, respectively, in 2022. Headline inflation peaked at 17 percent year on year in October, fueled by rising food, transportation, and utilities prices, and has since declined. Core inflation, driven mainly by pent-up demand in tourism, supply chain disruptions of durables, and labor shortages, seems to have peaked at 7.2 percent y-o-y in March. Average net wages have been rising, driven by public and minimum wage increases in both entities (RS and FBiH), but real net wages have been rising only since January 2023. Public wage increases amounted to 0.5 % of GDP. Pension increases amounted to 0.8 % of GDP. Cash and in-kind social assistance (all one-off) amounted to 0.5 % of GDP. They comprised payments to pensioners, war veterans, disabled people, young people, unemployed people, and unemployed children of fallen soldiers.

After four successive quarters with two-digit price growth rates, an annual price growth of 6.38% was recorded in the second quarter of 2023. Quarterly price growth amounted to 0.3%, representing the lowest quarterly growth rate since 2021. Price indices for the consumer basket's most significant and volatile categories in the second quarter of 2023 pointed out the weakening of price pressure and lower annual price growth rates.

Following continuing growth in the first three months of this year, the industry producer price index growth also slowed down in the second quarter – the lowest annual growth rate since the beginning of 2021. Such a trend of producer prices was partly conditioned by the pace of price development of industrial products in non-local markets, which, for the first time since the beginning of 2021, declined at the annual level in June 2023.

The current account deficit is 3.6% of GDP

The external position is assessed as being broadly in line with fundamentals and desirable policies. The net international investment position (NIIP) has been improving gradually in the last ten years, reaching – 27.3 % of GDP at the end of 2022. From 2017 to 2021, the improvement was largely supported by narrowing the current account deficit and increased foreign exchange reserves. However, since the pandemic, the decrease in FDI, bank liabilities, and government loans have also contributed to a less negative NIIP. Banks have seen a significant decline in foreign deposit financing since 2020 but also in their foreign assets, with no significant impact on the overall investment position of the banking sector.

In the first quarter of 2023, there were no significant changes in terms of the balance of payments of BH compared to the same period of the previous year. The growth of the deficit in the goods account was compensated by the growth of the surplus in the services account and remittances from abroad. Nominal GDP growth, fueled by inflationary pressures, influenced the decline in the current account deficit expressed as a percentage of GDP. In the first half of the year, due to the nominal growth of GDP, the value of the current account deficit expressed as a percentage of GDP dropped to the level of 3.6%, which is 43 bp less than in the same period of the previous year.

The net inflow on the services account in the first quarter of the current year was BAM 683.0 million, which represents an annual growth of 10.1%. Remittances from abroad, the inflow on the secondary income account that covers a significant part of the current account deficit, amounted to BAM 746.3 million in the first quarter of the current year, representing an annual growth of 7.0%. The pensions from abroad also recorded an annual growth of 5.0%.

In the first quarter of 2023, the financial account recorded an inflow of funds for BAM 319.4 million. The deficit on the current account was mostly financed by the reduction of reserve assets and foreign direct investments. Net inflows based on direct foreign investments in the first quarter amounted to BAM 413.1 million, of which more than half pertains to reinvested earnings. Portfolio investments registered a net outflow of funds as a result of the financial sector companies' investments in debt securities. Within other investments, there was a significant net outflow of funds.

The banking sector, in aggregate, appears sound, but financial sector risks persist

At the beginning of 2022, the banking sector was exposed to a significant outflow of household deposits, but thanks to high liquidity and the efficient and timely reaction of entity banking agencies, the stability of the banking sector of Bosnia and Herzegovina was preserved. Banks are well capitalized, liquid, and profitable, with NPLs at their lowest level in a decade (4.2 percent, Q1 2023). There have been no direct spillovers from financial stress in advanced economies owing to the limited reliance on international and wholesale funding and fixed-income assets of B&H banks.

Interest rates in B&H have not adjusted much, and some lending rates are below those in the euro area. Deposit rates in B&H have increased somewhat, particularly at longer maturities, but much less than elsewhere. Lending rates, however, have yet to adjust and are still close to historic lows, particularly for households. Household debt to disposable income in B&H is relatively low. Yet the risks from rising interest rates should not be underestimated, especially in the case of adjustable interest rates – around one-third of household loans. With real wages declining in 2022, debt service payments are likely to add pressure to household budgets. Loans to households followed contributed the most to total credit growth. Growth in credit to the private sector remains sluggish. Still, corporate leverage (especially in FBiH) is relatively high on average, and some sectors are particularly exposed.

The delayed adjustment in B&H rates is due to policies and the higher reliance on domestic funding and fixed interest rate loans (particularly to households) in the last decade. Since the banking sector is dominated by foreign groups, negative spillovers from parent banks cannot be ruled out. Further, domestic deposit and lending rates have yet to reflect the tighter financial conditions, in part because the CBBH has been slow in raising the remuneration rates on bank reserves. The central bank of B&H has raised the remuneration rates on bank reserves only marginally in three steps since July 2022. Banking agencies in both entities have issued temporary regulations capping lending rate increases for certain loans and restricting banks' investments in foreign securities. Additional risks stem from several domestic crypto asset-related lawsuits and fines and the lack of a regulatory framework for virtual assets.

The fiscal position improved but with growing differences between entities

B&H's overall fiscal surplus increased to 0.9 percent of GDP in 2022 from 0.6 percent in 2021, helped by a larger decline in the expenditure-to-GDP ratio than the revenue-to-GDP ratio, with nominal tax revenues boosted by inflation. A surge in current spending (13.7 percent), reflecting measures to mitigate the cost-of-living crisis (2 percent of GDP), was accompanied by a smaller increase in capital spending (11.4 percent). At the entity level, the RS recorded a growing deficit reflecting large cost-of-living crisis mitigating measures (3.1 percent of RS GDP), while the FBiH recorded a growing fiscal surplus due to more modest cost-of-living spending (1.3 percent of FBiH GDP) and low execution of public investment. Total government debt declined to 29.6 percent of GDP, also reflecting a shortfall in international financial institutions' project loans due to the political stalemate and delays in project implementation.

Table BH1 Main economic indicators

	2022				Total 2022 year	2023	
	Q1	Q2	Q3	Q4		Q1	Q2
ECONOMIC ACTIVITY							
Real GDP (% change, yoy)	5.8	5.3	2.6	2.0	**3.8**	1,7	1,2
Real private consumption (% change, yoy)	4.2	3.7	0.4	-0.9	**1.9**	-1.6	1.7
Real government consumption (% change, yoy)	2.6	0.1	1.3	1.3	**1.3**	2.1	0.3
Real investment (% change, yoy)	0.6	8.5	-5.2	6.0	**2.4**	29.3	6.7
Industrial output (% change, yoy)	3.2	4.4	-0,3	-1,9	**1.7**	-2,4	-6,4
Unemployment rate (LFS, % pa)	16.7	15.7	14,8	14,3	**15,4**	**13,3**	**13,1**
Nominal GDP (EUR million)	4,868	6,220	6,219	5,965	**23,273**	5,769	6,791
GDP per capita (EUR)	1,411	1,802	1,802	1,729	**6,744**	1,681	1,979
PRICES, WAGES, AND EXCHANGE RATES							
Implicit GDP deflator (% change, yoy)	3.5	9.6	9.8	14.6	**9.5**	10.2	7.9
Consumer prices (% change, yoy, pa)	8.4	14.5	16.9	16.1	**14.0**	12.4	6.4
Producer prices (% change, yoy, pa)	12.8	22.3	22.3	19.0	**19.1**	11.8	2.0
Average gross wage (% change, yoy, pa)	8.9	11.9	14.4	14.1	**11.7**	15.6	13.1
Exchange rate (BAM/EUR, pa)	1.95	1.95	1.95	1.95	**1.95**	1.95	1.95
Exchange rate (BAM/USD, pa)	1.74	1.83	1.93	1.92	**1.86**	1.82	1.79
FOREIGN TRADE AND CAPITAL FLOWS							
Exports of goods (EUR million)	2,196	2,452	2,269	2,274	**9,190**	2,048	1,993
Exports of goods (EUR, % change, yoy)	39.92	39.96	23.48	6.28	**25.92**	-6.72	-18.7
Imports of goods (EUR million)	3,222	3,784	3,822	3,814	**14,642**	3,112	3,380
Imports of goods (EUR, % change, yoy)	43.07	42.03	31.23	18.66	**32.59**	-2.47	-10.65
Current account balance (EUR million)	-209	-340	-143	-355	**-1,046**	-236	-299
Current account balance (% of GDP)	-4.29	-5.41	-2.28	-5.92	**-4.47**	-4.10	-4.4
Foreign Direct Investment net inflows (EUR million)	105.1	155.7	119.2	207.7	**587.7**	263	268
Foreign exchange reserves (EUR million, eop)	8,172.2	8,142.6	8,460.4	8,228.7	**8,228.7**	7,775	7,831
Foreign debt (EUR million, eop)	8,739	8,934	9,106	9,107	**9,107**	9,879	9,805
GOVERNMENT FINANCE							
Revenues (BAM_million)	1,815	2,058	2,050	2,110	**8,033**	N/A	N/A
Expense (BAM million)	1,568	1,866	1,956	2,110	**7,658**	N/A	N/A
Net = Gross operating balance	247	193	94	-159	**375**	N/A	N/A
Net acquisition of non-financial assets (BAM million)	11	42	56	139	**248**	N/A	N/A
Net lending/borrowing (BAM_million)	236	151	38	126	**551**	184	311
Domestic government debt (EUR million, eop)	1,946	1,948	2,048	2,102	**2,102**	N/A	N/A
Foreign government debt (EUR million, eop)	4,789	4,831	4,859	4,733	**4,733**	4,712	4,649
Total government debt (eop. % of GDP)	32.3	31.1	30.7	29.2	**29.2**	N/A	N/A
MONETARY INDICATORS							
Narrow money, M1 (% change, yoy, eop)	15.6	14.0	13.6	10.9	**10.9**	9.3	5.6
Broad money, M4 (% change, yoy, eop)	7.3	6.4	6.7	5.5	**5.5**	5.5	4.6
Total domestic credit (% change, yoy, eop)	3.8	4.4	4.2	4.7	**4.7**	4.5	4.4
DMBs credit to households (% change, yoy, eop)	5.6	5.6	5.3	5.2	**5.2**	5.5	4.8
DMBs credit to enterprises (% change, yoy, eop)	3.1	4.4	3.9	4.3	**4.3**	4.1	4.2
Money market interest rate (%, pa)	**N/A**	**N/A**	**N/A**	**N/A**	**N/A**	**N/A**	**N/A**
DMBs credit rate for enterprises short-term (%, pa)	3.4	3.6	3.7	4.1	**3.7**	4.3	4.4
DMBs credit rate for households short-term (%, pa)	5.1	5.8	5.2	5.9	**5.5**	5.6	5.5

Conventional abbreviations: pa - period average, eop – end of the period, yoy – year on year, BAM – Bosnia and Herzegovina convertible mark, EUR- euro, USD – U.S. dollar, DMB – deposit money bank.

Sources: Agency for Statistics of BiH, The World Bank in BiH, The Central Bank of Bosnia and Herzegovina

Policy assumptions and projections summary

Decelerating economic growth resulting from weaker domestic and foreign demand

Growth is expected to decelerate in 2023 on weaker domestic and external demand. A further slowdown in Europe is expected to limit B&H's export growth, while the continued erosion in real incomes, ongoing political tensions, and higher borrowing costs will weigh on domestic demand. Real GDP growth will thus slow further to 2 percent in 2023 and, absent reforms, will remain subdued at around 3 percent in the medium term. The CA deficit will further widen in 2023 as external demand and prices of key B&H exports (electricity and aluminum) decline while imports rise; the CA deficit is expected to subsequently narrow gradually over the medium term.

Inflation is projected to also come down but gradually. Twelve-month headline inflation is projected to decline to 6 percent in line with the rapid decline in international food and fuel prices and a marginal increase in domestic electricity prices. Core inflation will continue to rise through Q3 2023 before receding with weakening demand from Europe, tighter financial conditions, and continued easing of supply chain bottlenecks—averaging around 8.5 percent in 2023. Inflation is projected to further decline to 3 percent in 2024 and 2 percent (euro area inflation) in outer years.

High uncertainty and downside risks cloud the outlook. An abrupt slowdown in Europe or additional spikes in food and fuel prices, possibly triggered by an escalation of the war in Ukraine, would negatively impact B&H through, inter alia, lower exports and remittance inflows. An increase in domestic political tensions may further delay reforms and dampen consumer and business sentiment. Tighter financial conditions or global financial shocks could lead to stress in the financial sector. Limited access to external marketsould complicate efforts to refinance government debt.

Table BH2 Summary of projections

	2023	2024	2025
Real GDP (% change)	**2.0**	**3.0**	**3.0**
Real final consumption (% change)	5.5	1.9	2.6
Real investment (% change)	1.0	5.0	4.7
Exports of goods and services (constant prices, % change)	2.3	6.7	5.5
Imports of goods and services (constant prices, % change)	6.3	5.1	4.9
Current account balance (% of GDP)	-4.7	-4.2	-4.0
Consumer prices (% change, pa)	6.0	3.0	2.7
Exchange rate, national currency/EUR (pa)	1.95	1.95	1.95
Unemployment rate (LFS, %, pa)	N/A	N/A	N/A
General government balance (ESA 2010 definition, % of GDP)	-1,5	-1,5	1.1
Total domestic credit (% change, eop)	N/A	N/A	N/A

Sources: Agency for Statistics of BiH, The World Bank in BiH, The Central Bank of Bosnia and Herzegovina

CROATIA

Growth in 2023, despite moderation, remained rather resilient

Economic growth in the first half of 2023 slowed down but picking up

In the first half of 2023, the economic growth in Croatia continued, although with more moderate rates reflecting the general global and European economy's slowdown. It continued to be affected and limited by persistent inflation, which remained rather stubborn despite its falling trend and measures to restrain it.

Despite such pressures, the growth was relatively resilient in both quarters of the year, although marked by much lower rates than a year before. Nevertheless, the achieved growth rates were among the strongest in the EU. According to revised data from the Croatian Bureau of Statistics, in Q1, a real GDP rate reached 1.6%, followed by 2.6% in Q2, which are still rather solid growth rates that surpassed initial cautious expectations for this year. The recently released first estimation of the growth rate for the Q3 of 2.8% confirmed expectations of a solid real growth rate for 2023 despite very unfavourable global macroeconomic circumstances caused by the war in Ukraine and other geo-political trade and investment distortions and fragmentation.

Based on the robust results achieved in the first half of the year and on expectations of further weakening of inflation impact, the Croatian Government revised the growth projections rate for 2023 twice this year. In May, growth projections were increased to 2.2%, while most recently, on the occasion of the second Budget revisions in November 2023, the growth rate projection further increased to 2.8%. The international organizations also followed suit in their autumn forecasts. The European Commission in November 2023 substantially revised its expectations from 1.6% to 2.6% growth rate. The World Bank also revised its expectations several times; the latest was in October, when it predicted a growth rate of 2.7%. In its latest World Economic Outlook, the IMF also envisages a substantially higher 2023 growth rate of 2.7%.

Major drivers of growth

The major drivers of the economic growth in the first half of 2023 continued to be fuelled by private consumption and investments based on affluent EU funding. The good results of service exports, primarily related to tourism and accompanying hospitality services, also added substantially to the growth of total economic activity. However, the export of goods experienced a substantial fall throughout 2023.

Personal consumption contribution remained rather robust and was the largest source of economic growth, although its expansion rates significantly moderated compared to the previous year (to 1.9% in Q1 and 2.1% in Q2). Factors that contributed to the recovery of consumption in the first half of 2023 were falling rates of inflation and the rise of nominal wages due to high demand for labour, both resulting in the recovery of the purchasing power of households' disposable income. Furthermore, the increase in tourism-related consumption throughout the year further contributed to the total level of personal consumption.

Government consumption also accelerated significantly in the first half of 2023, with rates of 2.6% in Q1 and 6.8% in Q2. The main reasons behind this were the continuation of the wide government intervention measures to buffer the effects of the energy crisis and high inflation by fixing the energy prices and introducing financial support packages for the most vulnerable parts of the population. The expansion of government consumption levels is also related to the rise of wages in the public sector and pensions.

Total real investments continued to be the second crucial driver of economic growth in the first half of 2023. The Government has a generous amount of EU funding at its disposal, directed especially toward large public construction and infrastructure projects as well as post-earthquake reconstruction. After a sluggish growth of investments in Q1 with a rate of 0.7%, the absorption of EU funding accelerated significantly in Q2 and reached a growth rate of 4.2%. The better performance in Q2 was propelled by the rush to spend available EU funding for post-earthquake reconstruction that was expiring on 30 June 2023. The Government also had at its disposal funding for the implementation of the National Plan of Recovery and Resilience, and had already successfully disbursed over 40% of total funding from that EU facility.

However, in the context of the investment market crowded out by abundant EU funding, the private investments share in the growth of total investments is rather modest, although their interest is increasing, especially since Croatia joined Eurozone and Schengen in effect from January 2023.

The decline in both export and import growth rates

The impact of distortions and disruptions in international trade caused by several exogenous shocks, most importantly related to the war in Ukraine, has negatively affected both import and export flows in 2023. While the post-pandemic recovery was beside services exports significantly driven by the high growth rates of exports of goods, the first half of 2023 brought a significant fall in exports of goods, reflecting the negative effects of the general slowdown of economic activity at the main EU and global markets.

In the first half of 2023, fall of exports of goods started with a traditionally weak first quarter of 2023 with a rate of only 3.2%, followed by a further fall towards a negative growth rate in the second quarter (-9.3%). The first released data for the third quarter shows an even more pronounced negative rate of exports of goods of -20.4%, which plummeted due to a significant fall in foreign demand on the main Croatian export markets, particularly in Germany, practically at the brink of a recession. Consequently, a substantial decline in exports of goods in 2023 also contributed to the moderation of economic growth in Croatia.

On the other hand, the exports of services further expanded strongly, with tourist revenues rising above the pre-pandemic levels on the wings of increased demand of foreign travellers in the first “normal” post-pandemic year. Apart from the 10% increase in the number of foreign tourists arriving, the increase in revenues also reflected a substantial rise in the prices of accommodation, restaurants, transport, and other hospitality-related services. In the situation of falling exports of goods, tourist revenues were very beneficial to easing the negative current account balance as well as to economic growth in general.

At the same time, the moderation of economic activities in Croatia also brought a decline in imports of goods, even more pronounced than in exports, reflecting the fall in the domestic demand. The fall in the first quarter reached -0.2%, followed by a decline in the second quarter of -4.3%. Such developments slightly improved the negative current account balance to -0.9% in Q1, but shortly after it further deepened it in Q2 to -1.1%.

The industrial output continued to fall

The industrial output continues to contract significantly in the first half of 2023, reflecting the strong increase in producers' expenditures under a variety of cumulative pressures starting from increased prices of imported raw materials and intermediate products to rising wages to keep qualified workers and general falling demand for industrial goods especially at foreign markets. The data on value added of Croatian industry in the first half of 2023 have shown that industry, much more than other economic sectors in Croatia, is fighting with harsh recessionary blows reflecting the negative implications of the war in Ukraine.

As a result, the industrial output further dropped by 1.7% in the first quarter of 2023, while the second quarter offset some of these negative developments with sluggish growth in some industrial sectors. On average, in Q2, the sector practically stagnated (0.0 %) when compared to the same quarter of the previous year. The fall in the industrial production y-o-y was recorded practically in most of the industrial sectors, with the largest declines attributed to the production of capital goods and durable products, while the decline in production of non-durable products was somewhat less pronounced in Q1 and even managed to slightly recover in Q2. The production of intermediate products also mildly increased in the second quarter after a decline in Q1. The only domestic production that continued to grow in both sectors in the first half of the year was related to the energy sector, which managed to also increase its exports in the same period. According to data from the Croatian Bureau of Statistics, since September 2023, industrial output has started to slowly recover.

Strong demand for workers despite the slowdown in economic growth

Despite the moderation of economic growth and high inflationary pressures, the developments in the labour market in the first half of 2023 have continued to be relatively favourable and resilient.

The demand for labour remained strong throughout 2023, with occasional shortages, especially related to tourism-related services and the construction industry sector, but also in other sectors. Such a situation led to a significant increase in the participation of foreign workers in the labour market, especially during the peak tourist season. Based on the number of work visas issued (around 150,000), some analysts estimate that by the end of 2023, they will represent around 10% of the total labour in Croatia. For that reason, the employment levels continued to increase in 2023, most notably in Q2 (2.5%) and also similarly in Q3 as a result of a significant recovery of private sector activities in tourism and other related services as well as in the construction sector.

The LFS unemployment rate, on the other hand, increased shortly in Q1 to 7.2% due to usual seasonal developments mainly related to workers in tourism. The unemployment levels, however, significantly declined in Q2 to a record low of 5.6% when the tourism and hospitality-related services started to pick up more intensively. For most of the summer, unemployment stayed at record-low levels.

The situation with unemployment worsened temporarily in August 2023 and more intensively from October in the third quarter when unemployment levels started to increase again, especially for seasonal workers in tourism-related services after the end of the main season.

Favourable developments in public finances also continue

The favourable developments in public finances also continued in the first half of 2023 after achieving a Budget surplus of 0.4% in 2022. The Budget revenues continued to rise significantly mostly through elevated VAT revenues on the wings of rather high inflation levels and an increase in personal consumption where tourist consumption also reached record levels in the pre-season period. This was also accompanied by rising income tax revenues because of the rise of nominal wages as well as due to an increase in the levels of employment, mostly in the private sector.

Budget expenditures have also risen in the same period but at a much slower pace. The significant impetus for the rise of Budget expenditures came from the fiscal measures to ease coping with high inflation and energy crisis targeted to the most vulnerable population groups as well as to the business sector, especially SMEs. The fiscal value of the adopted package in effect of April 2023 is estimated at EUR 1.7 billion, while the package in effect as of 1 October 2023 is estimated at an additional EUR 1.15 billion, according to the Ministry of Finance. Social transfers to the pensioners, unemployed, poor and other vulnerable population groups have also risen continuously not only in the first half of the year but also later on.

The general government debt to GDP ratio also kept significantly falling in both quarters of 2023, to the level of 69.5% in Q1 and 66.5% in Q2, thanks to the resilient economic growth as well as further reduction of foreign government debt levels and its servicing costs as a result of good debt management measures in the previous periods with record low-interest rates. The trend of falling levels of total government debt also continued in the third quarter, which led the Ministry of Finance to project the debt/GDP ratio to fall further to 60.7% by the end of 2023.

High inflation pressures easing

Although the inflation levels gradually slowed down in the first half of 2023, they remained rather stubbornly high, especially compared to the other Eurozone members. Nevertheless, the price levels stayed on the declining path till the summer of 2023. The consumer prices average rate in Q1 reached 8.8%, followed by a more modest rise of 7.9% in Q2. The prices of food, in particular, remained high in that period, reflecting the postponed effects of falling prices at the world market and the impact of floods on food production at the domestic market. On the other hand, the energy prices contributed to the CPI slowdown, reflecting a continuation of government-controlled prices and a better situation with energy prices in the world market. Contrary to public expectations, the adoption of the Euro as of January 2023 had a limited impact on CPI levels in 2023, according to the Croatian National Bank, which specifically monitors developments on this front.

However, the consumer prices of services, particularly related to the tourist sector, expanded significantly, especially during the peak summer months. That has led to an increase in the CPI rate in August to 7.8% and a short breach of a falling path, a phenomenon that has also happened in other EU countries with intensive tourist activities. The fast growth of service prices due to high foreign demand is also responsible for persistently high levels of core inflation in Croatia. The CPI rate returned to its falling path in September, alongside the decline in the number of tourists and their demand for such services after a peak season. The latest inflation rates for October (5.8%) and November (4.7%) are especially promising. Nevertheless, the Government expects that the inflation rate for 2023 will reach 8%, which is higher than initially expected.

Producer prices also continued to fall in both quarters, reflecting the moderation of energy and raw material prices at the world market, as well as the normalization of global supply chains. In the first quarter, they remained rather high (17.0%), while a more profound drop is related to the second quarter when they increased only by 5.8% which was much less than the rise in consumer prices. Accordingly, the contribution of producer prices rise to the level of core inflation also dropped reflecting not only the falling prices of industrial products but also the pronounced shift of demand towards the services sector due to tourism.

The Government continued with inflation-mitigating measures throughout 2023. Such measures encompassed the continuation of the price cups for electricity, gas, petrol, and the 9 most important basic food products through lowering the VAT and excise rates. The wide spectrum of intervention measures also included energy vouchers and direct money transfers to pensioners and other socially vulnerable citizens, such as the unemployed and poor as well as students and children.

The inflation-mitigating measures adopted by the Government in effect from 1 April 2023 are scheduled to last till the end of the heating season at the end of March 2024. The new package of inflation and energy crisis mitigating measures in effect from 1 October 2023 will also last until 31 March 2024 and are supporting the continuation of already adopted mesaures in April and the introduction of several additional ones, such as broadening the price cups for 30 basic consumer products and increasing the amounts of money transfers for pensioners, unemployed, poor and other most affected low-income citizens.

Despite the suggestions from the European Commission to start to phase out the measures of fixing the energy prices of oil, gas, electricity and basic food products as they distort markets, especially as their market prices have been significantly slowing down in 2023 compared to 2022, the Government decided to continue with them approaching the new elections in the first half of 2024. According to government plans, phasing out market intervention measures would begin in April 2024.

The rise of interest rates

Abundant liquidity and high capitalization ratios enabled the domestic banking sector to offer more favourable interest rates on the new loans in Croatia compared to the other EU member states where the counter-inflation monetary tightening was stronger due to higher level of interest rates on the new loans. For that reason, the total loans in Croatia, according to Croatian National Bank, continued to grow quite strongly in the first half of 2023, especially related to household loans, which further expended over 10% in that period due to the new round of government-subsidized loans. Also, household cash loans significantly rose in that period as a result of increased spending and revived consumer confidence. For that reason, the growth rate of new loans to the household sector remained at a rather strong 6.6% in June 2023.

As opposed to households, the enterprise sector was more cautious when it came to acquiring new loans at higher interest rates, and their growth was thus much more subdued in the first half of 2023 and later on. The growth rate of new loans to the enterprise sector was reduced from 20.7% in December 2022 to 13.5% in June 2023.

The rise of interest rates in the first half of 2023 was higher for an additional 150 base points compared to the end of 2022. The rise of lending interest rates and strong demand for new loans have led to a very steep increase in the banking sector's profitability to levels not seen in more than a decade. On the other hand, the increase of the interest rates for deposits is very slow and lags substantially behind the other EU member states, in particularly those from the Eurozone. Therefore, some analysts are calling for introducing a tax on extra profits, but this is not seen as likely.

Table HR1 Main economic indicators

	2022				Total 2022 year	2023	
	Q1	Q2	Q3	Q4		Q1	Q2
ECONOMIC ACTIVITY							
Real GDP (% change, yoy)	7.8	9.3	5,5	3.2	**6.3**	1.6	2.6
Real private consumption (% change, yoy)	6.4	7.8	6.9	3.3	**6.7**	1.9	2.1
Real government consumption (% change, yoy)	5.8	-2.2	1.3	6.8	**2.7**	2.6	6.8
Real investment (% change, yoy)	2.0	3.9	8.0	9.6	**5.8**	0.7	4.2
Industrial output (% change, yoy)	4.0	5.5	2.4	-3.7	**2.0**	-1.7	0.0
Unemployment rate (LFS, % pa)	7.1	7.3	6.7	6.8	**7.0**	7.3	5.6
Nominal GDP (EUR million)	14,387	16,863	18,881	17,259	**67,390**	16,162	18,840
GDP per capita (EUR)	3,737	4,478	4,899	4,478	**17,486**	4,198	4,760
PRICES, WAGES, AND EXCHANGE RATES							
Implicit GDP deflator (% change, yoy)	6.0	9.1	10.1	11.2	**9.1**	8.9	7.8
Consumer prices (% change, yoy, pa)	6.4	10.8	12.5	13.3	**10.8**	8.8	7.9
Producer prices (% change, yoy, pa)	17.9	23.2	22.8	16.9	**20.2**	17.0	5.8
Average gross wage (% change, yoy, pa)	7.0	8.4	8.5	9.2	**8.3**	13.3	13.5
Exchange rate (HRK/EUR, pa)*	7.54	7.53	7.51	7.53	**7.53**	N/A	N/A
Exchange rate (HRK/USD, pa, as of 1 January 2023 USD/EUR)*	6.71	7.06	7.45	7.40	**1,05**	1.08	1.09
FOREIGN TRADE AND CAPITAL FLOWS							
Exports of goods (EUR million)	4,223	5,155	5,437	5,738	**20,552**	4,764	4,700
Exports of goods (EUR, % change, yoy)	18.5	22.4	38.7	16.3	**23.9**	3.2	-9.3
Imports of goods (EUR million)	8,401	9,730	10,633	9,902	**38,666**	9,128	9.416
Imports of goods (EUR, % change, yoy)	28.7	28.3	34.6	18.3	**27.3**	-0.2	-4.3
Current account balance (EUR million)	-2,923	-1,217	3,993	-1,747	**-1,894**	-2,479	-542
Current account balance (% of GDP)	1.3	0.2	-1.2	-1.6	**-1.6**	-0.9	-1.1
Foreign Direct Investment net inflows (EUR million)	988.2	659.9	848.3	1,154.1	**3,650,6**	538.2	176.6
Foreign exchange reserves (EUR million, eop)	24,069	25,243	26,260	27,877	**27,877**	3,128	2,890
Foreign debt (EUR million, eop)	48,121	49,843	48,716	49,826	**49,826**	56,790	57,665
GOVERNMENT FINANCE							
Revenues (EUR million)	6,472.9	7,362.6	8,158,9	8,471.1	**30,465,6**	7,517,7	9,044,8
Expense (EUR million)	6,566,2	7,180,5	7,153.8	9,303,1	**30,203,6**	7,770,9	8,462,9
Net = Gross operating balance	-194	-51.9	912.1	-1,007.0	**284.2**	-253,2	581,9
Net acquisition of non-financial assets (EUR million)	-101	-234	-93	-245	**22.3**	11,3	512,8
Net lending/borrowing (EUR million)	-93.3	182.1	1,005.1	-832.0	**261.9**	-264,5	69,1
Domestic government debt (EUR million, eop)	29,753	30,621	31,240	31,160	**31,160**	32,711	32,108
Foreign government debt (EUR million, eop)	18,254	18,440	17,924	18,752	**18,752**	14,589	14,692
Total government debt (eop. % of GDP)	76.7	75.8	74.6	73.5	**68.4**	69.1	66.5
MONETARY INDICATORS							
Narrow money, M1 (% change, yoy, eop)	13.6	13.0	8.5	9.4	**9.4**	N/A	N/A
Broad money, M4 (% change, yoy, eop)	8.6	10.7	10.4	8.4	**8.4**	N/A	N/A
Total domestic credit (% change, yoy, eop)	4.2	7.6	10.4	10.1	**10.1**	9.3	9.1
DMBs credit to households (% change, yoy, eop)	4.1	6.9	5.1	5.4	**5.4**	6.3	6.6
DMBs credit to enterprises (% change, yoy, eop)	5.7	12.3	21.2	20.7	**20.7**	15.2	13.5
Money market interest rate (%, pa)	N/A	N/A	N/A	N/A	**N/A**	N/A	N/A
DMBs credit rate for enterprises short-term (%, pa)	2.0	2.0	2.1	3.0	**2.3**	3.6	4.3
DMBs credit rate for households short-term (%, pa)	5.2	5.1	5.7	6.2	**5.6**	5.3	5.9

Conventional abbreviations: pa – period average, eop – end of period, yoy – year on year, HRK – Croatian kuna, EUR- Euro, USD – U.S. dollar, DMB – deposit money bank.

Sources: Croatian Bureau of Statistics, Croatian National Bank and Ministry of Finance.

Policy assumptions and projections summary

The solid economic growth rate is expected to continue in 2024-2026

According to the latest European Commission comparative forecasts, the Government projects that economic growth in 2023 will reach a solid 2.8%, which is among the highest in the EU. This year's economic performance is surprisingly robust despite the unfavourable geo-political developments and general slowdown at the main EU trading markets.

The Government's medium-term economic outlook anticipates the continuation of similar growth rates in 2024 and 2025 (2.8% and 2.7%, respectively), with a mild slowdown envisaged in 2026 (2.5%). Again, these rates are much stronger than the average rate of 1.1% envisaged for the Eurozone members in the same period. Positive growth assumptions are attributed to the further weakening of inflation's impact on the economy and increased domestic demand on the wings of investments led by EU funding as well as by further solid growth of private and public consumption. Nevertheless, the Government underlined that such positive expectations may be jeopardised by the negative global risks and increased uncertainties after the Israel-Gaza conflict, in addition to the uncertain ending of the war in Ukraine. Consequently, increased recessionary pressures and further economic slowdown in the main trading markets might further decrease foreign demand for Croatian products and services.

The largest impetus for economic growth in the next three years will originate from increased investments backed by the significant amount of EU funding in the form of grants and very favourable loans within the National Recovery and Resilience Plan (NRRP). It is expected that faster investments and structural reforms through the NRRP would dominantly drive growth in that period. Croatia complied with all the required NRRP implementation indicators to withdraw the 700 million Euro portion of funding in 2023. Apart from that, 2023 was also marked by a significant acceleration in the absorption of additional EU funds for the post-earthquake reconstruction of the Zagreb and Banija region from the EU Solidarity Fund.

The positive implications of joining the Eurozone and Schengen area are also expected to be more visible in the medium term, especially relating to a potential increase in private investments and rising benefits in sectors such as tourism and foreign trade due to the elimination of transaction costs and currency risks.

The other positive growth assumption is that inflation in the medium term would further significantly decline and return to the ECB target values closer to 2% by 2026. The envisaged relatively high 8% inflation rate for 2023 is expected to fall to 3.1% in 2024, followed by a 2.4% rate in 2025 and 2.2% in 2026. Such expectations are backed by a significant fall of inflation in the Eurozone and further moderation of domestic demand due to the rise of interest rates, as well as the substantial decline of prices of oil, gas, raw materials, and food at world markets. However, the core inflation in Croatia could prove to be more stubborn. According to the Croatian National Bank, it is now much more driven by service prices than by industry prices and is presently significantly higher than in the other Eurozone members.

As for traditional drivers of Croatian economic growth, such as private consumption and tourism, their contribution might be smaller than in previous years, characterised by very high growth rates. However, both of them would remain important as a source of growth in 2024-2026. Exports of goods are envisaged to slightly recover in 2024 from negative rates achieved in 2023 due to a fall in demand as a result of recessionary pressures at Croatia's main export markets, such as Germany, Austria and Italy. However, it is expected that further growth of goods' exports in 2025-2026 will very much depend on the speed of recovery in these markets.

Croatia's solid economic growth outlook was affirmed by all three major credit rating agencies this autumn. Standard & Poor's recently revised credit rating of Croatia to BBB+/ /A-2' with a positive outlook. Such a positive investment rating is based on their expectations that Croatia's economic growth will be faster than in most Eurozone countries, supported by a dynamic tourism sector, resilient consumption, and solid investments. In October 2003, Fitch also increased their ratings for Croatia to "BBB+" changing their outlook also to positive. Moody's credit rating agency also upgraded Croatia's rating to "Baa2" by revising its outlook from stable to positive in November 2023. Moody's rating accented that such a positive outlook is based on the successful implementation of significant investments and reforms within the NRRP as well as on significant fiscal improvements in 2023.

Most international organisations also substantially increased their medium-term economic growth projections for Croatia. The European Commission's Autumn 2023 Economic Forecast expects that Croatia's GDP will grow in 2023 at a rate of 2.6%, followed by a rate of 2.5% in 2024 and 2.8% in 2025. The World Bank prognoses were corrected upwards several times this year. Most recently, its October 2023 publication Europe and Central Asia Economic Update forecasts a 2.7% growth rate in 2023, followed by 2.5% in 2004 and a 3.0% growth rate in 2025. The International Monetary Fund, in its World Economic Outlook from October 2023, also increased GDP real growth expectation for Croatia to 2.7% in 2023, followed by 2.6% in 2024 and 2.8% in 2025. ■

Table HR2 Summary of projections

	2023	2024	2025	2026
Real GDP (% change)	**2.8**	**2.8**	**2.7**	**2.5**
Real private consumption (% change)	2.7	2.7	2.6	2.2
Real government consumption (% change)	2.9	2.9	2.7	2.3
Real investment (% change)	4.4	3.7	3.2	2.9
Exports of goods and services (constant prices, % change)	-1.1	2.4	2.2	2.1
Imports of goods and services (constant prices, % change)	-0.8	2.5	2.4	2.3
Current account balance (% of GDP)	-1.8	-0.1	-0.5	-0.9
Consumer prices (% change, pa)	8.0	3.1	2.4	2.2
Exchange rate, national currency/EUR (pa)*	N/A	N/A	N/A	N/A
Unemployment rate (LFS, %, pa)	6.5	5.9	5.4	5.2
General government balance (ESA 2010 definition, % of GDP)	-0.3	-1.9	-1.6	-1.5

Source: Ministry of Finance of the Republic of Croatia and Croatian National Bank.
*The conversion rate of Kuna to Euro was fixed at 7.53 at the time Croatia joined the Eurozone and adopted the Euro on 1 January 2023.

MONTENEGRO

Challenges of the Montenegrin economy – internal cohesion and geopolitical turmoil

According to official data, in 2022, the GDP grew by 6.4%. During the previous year, continuing in the first two quarters of 2023, the situation in the Montenegrin economy was dominantly influenced by two tendencies. The start of the war in Ukraine had, as a consequence, the growth of inflation, which was dominantly imported, but also a significant influx of residents from Eastern Europe, which is estimated at close to 80,000 people. On the other hand, there was a significant increase in private consumption, which, with the inflationary effect, increased and expanded the tax base, thereby enabling better budget filling. The first half of the current year was still marked by political instability and uncertainty, with the holding of two rounds of political cycles, presidential and snap parliamentary elections.

Continuity of political challenges

Political instability characterized events in Montenegro's public life during the first part of 2023. The period was very intense and stormy in the political sense. During March and April, two rounds of presidential elections were held, which were followed by snap parliamentary elections on June 11. Political instability also negatively affected the process of European integration

of Montenegro, which was not in the focus of the public institutions, as a consequence of the lack of internal cohesion and agreement on crucial issues. Progress was made in the unblocking of the Constitutional Court, with the election of three judges in the Assembly of Montenegro at the end of February.

Inflation slowing down

During the first six months, there was a slowdown in price growth, i.e. a decrease in the inflation rate. The reason for this lies in the fact that there has been a significant increase in reference interest rates on the European market, the energy market has stabilized, and supply chains have partially recovered. The food price index reached a two-year low in June and was 23.4% below the maximum level recorded in March 2022 after the start of the war. According to the data of the Directorate for Statistics of Montenegro, observed annually, in June, the prices were higher by 11% compared to the comparative period 12 months earlier. Observed in relation to the end of 2022, an increase in consumer prices of 1.9% was recorded.

The increase in prices in the half-year period was mainly contributed by the increase in prices in the category of food and non-alcoholic beverages by 1.9%, ie hotels and restaurants by 10.5%. The mentioned period is characterized by price growth in 9 out of 12 categories that are an integral part of the consumer basket calculated by the Directorate for Statistics of Montenegro. On the other hand, the drop in oil prices on the international market had a slight effect on the decrease in the transportation category by 0.5%. The education sector did not record changes at the half-yearly level, while a slight decrease of 0.2% was recorded in the category of transportation services.

In the period from March 21 to June 30, the action "Stop Inflation" was carried out, which included the formation of the so-called anti-inflationary basket to preserve the standard of living of citizens, which the Ministry of Economic Development initiated in cooperation with retail chains in Montenegro. For the selected group of products, the trading margin was limited to 5%.

Labour market and wages

According to data based on the Labour Force Survey conducted by the Statistics Authority, in the second quarter of 2023, the active population in Montenegro was about 320,000. The mentioned period is characterized by better performance of the labour market in terms of the number of employed persons and wage growth. Namely, the average number of employed persons amounted to 238,799 thousand, which is a growth of 9.28% on an annual basis. The highest growth in the number of employees was recorded in the information and communication sectors (46.28%) and real estate business. The structure of employees in the Montenegrin labour market continuously shows stable tendencies without significant changes. The number of employed persons is still the highest in the wholesale and retail trade, repair of motor vehicles and motorcycles (19.40%), accommodation and food service sector (9.74%), i.e., state administration and mandatory social insurance (9.68 %).

Observed in absolute terms, based on records kept by the Employment Office of Montenegro, there were 40,300 unemployed persons at the end of June, which is a decrease of 12.68% annually. In the context of current events in Eastern Europe and a large number of migrations, the information indicated by the Central Bank of Montenegro in its quarterly report notes that in the period from January 1 to July 4 of the current year, the Ministry of Internal Affairs issued 21,560 permits for temporary residence of foreigners, which is an increase of 50.79% on an annual basis. Of that number, 82.93% are foreigners from the following countries: Russian Federation (34.38%), Turkey (20.71%), Serbia (18.19%), Bosnia and Herzegovina (5.37%) and Albania (4.28%).

We should not additionally ignore the fact that Montenegro faces the chronic challenge of the mismatch between the needs of the educational system and the labour market, which leads to a mismatch between supply and demand and partly affects the existence of long-term unemployment. In this sense, it is worrying data that of the total number of persons registered with the Employment Office of Montenegro, 28% are looking for employment for more than three years, and 28% for more than five years.

According to the Employment Office of Montenegro data, the registered unemployment rate in June 2023 was 17.37% and is lower by 2.53 pp compared to the same month of the previous year. According to MONSTAT data, the average net salary in Montenegro without taxes and contributions amounted to 781 EUR, an increase of 20% annually. The increase in wages in the public sector contributed significantly to wage growth.

Foreign trade and capital flows

The total foreign trade of Montenegro in the first six months of 2023 amounted to 2,180.4 million EUR. This implies that it is a growth of 9.3% compared to the comparative period. The value of exported goods was 370.7

million EUR, and the value of imported goods was 1809.7 million EUR. The coverage of imports by exports and the negative foreign trade balance of goods exchange continue to represent one of the significant ballast in the context of the development and sustainability of the national economy. The coverage of imports by exports amounted to 20.5%, which is a decrease of 3.2% compared to the previous period.

Apart from the relationship itself, the structure of commodity exchange is also extremely unfavorable. According to the international trade classification, the most represented in the export structure are mineral fuels and lubricants (sector 3), in the amount of 182.9 million EUR, the dominant part of which is the export of electricity with 171.8 million EUR. In the import structure, the most represented sector is 7 - Machinery and transport devices, with 428.7 million EUR.

Montenegro's largest foreign trade partners in terms of exports are Serbia (95.7 million EUR), Bosnia and Herzegovina (50.2 million EUR) and Slovenia (50.1 million EUR). Regarding imports, Serbia is dominant with (313.2 million EUR), then China (205.9 million EUR), ie, Germany with 168.1 million EUR. Traditionally, the largest foreign trade is with the signatories of the CEFTA agreement and the European Union.

In the part of the external sector and the financial account, the first half of the year was characterized by a decline in the value of the realized net inflow of capital, in the total amount of 123.76 million EUR, according to the Central Bank of Montenegro data. The result of the reduced net inflow of capital is a decrease in the net inflow of foreign direct investments, i.e., the outflow on the account of other investments. The net inflow of FDI amounted to EUR 267.07 million, which represents a decrease of 26.37% compared to the same period of the previous year. The total inflow of foreign direct investments amounted to 462 million EUR, while at the same time, an outflow was recorded in the amount of 194.93 million EUR.

Regarding the structure of foreign direct investments, of the total amount, the inflow based on debt investments (intercompany debt) amounted to 158.46 million EUR, while equity investments amounted to 274.73 million EUR. On both bases, a decrease of 7.53% and 7.19% was recorded, respectively.

Monetary developments

The liquidity of the banking sector represents continuity and continued during the first part of the current year. The banking sector is very liquid, as shown by the data on the aggregate liquidity of banks, which are continuously below the prescribed minimums. The daily liquidity ratio at the end of the observed period was 1.92, which is slightly lower than at the end of the previous year when it was 2.20.

Summarized at the level of all 11 banks, they regularly settled their current obligations and had appropriate indicators. The total liquid assets of banks amounted to 1,690.46 million EUR, which is an increase of over 200 million or 13.52% compared to the period half a year earlier. The loan/deposit ratio was 0.76 and is lower by 0.03 pp compared to the comparative period 12 months ago. The biggest contribution to the growth of bank assets was the increase in total loans by 8.85% or 324 million EUR, according to official data from the Central Bank of Montenegro. In the structure of banks' liabilities, there was an increase in deposits by 18.07% and total capital by 28.33%, with a decrease in loans by 87.77%. In the structure of assets, it is important to note that total loans had a dominant share of 61.26%, while total deposits in the structure of liabilities had a share of 81.03%.

The growth of interest rates is one of the important characteristics of the banking sector in the first two quarters. The average weighted nominal interest rate on total loans was 5.82% and recorded an increase of 0.76% compared to the period before 12 months and 0.42% compared to December. The growth of interest rates is also noticeable for newly approved loans, namely 0.96% observed on an annual basis. The average weighted effective interest rate increased by 0.77% in that period. No major fluctuations were noticeable in terms of passive interest rates, as they recorded a growth of 0.02% compared to the previous year, and amounted to 0.28%.

When it comes to the value of the Monex stock market index, it is noticeable that it fluctuated more significantly than the MNSE10 index. Namely, at the end of June of the current year, the stock market index Monex recorded a growth of 32.41% compared to June 2022, i.e., a growth of 3.92% compared to December. On the other hand, Index MNSE10 recorded an annual growth of 24.23% and a decrease of 0.72% compared to December.

Fiscal sector

For the first 6 months of the current year, positive trends were recorded in the structure of the public finances of Montenegro when it comes to the revenue side of the budget. Data obtained by the Ministry of Finance of Montenegro indicate that revenues in the observed period amounted to 1,382.32 million EUR or 21.44% of the estimated GDP. Observed with the planned flows provided by the Budget Law, the realized revenues were higher by 18.01%. The growth of income, viewed with comparative data 12 months earlier, amounted to 325.10 million EUR or 34.18%. The biggest increase was recorded in income from value-added tax, 74.54 million EUR.

On the expenditure side of the budget, realized public consumption amounted to 1,209.44 million EUR or 18.76% of the estimated GDP. This is an increase in public spending by 8.80% compared to the end of the previous year. The largest increase in expenditures is recorded in transfers for social protection, due to the increase in expenditures for pensions caused by the increase in the minimum wage and adjustment in accordance with the change in the annual inflation rate. The missing funds during the first 6 months amounted to 1.19 million EUR.

The national debt of Montenegro at the end of the second quarter was 4,024.47 million EUR or 62.42% of GDP. Total government debt with deposits amounted to 58.19% of GDP. External debt is dominant in the total amount of 56.05 million EUR, while internal debt amounted to 411 million EUR. During the second quarter, the state debt decreased by 56 million EUR, which is the result of the repayment of government bills in the amount of 39 million EUR, as well as the regular repayment of debt obligations. During the second quarter, a hedging arrangement was realized, and based on that, an income of 64 million US dollars was realized for the state. The currency structure of the debt underwent certain changes, so the share of euro debt in the total social debt decreased from 95.58% to 79.68%.

Table MN1 Main economic indicators

	2022				Total 2022 year	2023	
	Q1	Q2	Q3	Q4		Q1	Q2
ECONOMIC ACTIVITY							
Real GDP (% change, yoy)	7.3	13.0	3.6	3.6	**6.4**	6.2	6.9
Real private consumption (% change, yoy)**	13.6	12.2	7.3	6.9	**9.7**	15.5	6.4
Real government consumption (% change, yoy)**	0.7	-1.1	2.9	3.2	**1.5**	3.0	3.0
Real investment (% change, yoy)**	4.8	-0.1	-6.7	3.5	**0.1**	12.6	-2.7
Industrial output (% change, yoy)	-15.2	17.2	-6.8	-1.9	**-3.3**	9.5	-1.0
Unemployment rate (**LFS**, % pa)	16.8	14.6	13.0	14.4	**,14.7**	15.5	12.9
Nominal GDP (EUR million)	1,045.5	1,423.5	1,868.9	1,586.1	**5,924.0**	1,232.2	1,689.4
GDP per capita (EUR)***	1,694	2,306	3,028	2,570	**9,598**	1,998	2,739
PRICES, WAGES, AND EXCHANGE RATES							
Implicit GDP deflator (% change, yoy)**	10.7	10.7	12.9	14.3	**12.4**	10.9	11.0
Consumer prices (% change, yoy, pa)	7.4	12.2	15.3	17.2	**13.0**	13.9	8.2
Producer prices (% change, yoy, pa)	6.0	11.5	14.3	13.0	**11.2**	12.0	4.9
Average gross wage (% change, yoy, pa)	11.3	10.5	11.5	11.8	**11.3**	9.0	12.8
Exchange rate (_____/EUR, pa)	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Exchange rate (_____/USD, pa)	N/A	N/A	N/A	N/A	N/A	N/A	N/A
FOREIGN TRADE AND CAPITAL FLOWS							
Exports of goods (EUR million)	216.08	196.81	156.10	194.47	**763.46**	226.81	170.38
Exports of goods (EUR, % change, yoy)	99.95	47.39	20.57	25.69	**45.20**	4.96	-13.43
Imports of goods (EUR million)	631.72	934.63	996.23	870.98	**3,433.56**	796.10	962.43
Imports of goods (EUR, % change, yoy)	46.84	47.83	38.15	32.49	**40.66**	26.02	2.97
Current account balance (EUR million)	-189.95	-361.34	69.22	-283.96	**-766.03**	-259.87	-279.10
Current account balance (% of GDP)	N/A	N/A	N/A	N/A	**12.93**	N/A	N/A
Foreign Direct Investment net inflows (EUR million)	168.48	194.21	243.32	176.61	**782.62**	117.82	148.52
Foreign exchange reserves (EUR million, eop)	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Foreign debt (EUR million, eop)	9,402.44	9,373.73	9,394.79	9,353.69	**9, 421.3**	9,289.00	9,167.79
GOVERNMENT FINANCE							
Revenues (_____ million)	470.56	559.66	626.46	642.55	**2,299.23**	606.87	775.45
Expense (_____ million)	449.13	515.31	531.74	749.52	**2,245.70**	516.70	621.70
Net = Gross operating balance	21.43	44.35	94.72	-106.97	**53.53**	90.17	153.75
Net acquisition of non-financial assets (____ million)	49.89	97.24	72.31	133.53	**352.97**	27.39	43.65
Net lending/borrowing (______ million)	-28.46	-52.89	22.40	-240.49	**-299.44**	62.78	110.10
Domestic government debt (EUR million, eop)	393.21	382.47	375.25	468.77	**468.77**	461.00	411.07
Foreign government debt (EUR million, eop)	3,671.19	3,632.18	3,624.50	3,557.56	**3,557.56**	3,619.56	3,613.40
Total government debt (eop. % of GDP)	68.61%	67.77%	67.52%	67.97%	**67.97%**	61.60%	60.75%
MONETARY INDICATORS							
Narrow money, M1 (% change, yoy, eop)	N/A	N/A	N/A	N/A	**N/A**	N/A	N/A
Broad money, M4 (% change, yoy, eop)	N/A	N/A	N/A	N/A	**N/A**	N/A	N/A
Total domestic credit (% change, yoy, eop)	4.37	6.00	6.10	7.74	**7.74**	6.44	5.70
DMBs credit to households (% change, yoy, eop)	5.35	6.79	7.25	8.63	**8.63**	7.93	7.09
DMBs credit to enterprises (% change, yoy, eop)	8.30	11.93	11.18	8.99	**8.99**	4.84	2.10
Money market interest rate (%, pa)	N/A	N/A	N/A	N/A	**N/A**	N/A	N/A
DMBs credit rate for enterprises short-term (%, pa)	4.34	4.52	4.26	4.34	**4.34**	4.69	4.92
DMBs credit rate for households short-term (%, pa)	5.66	5.52	5.62	5.82	**5.82**	6.55	4.53

* **Source**: Monstat, final data for 2022 (September 2023), data for GDP in 2023 are preliminary.
** Authors' calculations based on Monstat data.
*** For 2023. estimated number of population on 1. January 2023.

Policy assumptions and projections summary

According to the projections of international institutions, GDP growth in Montenegro in 2023 will amount to 4.8%, while during the next two years, the economic growth rate will decrease. In the current economic conditions, which are characterized by growing uncertainty on international markets, which is a consequence of numerous geopolitical turmoils and war events, it is not possible at this moment to give a clear, precise, and unequivocal answer to the numerous challenges facing the economy of Montenegro. What kind of repercussions will this have on the macroeconomic performance of the economy, time ahead will show. Below is an overview of the projections of the basic macroeconomic indicators. ■

Table MN2 Summary of projections

	2019	2020
Real GDP (% change)	**4.0**	**3.5**
Real private consumption (% change)	2.2	1.5
Real government consumption (% change)	0.3	0.2
Real investment (% change)	1.6	1.5
Exports of goods and services (constant prices, % change)	3.6	3.4
Imports of goods and services (constant prices, % change)	3.8	3.1
Current account balance (% of GDP)	-9.9	-8.9
Consumer prices (% change, pa) (average)	6.0	2.5
Exchange rate, national currency/EUR (pa)	N/A	N/A
Unemployment rate (LFS, %, pa)	13.7	12.9
General government balance (ESA 2010 definition, % of GDP)	N/A	N/A
Total domestic credit (% change, eop)	7.9	6.8

* The inflation forecast for 2024 is the average of the 9 months of 2024.

NORTH MACEDONIA

An uncertain recovery looms for the Macedonian economy

Modest GDP Growth

The expectation for the recovery of the economy in 2022 was overestimated. In 2022, North Macedonia had a positive growth rate of 2.1%, which was less than the expected 3.8 %. The path to achieving stable and sustainable growth is uncertain. The war in Ukraine, associated with European energy crises, affected the recovery of the global economy after the pandemic crises and also jeopardized the stability of Europe. GDP dropped in almost every country in Europe, but to a slightly smaller extent than anticipated. The inflation rate in the Eurozone is decreasing. The forecast of food, beverage, and tobacco prices, along with services and energy prices, imposed high inflation, which continues to persist and varies widely across European countries. North Macedonia faces the same challenges.

Initially, in the first quarter of 2023, GDP growth was 2.1 %. The decrease in GDP growth in the second quarter of 2023 is evident (1.1%). The drop in GDP is around 2/3, compared to the same period in 2022. Private consumption has a similar trend as in 2022 (2.7 % in Q1/2023 and 1.6 % in Q2/2023). The significant changes are in public consumption, which fell by 5.9% in the first quarter of 2023. Also, public consumption was -2.7 in Q2/2023. Consumption, particularly government consumption in the second quarter of

2023, was the driving force behind GDP growth. The first half of 2023 saw a decrease in exports and imports, and the decline in imports was greater than that in exports. Net exports had a positive impact on the economic growth rate because the decline in imports was partially offset by a significant drop in investment. Industrial output remained muted at 0.1% in Q1/2023, but construction activity picked up by 12.7% due to growth in both segments, namely buildings and civil engineering. Certain improvements in industrial output were registered in Q2/2023 (2.7%).

The data from Q1 and Q2 in 2023 are not comparable with the data from the previous quarters of other years due to the application of the new EU Regulation related to the Labour Force Survey (LFS).[1] It caused changes in the survey, related to the design of the questionnaire, the order of questions, changes and removal of existing and addition of new questions, as well as in the scope and definition of employment and unemployment.[2] Therefore, the analysis is made separately for 2022 (by quarters and annually) and for the first two quarters of 2023.

The quarterly data for 2022 shows that the working-age population (15–64 years) in the Republic of North Macedonia decreased from 1,205.572 (Q1) to 1,197.933 persons (Q4), or for 0.6%, while the number of active population from 801,494 to 791,700 persons and 1.2%, respectively. There is also a

1 The Regulation (EU) no. 2019/1700 of the European Parliament and the Council for Social Statistics and the corresponding executive regulation of the Commission (EU) no. 2019/2240 for the area of the workforce were adopted, while the previous Regulation (EC) no. 577/98 has been repealed.

2 The mentioned changes caused the interruption of data time series. A revised series of core employment and unemployment indicators are planned to be calculated for the period from the first quarter of 2009 to the fourth quarter of 2022 to allow comparability of data.

decrease in the number of employed and unemployed persons. The decline between Q1 and Q4 of 2022 is more pronounced for the unemployed (6%), compared to employed persons (0.4%). These changes are accompanied by an increase in the inactive population (for 2.155 persons or 0.5%). The activity rate declined from 66.5% (Q1) to 66.1% (Q4), the employment rate remained almost the same (56.6% and 56.8%), while the unemployment rate decreased from 14.9% to 14.2%, respectively. In Q4 compared to Q1, there is a decreasing trend of all these rates for men and only of the unemployment rate for women.

The News releases of the State Statistical Office for Q1 and Q2 of 2023 give data for the number of the working-age population, labour force and inactive population aged 15-89 years, while the corresponding rates are calculated for different age groups. Therefore, the analysis is made only for the indicators related to the population aged 15–64 years. The activity rates in Q1 (65.2%) and Q2 (65.4%), as well as the employment rates (56.5% and 56.8%, respectively), are noticing a slight increase. At the same time, the unemployment rate is decreasing (from 13.4% to 13.2%). These indicators observed by sex show that there was an increase in the activity and employment rates and a decrease in the unemployment rates for men, while they noticed reverse changes for women.

The analysis shows that, apparently, there are similar numerical values of the labour market indicators for Q1 and Q2 in 2022 and 2023, but they are not comparable due to the methodological changes in the LFS. Nevertheless, in 2023, the problem of the lack of skilled workers in some occupations has become even more emphasized despite the government having taken measures to increase the quota for the recruitment of workers from abroad. It implies that this problem will accelerate in the near future unless more comprehensive measures for mitigation of the labour force deficiency are implemented.

Fiscal policy continues to be challenging

According to the Budget 2023, total revenues increased by 14.8 % compared to 2022, while total expenditures increased by 12.6%. The budget deficit in 2023 is planned at a level of 4.6% of GDP. In the Budget 2023, an increase in all types of taxes is expected according to the Budget 2022. Some of them are the result of high inflation, and others are the result of the implementation of the tax reform.

By October 2023, 79.54% of revenues and 76.79% of expenditures have been achieved. The budget deficit was realized at 58.61% (of the planned 4.6% of GDP) mainly due to the poor implementation of current expenditures, especially capital expenditures. The public debt, as of the third quarter, has increased by EUR 331 million and amounts to EUR 8.033 million. A new borrowing of EUR 650 million is announced. Furthermore, considering that large borrowings for new capital roads are coming, it is justified to be concerned about the sustainability of public finances.

The biggest Budget ever is planned for 2024, in which revenues of EUR 6 billion are planned, and they are 10% higher than in 2023, while expenditures are planned at the level of EUR 6.6 billion or about 5.8% higher than in 2023. Thus, the planned budget deficit is at the level of 3.8% of GDP. In accordance with the Strategy for the management of the public debt of the Republic of North Macedonia for 2024–2026 (with a perspective until 2028), the public debt at the end of 2024 is expected to amount to 63.2%.

Restrictive monetary policy and a stable banking sector

The restrictive monetary policy continued to be implemented in 2023. The interest rate on CB bills increased to 4.75% at the end of 2022, reaching 6.3% in 2023, signaling a lasting tightening of the monetary policy aimed at securing price stabilization. Credits demonstrated an increase in 2022 and the first half of 2023, with a major driver in the growth of corporate loans and a smooth increase in household loans.

Capital adequacy (regulatory capital/risk-weighted assets) remained solid at 18.2% in the middle of 2023, with a solid NPL to total loan ratio of 2.8%, indicating enhanced asset quality. ROAA, with 2.1% in the middle of 2023, and ROAE, with 17.1%, represent increased and high profitability in the banking sector. The deposit base is continuously increasing, with a focus on long-term deposits and deposits in denars.

The share of "green" borrowings in total borrowings increased from 8.8% in 2019 to 12.1% in the middle of 2023, indicating increased awareness of the banking sector toward such a form of financing that enables borrowers to invest exclusively in projects that have a substantial environmental impact, including climate-related projects, as "green" loans are aimed at improving the energy efficiency of households and the corporate sector, supporting investments in green technologies, materials, and solutions, and supporting investments in renewable energy sources, the control, and prevention of pollution, protection of the environment, mitigation of the risks from climate change, etc.

Unstable and easily-disruptive inflation rate

The annual inflation rate measured according to the CPI Index was 16.1% in Q1/2023 and 11.2% in Q2/2003. The growth of consumer prices in the first quarter of 2023 recorded a gradual reduction after the peak in the fourth quarter (19.4%) as a result of the drop in prices of food and energy products in global markets. This trend continues in the second quarter with further price reductions for food and energy on the global stock market. Also, the producer price index marks a cat-back in the first half of 2023. So, producer prices in Q1 were 10.6% and dropped to 5.6% in Q2.

Over the last 18 months, the National Bank of North Macedonia has appropriately tightened monetary policy and increased the policy rate several times. The slowdown in credit growth has resulted in a restriction of domestic consumption and a decrease in the inflation rate due to these efforts. However, if the high nominal wage growth of around 15 percent is sustained, there are risks that inflation will reaccelerate.

Improved trade balance reduces current account deficit in the first half of 2023

The current account deficit in the first half of 2023 significantly declined to -0.1% of GDP after unfavorable external factors in 2022 caused it to reach a record -6.1% of GDP in the last 10 years. It's due to a goods trade balance improvement caused by significant reductions in imports and slight growth in exports in Q1 of 2023, as well as a smaller annual decline in exports than in imports in Q2.The reduced import pressures are mainly caused by the reduction of energy imports (petroleum derivatives and electricity), due to increased domestic production, reduced prices, and lower energy consumption. Furthermore, the lower import of raw materials for industry, primarily iron and steel, and non-ferrous metals, had a similar impact. In Q1 of 2023, secondary income and services surpluses contributed to narrowing the current account deficit, while in Q2, they and other components had the opposite effect. Specifically, the surplus in services decreased on an annual basis due to the initiation of large public infrastructure projects with high initial imports. The reduced net inflows in the secondary income had a similar impact, while the primary income balance recorded a slightly higher deficit.

In the first two quarters of 2023, the financial account continued to record inflows. In Q1, these are primarily the results of realized net income of portfolio investments, the newly issued government Eurobond, and, to a lesser extent, direct investments. In Q2, these mainly result from the net inflows of loans and direct investments and, to a lesser extent, from trade credits. Due to net inflows in the financial account, foreign exchange reserves continue to grow and remain in the safe zone.

Table NM1 Main economic indicators

	2022				Total 2022 year	2023	
	Q1	Q2	Q3	Q4		Q1	Q2
ECONOMIC ACTIVITY							
Real GDP (% change, yoy)	2.2	4.0	2.0	0.6	**2.1**	2.1	1.1
Real private consumption (% change, yoy)	2.5	1.5	5.4	3.0	**3.1**	2.7	1.6
Real government consumption (% change, yoy)	2.7	-5.2	-4.7	-2.8	**-2.6**	-5.9	-2.7
Real investment (% change, yoy)	31.8	41.5	9.0	-5.3	**15.0**	-22.3	-1.2
Industrial output (% change, yoy)	3.5	1.9	-1.8	-3.4	**-0.3**	0.1	2.7
Unemployment rate (**LFS**, % pa)	14.7	14.5	14.3	14.0	**14.4**	13.3	13.1
Nominal GDP (EUR million)	2,765.1	3,089.1	3,283.9	3,761.0	**1,289.9**	3,224.0	3,361.4
GDP per capita (EUR)	1,368.9	1,529.3	1,625.7	1,861.9	**6,385.6**	1,596.0	1,664
PRICES, WAGES, AND EXCHANGE RATES							
Implicit GDP deflator (% change, yoy)	1.3	3.7	9.4	16.3	**8.0**	n.a.	n.a.
Consumer prices (% change, yoy, pa)	7.7	12.3	17.2	19.4	**14.2**	16.1	11.2
Producer prices (% change, yoy, pa)	19.6	21.7	25.2	21.2	**21.9**	10.6	5.6
Average gross wage (% change, yoy, pa)	0.0	-1.6	-4.4	-4.4	**-2.7**	-2.5	3.8
Exchange rate (MKD/EUR, pa)	61.69	61.66	61.51	61.62	**61.62**	61.67	61.56
Exchange rate (MKD/USD, pa)	54.98	57.80	61.01	60.52	**58.60**	57.52	56.55
FOREIGN TRADE AND CAPITAL FLOWS							
Exports of goods (EUR million)	1,666.44	1,890.87	1,854.36	1,908.61	**7,320.29**	1,839.75	1,865.78
Exports of goods (EUR, % change, yoy)	17.7	22.0	22.0	22.8	**21.2**	10.4	-1.3
Imports of goods (EUR million)	2,517.63	2,786.27	2,726.62	2,770.77	**10,801.29**	2,440.79	2,456.82
Imports of goods (EUR, % change, yoy)	32.0	33.4	34.7	17.5	**28.9**	-3.1	-11.8
Current account balance (EUR million)	-391.8	-236.9	105.9	-274.6	**-797.4**	105.0	-116.9
Current account balance (% of GDP)	-3.0	-1.8	0.8	-2.1	**-6.1**	0.7	-0.8
Foreign Direct Investment net inflows (EUR million)	108.0	138.1	178.1	230.0	**654.2**	131.4	105.3
Foreign exchange reserves (EUR million, eop)	3,272.5	3,116.1	3,753.8	3,862.9	**3,862.9**	4,159.2	4,189.7
Foreign debt (EUR million, eop)	9,973.7	10,346.2	11,076.2	10,790.0	**10,790.0**	11,059.7	11,397.3
GOVERNMENT FINANCE							
Revenues (MKD million)	57,106	59,207	62,200	64,520	**243,033**	66,009	65,153
Expense (MKD million)	63,775	62,882	67,912	83,947	**278,518**	69,529	85,200
Net = Gross operating balance	-6,669	-3,675	-5,712	-19,427	**-35,485**	-3,520	-20,047
Net acquisition of non-financial assets (MKD million)	-4,636	-3,108	-3,221	-15,400	**-26,364**	-5,131	-16,405
Net lending/borrowing (MKD million)	-2,033	-567	-2,491	-4,027	**-9,121**	1,611	-3,642
Domestic government debt (EUR million, eop)	2,466	2,465.5	2,602.4	2,597.4	**2,597.4**	2,726.9	2,804.2
Foreign government debt (EUR million, eop)	3,647.4	3,631.3	3,895.1	3,983.7	**3,983.7**	4,475.0	4,450.0
Total government debt (eop. % of GDP)	47.4	47.3	50.4	51.0	**51.0**	50.0	50.4
MONETARY INDICATORS							
Narrow money, M1 (% change, yoy, eop)	0.3	-0.4	2.3	6.0	**6.0**	9.5	14.5
Broad money, M4 (% change, yoy, eop)	2.8	1.4	2.9	5.1	**5.1**	6.9	13.9
Total domestic credit (% change, yoy, eop)	9.8	10.0	9.9	9.4	**9.4**	6.6	6.5
DMBs credit to households (% change, yoy, eop)	7.9	7.7	7.6	7.3	**7.3**	6.9	6.4
DMBs credit to enterprises (% change, yoy, eop)	11.9	12.4	12.6	11.5	**11.5**	6.2	6.5
Money market interest rate (%, pa)	N/A	N/A	N/A	N/A	**N/A**	N/A	N/A
DMBs credit rate for enterprises short-term (%, pa)	3.1	4.0	4.4	4.5	**4.2**	5.2	5.5
DMBs credit rate for households short-term (%, pa)	3.3	3.3	3.4	3.1	**3.2**	3.0	3.0

Conventional abbreviations: pa – period average, eop – end of the period, yoy – year on year, MKD – Macedonian denar, EUR – euro, USD – U.S. dollar, DMB – deposit money bank.

Source: Ministry of Finance of the Republic of North Macedonia, National Bank of the Republic of North Macedonia, State Statistical Office of the Republic of North Macedonia and https://www.ceicdata.com/en/indicator/macedonia/gdp-deflator-growth

Policy assumptions and projections summary

The economy of North Macedonia continues to recover in 2023, but the growth is forecast to remain modest at 2.3%. Inflation control measures will have an impact on household consumption. In particular, the private consumption will continue to decrease. The main goal will be to keep current spending at sustainable levels ahead of the elections. Therefore, wage increases in the next year should not exceed what has already been agreed in the general collective agreement. One of the bright sides is that the recent increases in capital expenditures will scale up public investment, especially with the Corridor 8/10 project. By improving public investment management, public investment projects can be prioritized better.

Inflation is falling thanks to monetary policy tightening and the normalization of global energy and food prices. The recent administrative price-control measures have also provided some relief, but that is only temporary, and they should not be counted as a lasting solution to inflationary issues. However, risks that increase inflation remain, and the central bank needs to stand ready to tighten further if these risks materialize.

Future steps in monetary policy should continue the permanent adjustment in the monetary policy instruments, conditioned by developments in the foreign exchange market, inflation, and external developments, aiming to ensure price stability and financial stability in the country by permanently supporting the real sector. Further challenges from climate change should also be part of the banking sector's role in mitigating and implementing climate change.

The trend of narrowing the trade deficit and the movement of other components is expected to continue during the second half of 2023, with a significant downward correction projected for the deficit of current transactions in 2023 compared to the previous year. Due to the slight increase in energy prices (gas and electricity) over the next two years (2024 and 2025), as well as a rise in the import of raw materials and investments for the industry in the coming years, the current account deficit is expected to slightly increase with the gradual increase in trade and normalization of import dynamics.

There is, however, a significant likelihood that the predicted expectations may not be realized due to geopolitical turmoil, geo-economic fragmentation and increasingly pronounced climate change, which can cause significant instability in the world food and energy prices. Political uncertainty and the upcoming elections in the country may also delay the realization of the predicted expectations.

Table NM2 Summary of projections

	2024	2025
Real GDP (% change)	**2.5**	**2.9**
Real private consumption (% change)	1.5	2.4
Real government consumption (% change)	0.2	0.2
Real investment (% change)	6.5	6.5
Exports of goods and services (constant prices, % change)	5.5	5.0
Imports of goods and services (constant prices, % change)	4.5	4.5
Current account balance (% of GDP)	-3.2	-2.8
Consumer prices (% change, pa)	3.0	2.0
Exchange rate, national currency/EUR (pa)	N/A	N/A
Unemployment rate (LFS, %, pa)	13.7	13.5
General government balance (ESA 2010 definition, % of GDP)	-3.8	-3.5
Total domestic credit (% change, eop)	N/A	N/A

Source: International Bank for Reconstruction and Development / The World Bank, The Macro Poverty Outlook (MPO), October, 2023, available at: https://thedocs.worldbank.org/en/doc/d5f32ef28464d01f195827b7e020a3e8-0500022021/related/mpo-mkd.pdf and European Commission, Directorate-General for Economic and Financial Affairs, European Economic Forecast, Autumn 2023, EUROPEAN ECONOMY, Institutional Paper 258, November 2023, available at: https://economy-finance.ec.europa.eu/system/files/2023-11/ip258_en.pdf

S E R B I A

Serbia grappled with economic turmoil in the initial half of 2023

The escalation of geopolitical tensions, the energy crisis, and the tightening of global financial conditions due to soaring inflation molded Serbia's 2023 economic landscape. Namely, since the outset of the year, akin to the states worldwide, Serbia experienced substantial macroeconomic imbalances, growth decelerations, and financial distress. As the Chamber of Commerce and Industry of Serbia representatives claim, the country's inflation rate in the 2023 first six-month interval amounted to 15.3%, significantly surpassing its targeted range (3.0% ± 1.5 percentage points) set by the National Bank of Serbia. Nevertheless, following the Q1 2023 inflation's zenith, the rate value has been steadily decreasing, and the National Bank of Serbia representatives foretell a continued decrease in the latter part of the year. Anticipations are that inflation will re-enter its designated target range, but not until the middle of 2024.

The first half of 2023 saw a year-on-year economic activity growth of 1.3% (0.9% and 1.7% growth in the first and the second trimester of 2023, respectively). According to the Statistical Office of the Republic of Serbia's estimation, this real GDP positive momentum is largely driven by the Services

sector and the Construction sector, contributing 1.2 and 0.8 percentage points, respectively. On the flip side, the Trade sector made a major negative contribution, deducting 0.6 percentage points from the overall real GDP movement.

When it comes to real private consumption and real government consumption year-on-year values, the National Bank of Serbia's data reveal its declines in the initial two quarters of 2023 (drops of -0.35% and -2.95%, respectively). Additionally, when it comes to the real investment year-on-year value, the scenario is reversed – statistical data provide evidence of a 3.05% value increase during the opening half of 2023.

The first half of 2023 witnessed a notable upswing in Serbia's GDP per capita

The Serbian central bank's statistics signal that at the end of the 2023 first semi-annual period, nominal GDP amounted to EUR 17,272 million (which is an increase of 15.3% compared to the value recorded at the end of the preceding year's first semi-annual interval). Concerning the country's GDP per capita, it is noteworthy that economic output per person remained robust in the 2023 first six-month interval, experiencing a notable year-on-year increase of 17.2%. Regarding Serbia's industrial output, the aforementioned source also provides evidence of a moderate year-on-year increase in total industrial production of 1.75% during the first half of 2023. Growth was solely recorded in the Electricity, gas, steam, and air conditioning supply sector (16.9%) – the Mining sector and the Manufacturing industry sector experienced declines (-0.5% and -1%, respectively).

Serbia's unemployment rate stood at 9.85% in the opening six months of 2023

The latest available country-specific data from the Labor Force Survey reveal that, in Q2 2023, the number of individuals employed reached 2,876,600. In addition, 306,600 individuals were unemployed, whilst 2,521,600 individuals aged 15 and older were classified as individuals out of the labor force. The employment rate during the aforementioned trimester stood at 50.4%, contrasting with an unemployment rate of 9.6%.

Observing the regional context, the Statistical Office of the Republic of Serbia data unveiled that in Q2 2023 the Belgrade region exhibited the highest employment rate of 55.4%, followed by the Vojvodina region rate of 51.5%, and the Šumadija and Western Serbia region rate of 49.8%. Contrarily, the employment rate reached its lowest level in the Southern and Eastern Serbia region (44.0%). Regarding the regional assessment of the unemployment rates registered in Q2 2023, it is important to emphasize that the Vojvodina region and the Southern and Eastern Serbia region stood at 7.9% and 13.8%, respectively, marking a decline from 8.8% and 14.9% recorded in the preceding quarter. Meanwhile, the Belgrade region recorded a rate of 7.7%, which reflects a marginal increase compared to the rate observed in the previous trimester of the year (7.6%). Lastly, the Šumadija and Western Serbia region's Q2 2023 unemployment rate remained steady (10.2%), mirroring its Q1 2023 level.

In the context of the sectoral distribution of individuals employed during Q2 2023, the data released by the Statistical Office of the Republic of Serbia showcase that the Services sector had the highest proportion of employment (57.7%), followed by the Industry sector and the Agriculture sector (23.7% and 12.8%, respectively). On the other hand, the Construction sector experienced the lowest employment share (5.8%). Additionally, compared to Q1 2023, there was a slight decrease in the employment share for the Agriculture, forestry, and fishing sector, as well as for the Industry sector, which went from 13% to 12.8%, and from 23.9% to 23.7%, respectively. Conversely, the Services sector and Construction sector saw a slight increase in their employment shares, going from 57.4% to 57.7%, and from 5.6% to 5.8%, respectively.

The net monthly income in Serbia during 2023 initial six-month interval totaled EUR 718

For the initial six-month interval of 2023, the calculated average net monthly salary amounted to RSD 84,204, i.e., EUR 718. Compared to the same period of the preceding year, this indicator's value was nominally higher by 15.4% (or, in real terms, higher by 0.1%). Finally, all the presented findings regarding the Serbian labor market underscore a considerable resilience to challenges overflowing from the global environment, and it can be concluded that this state of affairs is primarily owed to enhanced macroeconomic stability attained during the preceding period.

Fiscal developments were better than expected, but the deficit remained high

Fiscal developments during 2023 were much different from those initially envisaged by the 2023 budget adopted at the end of 2022. The bulk of the fiscal deficit in 2022 was generated by the appropriations covering the losses that occurred from the poor performance of non-reformed public companies from the energy sector (Srbijagas and Elektroprivreda Srbije). This was also reflected in the initial budget for 2023, where a significant amount of subsidies was dedicated to cover the anticipated loss of those companies in 2023. Nevertheless, fiscal trends in 2023 were better than expected, especially on the expenditure side: the mild winter, the global fall in the price of energy and the recovery of the domestic production of electricity led to a significant decline in budget costs envisaged for subsidizing domestic energy sector for approximately EUR 358 million. Positive development also occurred on the revenue side due to the unanticipated increase in corporate income taxes and excises, which was partially offset by the underperformance of the VAT collection, so budget revenues have surged around EUR 510 million above the initial plan.

Despite favorable fiscal developments, the fiscal deficit in 2023 will most likely be only 0.2 percentage points lower than initially planned by the original 2023 budget. According to the estimates of the Fiscal Council, positive developments in public revenues and public expenditures would result in a strong reduction of the fiscal deficit to 1.5% of GDP and subsequently to a reduction of the government borrowing needs by about EUR 1.3 billion compared to the original budget plan. However, the government has decided to rebalance the budget by introducing new fiscal measures, which have contributed to the significant increase in budget expenditures. More specifically, those measures are: i) an increase in subsidies for agriculture, ii) a one-off discretionary increase in pensions, iii) an increase in wages for employees in education and the health sector and iv) a one-time payment of around EUR 85 for each child up to 16 years of age. While this increase in expenditure will not endanger fiscal solvency, it still has multiple negative consequences. For instance, discretionary increase in pensions ruled out recently established fiscal rules, further undermining credibility of the budgeting process that has already been shaken by frequent arbitrary one-off payments to certain social groups, which have become the modus operandi of the government since the outbreak of the Covid-19 pandemic. In addition to the fiscal risks that emerged on the expenditure side after budget rebalancing, a decrease in the VAT collection rate, most likely due to a drop in collection efficiency, has become a matter of particular concern.

The key policy rate has stabilized in the second half of 2023

Up to July 2023, the National Bank of Serbia had been continuously increasing the key policy rate, which has reached 6.5%. In the second half of 2023, the National Bank of Serbia did not change the key rate, following the relaxation of global inflationary pressures and stabilization of domestic inflation, as well as the expectation that the inflation rate will return below the lower target bound by the middle of 2024. Nevertheless, trends of increase in interest rates and slowing down of credit activities from the first half of 2023 have continued in the second half of the year. When Q3 in 2022 is compared to Q3 in 2023, the average money market rate increased by 3.3 percentage points (from 2.16% to 5.46%), the average short-term rate on new loans to enterprises more than doubled (from 3.32% to 7.16%), while the average short-term interest rate on new loans to households increased from 7.62% to 10%. The credit to households has slowed down, reaching growth of only 1.6% in the third quarter of 2023, while the credit to enterprises has declined for the first time since 2014 – in 2023 Q3, it was -0.3%. Since the NBS will most likely keep the key policy rate high in the first half of 2024 to secure a decline in inflation, it is reasonable to expect that the domestic interest rates will also remain high and credit activities low through most of 2024.

Prices, wages, and exchange rates

Since the beginning of the year, robust inflationary pressures persisted through Q1, followed by a gradual weakening in Q2. Notably, in June, year-on-year inflation stood at 13.7%. This deceleration in inflation is primarily attributed to a marginal uptick in processed food and energy prices, coupled with a decline in core inflation to 9.9% in June. Concurrently, the National Bank of Serbia continued raising reference interest rates, bringing the key interest rate to 6.3% in June. This marks the fourteenth consecutive increase since April 2022. Simultaneously, deposit facility and lending facility interest rates rose by 5.0% and 7.25%, respectively. In addition, the government contributed to the slowdown of inflationary pressures through administrative measures such as freezing and limiting the price of certain food products and energy products. The producer prices of industrial products for the domestic market also exhibited a slowdown in year-on-year growth during Q2, recording 1.2% in June compared to 5.5% in March. A notable factor contributing to easing inflationary pressures was the relative stability of the dinar against the euro. In the first two quarters of 2023, the domestic foreign exchange market experienced mainly appreciation pressures, with the National Bank of Serbia intervening through foreign exchange purchases to maintain the exchange rate's stability. This contributed to the nation's foreign exchange reserves reaching a record high. By the end of June, the dinar's value was nominally 0.1% higher than at the end of 2022, and it had strengthened against the dollar by 2.2% since the beginning of the year. Meanwhile, gross wages experienced a nominal growth of 15.4% in the first half of 2023, i.e., a 0.1% increase in real terms compared to the same period in the previous year. The average gross wage at the close of Q2 amounted to RSD 118,025. The coexistence of high inflation and substantial nominal wage growth, coupled with a stable dinar against the euro, has increased economic costs, consequently diminishing its competitiveness among key trade partners.

The current account gap narrows as imports slip

According to the National Bank of the Republic of Serbia, Serbia's current account deficit significantly narrowed in the first half of 2023, falling to EUR 566 million (or 1.8% of GDP), which is an 80.4% drop compared to the same period in 2022. This positive shift was primarily caused by a significant reduction in the merchandise trade deficit, which shrank by 40% to EUR 3,222 million from a year ago when it was recorded at EUR 5,330 million. The trade deficit reduction was, on the other hand, a consequence of the slowing of imports, as well as the growth of exports of services, manufacturing, and electricity. In addition, the current account deficit was fully covered by the FDI inflow, which increased by 33% year-on-year and amounted to EUR 2,017.6 million. Of that amount, a great deal of FDI inflows originated from the EU countries (EUR 1,074.6 million) and Asia (EUR 696.8 million). Observing the individual countries, China (EUR 591.6 million) had the leading position, followed by the Netherlands (EUR 423.9 million), Romania (EUR 129.3 million) and Great Britain (EUR 122.0 million).

Total trade slowed down, reflecting lower import volumes amid weaker demand in the EU countries and region

In the first half of 2023, a slowdown in merchandise total trade was recorded compared to the same period of the previous year. Namely, while total trade increased by almost 38% year-on-year in the first six months of 2022, it was only 1.1% year-on-year higher in 2023, amounting to EUR 31,607 million. This modest performance followed the slowdown of exports (9.5% year-on-year growth compared to 32.6% in the first six months of 2022) and the decline in imports (by 4.8%, while in the same period of 2022, imports were up 42.6% year-on-year). Apart from the high base in the previous year, a decrease in demand from the EU and the region contributed to the slowing of exports growth, while significantly lower imports were primarily driven by reduced intermediates imports and a drop in energy prices.

Analysis of the trade structure by Standard International Trade Classification (SITC), in accordance with the data of the Statistical Office of the Republic of Serbia, showed that in the first half of 2023, in terms of exports, *Machinery and transport equipment* and *Manufactured goods classified chiefly by material* were the main sections, with a share of 29.9% and 19.9%, respectively. On the imports side, the main sections were *Machinery and transport equipment* (22.8% of total imports of goods), *Manufactured goods classified chiefly by material* (17.3%), and *Mineral fuels, lubricants and related materials* (15.4%). However, it should be mentioned that despite the significant share of *Mineral fuels, lubricants and related materials* section in total imports, its volume decreased by 24.4% compared to 2022, reflecting the reduced energy import prices.

The EU countries, CEFTA and China remain leading trade partners of Serbia

The EU countries remained Serbian main trade partners, with a share of 63.9% in exports and 56.8% in imports. The key individual trade partners in Serbia's total exports were Germany (14.8%), Bosnia and Herzegovina (6.7%) and Italy (6.4%). The leading position in Serbian imports had Germany (12.8%), followed by China (11.8%) and Italy (7.1%).

According to the Finance Ministry of the Republic of Serbia, the total value of exports of the 15 largest exporters was EUR 4.2 billion in the first seven months of 2023. The largest three exporters were Serbia Zijin Mining, followed by Serbia Zijin Copper and HBIS Group. According to the records of the Customs Administration, in the period from January to July, the company Serbia Zijin Mining exported goods worth EUR 631.2 million, Serbia Zijin Bor Copper exported goods worth EUR 427.5 million, while HBIS Group Serbia Iron & Steel exported goods worth EUR 374.3 million.

Table SRB1 Main economic indicators

	2022				Total 2022 year	2023	
	Q1	Q2	Q3	Q4		Q1	Q2
ECONOMIC ACTIVITY	4.0	3.8	1.0	0.5	**2.3**	0.9	1.7
Real GDP (% change, yoy)	6.8	3.8	3.0	1.5	**3.8**	-0.2	-0.5
Real private consumption (% change, yoy)	2.7	4.9	-3.8	-2.4	**0.4**	-4.8	-1.1
Real government consumption (% change, yoy)	1.1	2.1	-1.9	-2.7	**-0.4**	2.2	3.9
Real investment (% change, yoy)	2.3	4.6	-0.6	0.7	**1.8**	2.6	0.9
Gross fixed capital formation (% change)	10.9	8.9	9.0	9.4	**9.6**	10.1	9.6
Industrial output (% change, yoy)	12,956	14,980	15,646	16,847	**60,429**	15,244	17,272
Unemployment rate (LFS, % pa)	1,940	2,250	2,350	2,530	**9,070**	2,300	2,610
Nominal GDP (EUR million)	4.0	3.8	1.0	0.5	**2.3**	0.9	1.7
GDP per capita (EUR)	6.8	3.8	3.0	1.5	**3.8**	-0.2	-0.5
PRICES, WAGES, AND EXCHANGE RATES							
Implicit GDP deflator (% change, yoy)	1.3	9.9	13.1	17.2	**10.6**	-0.3	8.5
Consumer prices (% change, yoy, pa)	9.1	11.9	14.0	15.1	**15.1**	16.2	13.7
Producer prices (% change, yoy, pa)	17.0	19.7	16.9	13.3	**13.3**	5.5	1.2
Average gross wage (% change, yoy, pa)	14.3	14.2	15.0	12.8	**13.8**	14.49	5.12
Exchange rate (EUR/USD, pa)	117.75	117.41	117.32	117.32	**117.32**	117,29	117.23
FOREIGN TRADE AND CAPITAL FLOWS							
Exports of goods (EUR million)	6,147	6,820	6,819	7,142	**26,928**	7,097	7,096
Exports of goods (EUR, % change, yoy)	-2.2	34.6	25.9	21.8	**19.0**	15.4	4.1
Imports of goods (EUR million)	8,733	9,564	8,707	9,289	**36,292**	8,819	8,595
Imports of goods (EUR, % change, yoy)	55.3	43.3	26.3	18.4	**34.2**	1.0	-10.1
Current account balance (EUR million)	-1,531	-1,360	-407	-865	**-4,162**	-148	-412
Current account balance (% of GDP)	-11.8	-9.1	-2.6	-5.2	**-6.9**	-1.0	-2.5
Foreign Direct Investment net inflows (EUR million)	586	929	1,264	1,550	**4,328**	783	1,235
Foreign exchange reserves (EUR million, eop)	14,296	14,776	16,502	19,416	**19,416**	21,381	22,585
Foreign debt (EUR million, eop)	36,921	38,260	39,964	41,895	**41,895**	43,592	44,396
GOVERNMENT FINANCE							
Revenue (RSD billion)	685	809	780	830	**3,103**	904	839
Expense (RSD billion)	683	626	625	868	**2,802**	731	751
Gross operating balance (RSD billion)	2	184	154	-38	**301**	173	88
Net acquisition of non-financial assets (RSD billion)	81	125	98	222	**526**	103	117
Net lending/borrowing (RSD billion))	-79	58	56	-260	**-225**	70	-29
Domestic government debt (EUR million, eop)	11,191	11,359	11,667	11,760	**11,760**	11,125	11,204
Foreign government debt (EUR million, eop)	19,406	19,956	20,753	21,566	**21,566**	24,127	24,541
Total government debt (eop. % of GDP)	56.51	55.86	55.94	55.63	**55.63**	56.68	55.45
MONETARY INDICATORS							
Narrow money, M1 (% change, yoy, eop)	8.05	1.23	-0.88	2.47	**2.47**	10.8	15.9
Total domestic credit (% change, yoy, eop)	7.54	7.32	7.31	4.46	**4.46**	3.26	2.00
DMBs credit to households (% change, yoy, eop)	10.53	9.56	8.07	6.06	**6.06**	4.19	2.60
DMBs credit to enterprises (% change, yoy, eop)	8.02	8.98	8.89	4.14	**4.14**	1.79	0.25
Money market interest rate (%, pa)	0.75	1.27	2.16	3.53	**3.53**	4.67	5.22
DMBs credit rate for enterprises short-term (%, pa)	2.38	2.55	3.32	4.49	**4.49**	6.26	6.81
DMBs credit rate for households short-term (%, pa)	6.34	6.51	7.62	8.02	**8.02**	9.15	9.77

Conventional abbreviations: pa – period average, eop – end of the period, yoy – year on year, RSD – Serbian dinar, EUR- euro, USD – U.S. dollar, DMB – deposit money bank.

Source: National Bank of Serbia, Statistical Office of the Republic of Serbia, Eurostat, Ministry of Finance

Policy assumptions and projections summary

The revised Fiscal Strategy for 2024-2026 (adopted in October) did make some corrections of the macroeconomic assumptions, but the long-term forecasts have not considerably changed. More specifically, initial forecasts (from Fiscal Strategy draft, June 2023) of solid and steady GDP with gradually increasing rates in the mid-run, starting from 2.5% in 2023 up to 4.3% in 2026, haven't changed at all. However, growth assumptions have changed, especially regarding private consumption for 2023-2024. The contribution of private consumption, which in "normal" years has the largest impact on the growth rate, is reduced to only 0.7 p.p. in 2023 (initially projected at 1.5) but is expected to bounce back in 2024 to 3 p.p. (initially 2.5). On the other hand, contribution of net export, which is usually close to zero, is estimated at 3.2 p.p. (initially 0.4) in 2023 and -1.0 (initially 0.1).

The considerable improvement of the net export in 2023 reflects a continuation of positive trends from the first half of the year, mostly due to a further decline in the import of energy, both in value (decline in prices) and quantity (recovery of domestic production of electricity). The increase in net export above initial expectations is also reflected in the considerable correction of the current account deficit, which is estimated at 2.9% (initially projected at 5.3%). The sluggish domestic consumption in 2023, below the original expectation, has been caused by the harsh monetary policy combined with persistent inflation, which we warned in the summer issue of the Outlook. The government deficit in 2023 is estimated at 2.8% (initially 3.0%), corresponding to our summer projection. Overall, we have kept our summer estimate of economic growth in 2023 at 2.3%, which is a bit lower than the official estimate at 2.5%.

Regarding mid-term forecasts for 2024-2026, the revised Fiscal Strategy did not make some significant corrections, apart from the abovementioned correction of private consumption and net export contribution to GDP growth in 2024. In 2025-2026, it is envisaged that private consumption and investment will regain the role of the most significant contributors to economic growth, as usual, while the current account deficit will stabilize at around 4%. The revised Fiscal Strategy envisaged a mid-term decline in fiscal deficit from 2.2% in 2024 down to 1.5% in 2026, followed by the gradual decline of gross government debt from 51.7% in 2024 to 52% in 2026. The revised forecasts of debt seem perplexing, being lower than initially forecasted (from 54% in 2024 to 51.9% in 2026), although forecasts of government deficit and GDP growth rates have not changed (and no explanation has been given for that).

Regarding the realism of the revised Fiscal Strategy projections, the major challenge is the achievement of the forecasted growth and inflation rates, especially in 2024. As the Fiscal Council warns, significant contributors to growth in 2023 (around 1 p.p.) were one-off recoveries of the agricultural sector and electricity production, which can not be counted on in 2024. The overall persistence of inflation, the recent increase in excises and the dubious practice of the government to provide one-off financial aid on a discretionary basis are risks for considerable reduction in inflation, forecasted in 2024 at 4.9%. Fiscal projections seem realistic; yet, having in mind the tendency observed in the last couple of years that the government usually overestimates budget expenditures to have more flexibility in spending, government deficits are likely to be slightly lower than forecasted.

Table SRB2 Summary of projections

	2023	2024	2025	2026
Real GDP (% change)	**2.3**	**3.2**	**4.0**	**4.3**
Real private consumption (% change)	0.9	4.1	3.4	3.3
Real government consumption (% change)	-1.3	1.5	1.1	1.8
Real investment (% change)	3.0	5.0	6.0	6.9
Exports of goods and services (constant prices, % change)	3.0	8.2	10.5	11.5
Imports of goods and services (constant prices, % change)	-1.2	8.6	9.2	10.2
Current account balance (% of GDP)	-3.0	-4.0	-4.0	-4.0
Consumer prices (% change, pa)	8.6	4.9	3.7	2.7
Exchange rate, national currency/EUR (pa)	107.3	107.3	107.3	107.3
Unemployment rate (LFS, %, pa)	9.0	8.7	8.3	8.1
General government balance (ESA 2010 definition, % of GDP)	-2.8	-2.0	-1.3	-1.2
Total domestic credit (% change, eop)	N/A	N/A	N/A	N/A

Sources: Fiscal strategy 2024-2026, authors' estimates

SLOVENIA

Economic uncertainty and low domestic and foreign demand weigh on economic growth

Gross domestic product growth subdued in 2023

A revision by Slovenia's statistical authority shows that the nation's gross domestic product expanded significantly less in 2022 than previously reported. GDP growth was revised downwards from 5.4% to 2.5%. GDP growth bottomed out in the last quarter of 2022, when GDP shrunk by 0.2%. Growth restarted in 2023 but at a subdued pace hindered by an economic slowdown in Slovenia's main trading partners, tighter financing conditions, and weak business and consumer confidence. In addition, Slovenia was hit by heavy flooding this August, causing massive damage to infrastructure and buildings. GDP expanded year-on-year by 1.3% in the first half of 2023 and slowed to 1.1% in the third quarter. A full recovery toward pre-pandemic levels seems far ahead as neither an improvement in trade in goods nor a noticeable increase in trade in services and value-added in manufacturing is expected in the near term.

Construction investment was a major driver of economic growth throughout the first three quarters of 2023. While household consumption growth was also rather strong in the first quarter (it increased year-on-year by 3.2%) and contributed strongly to GDP growth, it weakened substantially in the second quarter and turned slightly negative year-on-year in the third quarter (-0.8%).

In contrast, the year-on-year decline in government consumption observed throughout 2022 continued only in the first quarter of 2023. Afterward, government consumption increased notably in the second quarter (year-on-year by 3.4%) and remained rather strong in the third quarter. Despite a sharp weakening of exports in 2023, the contribution of net exports to GDP growth was positive and strong in the first half of 2023 as goods imports fell sharply amid lower demand and inventory decumulation.

Strong investment growth driven by construction

Investment activity was particularly strong throughout the first three quarters of 2023. It was mainly driven by buoyant construction investment that was particularly strong in the segment of other buildings and structures, but residential building construction also rose year-on-year and accelerated. Construction investment was, to a large extent, driven by government investment and will be further boosted by the elimination of the consequences of the August floods in Slovenia. However, investment in machinery and equipment was down year-on-year throughout the first three quarters of this year due to the decline in capacity utilisation in manufacturing and higher interest rates. The year-on-year decline escalated from 1.6% in the first quarter to 3.4% in the second quarter and 9.4% in the third quarter.

Despite strong construction investment, the high negative contribution of inventories contributed to a sharp year-on-year decline in gross capital formation in the first half of 2023 that eased somewhat in the third quarter.

Sharp decline in industrial output

The pandemic and subsequent supply chain problems, along with the energy crisis due to Russia's invasion of Ukraine, have significantly impacted the performance of industry worldwide and in Slovenia. Industrial production turned negative in the last quarter of 2022 and continued to decline throughout the first three quarters of 2023 amid the uncertain economic environment, low domestic and foreign demand, and tighter financial conditions. The year-on-year decline deepened in the third quarter of this year when industrial production contracted by 8.4%. In the first three quarters of 2023, the largest year-on-year decline was observed in electricity, gas, steam, and air conditioning supply (by 34.2%), followed by mining and quarrying (by 23.3%), while manufacturing contracted year-on-year by 3.8%.

While pandemic-induced supply chain problems have eased substantially in 2023, concerns about the energy outlook remain for the medium term. In 2023, the manufacturing industry has continued to face economic uncertainty and an ongoing shortage of skilled labour. Production increased in the first nine months of 2023 compared to the same period of the previous year only in high-technology manufacturing (6.1%), while it decreased in medium- and low-technology manufacturing. The fastest-growing sectors were the manufacture of computer, electronic, and optical products, the manufacture of machinery and equipment, and other transport equipment, while the strongest decline was observed in the majority of energy-intensive industries, in particular, the chemical and paper industries.

International trade deteriorates

Activity in the export-oriented part of the economy weakened substantially in 2023. While in the first quarter of the year, goods exports remained at similar levels to the first quarter of 2022, their year-on-year growth turned negative in the second quarter (-1.6%) and slumped in the third quarter (-9.7%) amid ongoing deterioration in external demand expectations. The decline in the imports of goods was even more pronounced. Imports were down year-on-year in the first quarter of this year (-3.6%), with the year-on-year decline accelerating further in the second and third quarters (-7.3% and -13.5%, respectively). Consequently, the net exports of goods were positive throughout the first three quarters of 2023.

Regarding services exports, we could observe a strong year-on-year growth in the first quarter of 2023 (11.4%) amid a rapid post-COVID-19 recovery in tourism. However, the year-on-year growth in services exports turned slightly negative in the second quarter and deteriorated further in the third quarter (-6.4%).

The current account balance in surplus

While in deficit in 2022, the current account balance recorded a surplus in the first three quarters of 2023. The surplus was particularly high in the second quarter, amounting to 7.2% of GDP, and stood at around 4% of GDP in the first and third quarters. The main contributor to the turnaround was the goods trade balance, which turned positive in the first quarter of 2023 and increased further in the second quarter amid weaker domestic spending relative to foreign demand. The high surplus in services, observed already throughout 2022, continued in 2023, mainly due to the high trade surplus in transport and travel services. Primary and secondary income further supported the positive current account balance.

The unemployment level declined further, but demand for new jobs went down

According to the Labour Force Survey, the unemployment rate declined from 3.8% in the first quarter of 2023 to 3.6% in the second quarter of the year. On a year-on-year basis, the unemployment rate was 0.5 p.p. and 0.6 p.p. lower in the first and second quarters, respectively. The data worth noting indicate that the unemployment rate of women fell below that of men in the second quarter of 2023 (3.4% and 3.8%, respectively), which is rare, and was 1.2 p.p. lower than in the same quarter of 2022.

In the first half of 2023, the number of unemployed declined year-on-year by 15%, while the number of employed stayed approximately the same compared to the first half of 2022. With regard to the sector of activity, construction recorded the largest year-on-year increase in the number of employed people, followed by administrative and support service activities and trade. In contrast, the activities with the largest decline in the number of people employed were electricity, gas, steam, and air-conditioning supply, as well as information and communication activities.

The year-on-year comparison shows a decline in demand for new jobs in 2023. In the second quarter of 2023, the average job vacancy rate was 2.8%, 0.4 p.p. lower than in 2022. It decreased below the euro area average (2.9%) but was still higher than the EU average (2.7%).

Nominal and real wages are higher

In the first six months of 2023, wages were higher year-on-year in both the private and the public sectors. With the slowdown in inflation, real wage growth strengthened as well. In the first half of the year, the average monthly gross wage in the private sector was higher year-on-year by 10.0% (in real terms by 0.8%) and in the public sector by 10.4% (in real terms by 1.2%). The rise in public sector wages was mainly the result of the autumn 2022 agreement with the public sector unions on wage increases, while the increase in the private sector was due to the tight labour markets and increases in the minimum wage and inflation compensation.

Due to a relatively strong year-on-year increase in hourly wage costs compared to the EU average, the cost competitiveness of the Slovenian economy in relation to its trading partners started to deteriorate in the last quarter of 2022 and continued in the first half of 2023. In the first and second quarters of this year, the hourly wage costs in Slovenia were higher year-on-year by 7.4% and 14.5%, respectively, while they increased on average in the EU by just over 5%.

Inflation gradually eases, but core inflation remains high

In 2023, inflation has been gradually declining. At the annual level, it stood at 10% in January and fell to 6.9% in October. Inflation has been easing mainly due to the moderation of price increases in the food and non-alcoholic beverages group, which has had the greatest impact on inflation this year. Still, according to the Bank of Slovenia, food prices are almost 30% higher at the end of the third quarter of 2023 compared to the pre-pandemic period. Despite signs of easing, core inflation remains high, driven mainly by services price inflation. There has been strong growth in service prices

When it comes to producer prices, these have dropped markedly in the first ten months of 2023. The producer price index declined from 18.2% in January to 0.9% in October. The decline came mainly from the intermediate goods group, for which prices in September and October 2023 were already down year-on-year, and the energy group. Price growth has also been weakening in the consumer goods sector and less so in the capital goods group.

Demand for credit plummeted

The tightening of the EU monetary policy has continued in 2023, and the ECB's interest rate increases have been reflected in domestic interest rates. The lending interest rates have increased significantly between the second quarter of 2022 and the second quarter of 2023, especially those for new credit to enterprises. The increase in the cost of borrowing, coupled with the slowdown in economic activity, has markedly reduced the level of demand for credit, especially among enterprises. The year-on-year growth in the volume of bank loans to enterprises has slowed from 12.5% in the last quarter of 2022 to 3.8% in the second quarter of 2023 and turned negative in the third quarter of the year (-1.9%). The drop in household loans was less pronounced. The year-on-year growth declined from 7.6% in December 2022 to 3.2% in September 2023 and was entirely driven by a rapid slowdown in the growth of housing loans amid a high rise in the interest rate for new loans for house purchases. The year-on-year growth in housing loans fell from just below 10% at the end of 2022 to below 1% in October 2023. In contrast, the year-on-year growth in consumer loans, which started in October 2022, accelerated throughout the first three quarters of 2023, reaching 9.6% in October 2023.

A rise in general government expenditure pushes the deficit up

In the first half of 2023, the general government deficit amounted to 3.7% of GDP, representing a slight increase compared to the same period in 2022 (3.5% of GDP). In the first six months of 2023, the general government expenditure was higher year-on-year by 9.0%, while the general government revenues increased by 8.3%.

Total general government expenditure was boosted mainly by the higher compensation of employees affected by the public sector wage agreement and by high year-on-year growth in subsidies due to measures to mitigate the consequences of rising energy prices. In the second part of the year, general government expenditure is expected to be further affected by the first costs related to the severe flooding that hit Slovenia in August this year. EUR 1.6 billion, or around 2.5% of the estimated GDP is foreseen for the financing of the flood recovery in 2023 and 2024.

On the revenue side, the year-on-year increase was mainly related to higher social contributions amid strong wage growth and higher employment in the economy as a whole. While tax revenue was also higher, its year-on-year growth slowed down considerably, especially from taxes on consumption, dampened by the temporary measures to mitigate energy price rises (VAT cut on energy products and the carbon emissions tax).

The trajectory of the general government debt as a ratio to GDP continued to improve due to the high nominal economic growth. By the end of the second quarter of 2023, general government gross debt decreased to 70.5% of GDP, representing an almost two percentage points drop compared to the last quarter of 2022 (72.3%).

Table SLO1 Main economic indicators

	2022 Q1	2022 Q2	2022 Q3	2022 Q4	Total 2022 year	2023 Q1	2023 Q2
ECONOMIC ACTIVITY							
Real GDP (% change, yoy)	5.0	4.4	0.9	-0.2	**2.5**	1.0	1.6
Real private consumption (% change, yoy)	9.1	7.4	-1.6	0.0	**3.3**	3.2	0.3
Real government consumption (% change, yoy)	2.2	-0.6	-2.1	-1.6	**-0.5**	-0.8	3.4
Real investment (% change, yoy)	26.1	3.1	2.2	1.9	**7.9**	-16.9	-15.0
Gross fixed capital formation (% change)	6.6	3.4	3.8	0.7	**3.5**	7.7	11.2
Industrial output (% change, yoy)	6.4	2.8	1.7	-5.7	**1.2**	-3.4	-4.1
Unemployment rate (LFS, % pa)	4.3	4.2	4.0	3.5	**4.0**	3.8	3.6
Nominal GDP (EUR million)	12,807	14,486	14,907	14,839	**57,038**	14,388	16,065
GDP per capita (EUR)	6,078	6,878	7,069	7,031	**27,040**	6,796	7,586
PRICES, WAGES, AND EXCHANGE RATES							
Implicit GDP deflator (% change, yoy)	4.4	5.5	9.0	6.8	**6.5**	11.3	9.2
Consumer prices (% change, yoy, pa)	6.0	8.5	10.7	10.1	**8.8**	9.9	8.2
Producer prices (% change, yoy, pa)	15.6	21.7	21.1	19.9	**19.6**	15.5	7.1
Average gross wage (% change, yoy, pa)	-1.2	0.8	5.0	6.5	**2.8**	10.4	9.9
Exchange rate (EUR/USD, pa)	0.89	0.94	0.99	0.98	**0.95**	0.93	0.92
FOREIGN TRADE AND CAPITAL FLOWS							
Exports of goods (EUR million)	10,000	11,045	10,834	10,749	**42,628**	10,887	10,881
Exports of goods (EUR, % change, yoy)	3.5	4	9.1	-4.2	**2.9**	0.2	-1.6
Imports of goods (EUR million)	10,511	11,563	11,212	11,516	**44,802**	10,814	10,335
Imports of goods (EUR, % change, yoy)	14.7	8.2	11.4	-1.9	**7.7**	-3.6	-7.3
Current account balance (EUR million)	-146	-232	153	-354	**-578**	582	1,151
Current account balance (% of GDP)	-1.1	-1.6	1.0	-2.4	**-1.0**	4.0	7.2
Foreign Direct Investment net inflows (EUR million)	592	770	480	209	**2,051**	548	413
Foreign exchange reserves (EUR million, eop)	709	742	781	757	**757**	804	814
Foreign debt (EUR million, eop)	51,839	51,769	52,161	51,825	**51,825**	54,952	55,915
GOVERNMENT FINANCE							
Revenues (EUR million)	5,819	6,370	6,372	6,621	**25,182**	6,294	6,908
Expense (EUR million)	6,203	6,944	6,519	7,233	**26,899**	6,823	7,503
Net lending/borrowing (EUR million)	-384	-573	-147	-613	**-1,717**	-529	-596
Domestic government debt (EUR million, eop)	35,228	35,283	35,607	35,546	**35,546**	36,267	36,537
Foreign government debt (EUR million, eop)	2,526	2,517	2,517	2,299	**2,299**	2,299	2,193
Total government debt (eop. % of GDP)	75.3	75.0	74.4	72.3	**72.3**	72.0	70.5
MONETARY INDICATORS							
Total domestic credit (% change, yoy, eop)	9.66	2.25	5.00	3.24	**3.24**	3.04	8.00
DMBs credit to households (% change, yoy, eop)	6.81	8.08	8.52	7.63	**7.63**	6.08	4.03
DMBs credit to enterprises (% change, yoy, eop)	7.70	12.40	16.90	12.47	**12.47**	4.98	3.76
Money market interest rate (%, pa)	-0.58	-0.58	-0.08	1.20	**-0.01**	2.25	3.07
DMBs credit rate for enterprises short-term (%, pa)	1.91	1.40	2.01	3.27	**2.15**	4.21	4.96
DMBs credit rate for households short-term (%, pa)	3.09	3.04	3.46	5.01	**3.65**	6.01	6.20

Conventional abbreviations: pa – period average, eop – end of the period, yoy – year on year, EUR- euro, USD – U.S. dollar, DMB – deposit money bank.

Source: Statistical Office of the Republic of Slovenia, Bank of Slovenia, Ministry of Finance, Institute for Macroeconomic Analysis and Development, Eurostat and calculations by the Institute for Economic Research

Policy assumptions projections summaries

After moderating in 2023, economic growth is forecast to accelerate in the next two years

Considering the downward revision of the 2022 growth rate to 2.5%, the European Commission estimates that Slovenia's GDP growth will decelerate to 1.3% in 2023 before it accelerates progressively to 2% in 2024 and 2.7% in 2025. The autumn forecast of the National Institute for Macroeconomic Analysis and Development (IMAD) is more optimistic for this and the next year. It projects that growth will slow to 1.6% this year and accelerate to 2.8% next year but afterward moderate to 2.5% in 2025. Several risks are associated with this forecast, including the weakening of the international economic environment, the speed of the reconstruction of flood damage, the pace of inflation moderation, and the impact of deteriorating cost competitiveness on the export-oriented part of the economy.

Economic growth is slowing this year mainly due to a decline in the export-oriented part of the economy amid weakening external demand and cost pressures. Private consumption will also be weaker this year as inflation and tighter credit conditions continue to erode household purchasing power and consumer confidence. Only investment activity will remain strong (4.5%), driven mainly by construction activity. According to the European Commission, the general government deficit is projected to widen to 3.7% of GDP this year due to a higher rise in expenditures than revenues. Expenditure is being driven by higher compensation of employees, subsidies to mitigate the consequences of rising energy prices and costs related to the reconstruction after the summer flooding. Exports are projected to stay at a similar level as in the previous year (0.1%), while imports are projected to decline significantly (-3.9%) due to lower domestic demand and the decumulation of inventories. Consequently, the contribution of net exports to GDP growth will be positive this year, and the current account is also projected to be in surplus (4.4% of GDP).

For 2024 and 2025, IMAD estimates that growth in the exports of goods and services will accelerate to 3.3% and 3.8%, respectively, amid a gradual increase in external demand. The rise in the imports of goods and services is estimated to be even stronger (5.3% and 3.9%, respectively), and the current account surplus is projected to narrow to 2.8%. Private consumption is projected to resume moderate growth in 2024 and 2025 (2.3% and 1.8%, respectively), supported by robust employment and strengthened real wage growth. Investment growth is projected to remain strong over the projection horizon amid buoyant construction investment, also boosted by the recovery and reconstruction after this year's floods and by resumed growth in business investment in machinery and equipment. Growth in government consumption is also expected to play a more prominent role in GDP growth in 2024 and 2025. According to the European Commission, the public debt-to-GDP ratio is forecast to decline to below 68% by 2025 due to changes in the headline deficit and the large increase in nominal GDP.

Despite the projected higher economic growth, employment is not expected to increase significantly over the next two years. Employment growth will be hindered by the already high employment levels and shortages in domestic labour supply amid the ageing of the labour force and the mismatch between demand and supply of certain skills. Regarding unemployment, IMAD projects a further minor decline in the unemployment rate over the projection horizon (from 3.6% in 2023 to 3.4% in 2025), while the European Commission estimates that the unemployment rate will not decrease any further (3.6% in 2023 and 2025) and IMF projects a moderate increase in the unemployment rate from 3.6% in 2023 to 3.9% in 2025.

Inflation is projected to remain relatively high on average this year, standing around 7.5%, and will be driven mainly by food price growth and services price inflation. In 2024, inflation is expected to decline to 3.9% and further moderate to below 3% in 2025 (estimated at 2.4% and 2.7% by EC and IMAD, respectively). Services price inflation is expected to be the dominant contributor to inflation throughout the forecast horizon amid high demand and wage growth, with food price growth also remaining rather high. ■

Table SLO2 Summary of projections

	2023	2024	2025
Real GDP (% change)	**1.6**	**2.8**	**2.5**
Real private consumption (% change)	0.9	2.3	1.8
Real government consumption (% change)	1.4	1.9	2.2
Gross fixed capital formation (% change)	4.5	5.5	4.3
Exports of goods and services (constant prices, % change)	0.1	3.3	3.8
Imports of goods and services (constant prices, % change)	-3.9	5.3	3.9
Current account balance (% of GDP)	4.4	2.8	2.8
Consumer prices (% change, pa)	7.6	3.9	2.7
Exchange rate, EUR/USD (pa)	0.917	0.912	0.912
Unemployment rate (LFS, %, pa)	3.6	3.5	3.4
General government balance (ESA 2010 definition, % of GDP)	-3.7	-3.3	-2.9

Sources: IMAD – Autumn Forecast of Economic Trends 2023, European Commission – Autumn 202 Economic Forecast.

ANALYSIS

Science, Technology, and Innovation Indicators in SEE-6 countries

Indicators for Science, Technology, and Innovation provide valuable insights into the region's research and innovation landscape. According to the European Innovation Scoreboard (EIS)[1] 2023, an annual assessment of research and innovation performance, Slovenia is categorized as a moderate innovator with a performance of 95.1% of the EU average, while Croatia, on the other hand, is classified as an emerging innovator, with a performance standing at 69.6% of the EU average. Meanwhile, other non-EU countries in Southeast Europe (SEE) are also emerging innovators, with the following results: Serbia at 63.2% of the EU average, Montenegro at 47% of the EU average, North Macedonia at 46.3% of the EU average, and Bosnia and Herzegovina at 36.2% of the EU average.

Most SEE-6 countries recorded slight growth or stagnation in R&D investment in the period 2010-2021. This is illustrated in Figure 1, which shows Gross domestic expenditure on R&D (GERD) as a percentage of GDP. GERD includes all expenditure on R&D carried out on national territory during a given reference period. GERD takes into account funding from all sectors – government, universities, companies, private non-profit organisations, and abroad. However, it does not include expenditure on R&D carried out abroad. The highest growth is seen in Croatia, where the GERD/GDP ratio

1 Based on the results of 32 indicators of Summary Innovation Index, all countries are grouped into four categories: 1) Innovation Leaders – countries with performance above 125% of the EU average; 2) Strong Innovators – countries with a performance between 100% and 125% of the EU average; 3) Moderate Innovators – states where performance is between 70% and 100% of the EU average and 4) Emerging Innovators – states that show a performance level below 70% of the EU average. EIS highlights the specific strengths and weaknesses within the research and innovation systems, aiding countries in identifying focal points for concentrated efforts to enhance their innovation performance.

has increased from 0.73% in 2010 to 1.24% in 2021. It is important to note that R&D spending in Slovenia has been above 2% of GDP throughout the period, while in Croatia, GERD has been above 1% since 2019. In the other SEE-6 countries, the GERD/GDP ratio was below 1%.

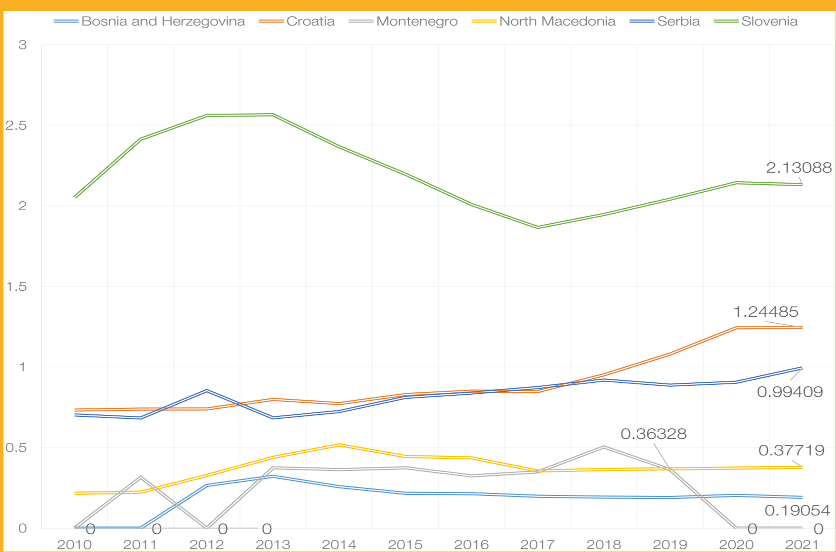
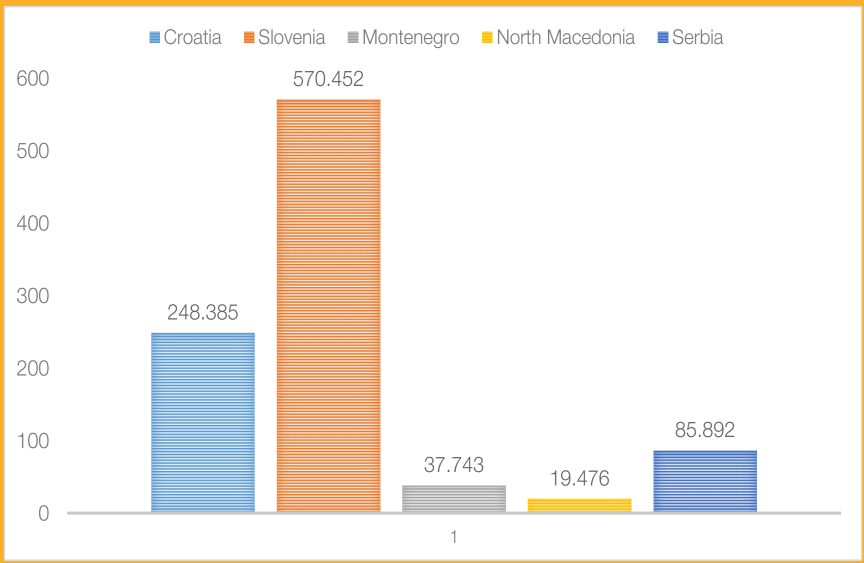


Figure 1. GERD as % of GDP

Source: UNESCO Institute of Statistics.

A more nuanced understanding of a country's commitment to R&D becomes possible when population size is taken into account (Figure 2). For example, Slovenia's gross domestic expenditure on R&D in 2022 was more than two times higher than Croatia's and more than six times higher than Serbia's.

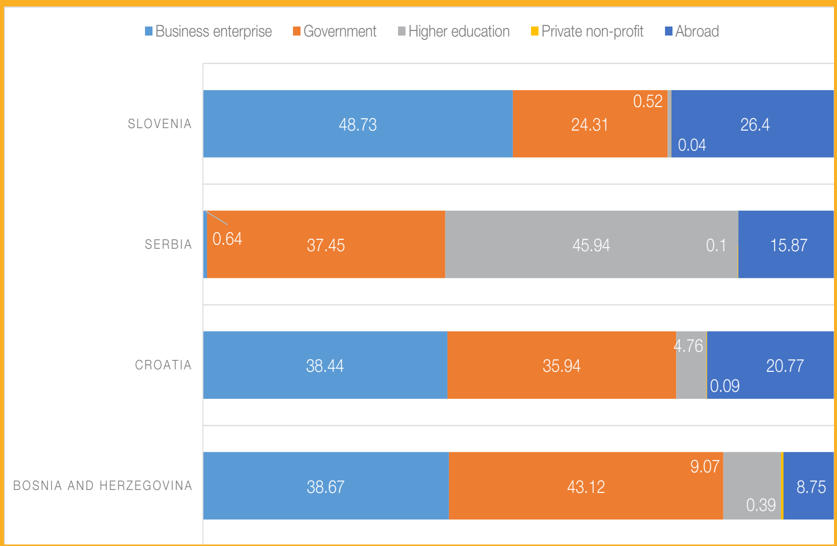
Figure 2. GERD in euro per inhabitant in 2022



Note: Data for Bosnia and Herzegovina are not available; data for Montenegro are for 2018; data for North Macedonia are for 2020.
Source: Eurostat

In Slovenia and Croatia, the main source of R&D funding is the business enterprise sector, and in Serbia it is the higher education sector. In Bosnia and Herzegovina it is the government sector (Figure 3). The very low percentage of R&D funded by the business sector in Serbia in 2021 (0.64%) has shown that there is an urgent need for an R&I policy that encourages the private sector to engage in research and development.

Figure 3. GERD by source of funds in 2021 (in %)



Note: Data for Montenegro and North Macedonia are not available.
Source: Eurostat

The number of researchers in a given economy generally indicates a greater potential for innovation and technological advancement. Over the last decade, the number of researchers full-time equivalent (FTE) has increased in all SEE countries for which data are available. The proportion of female researchers has only increased in Serbia and Bosnia and Herzegovina over the same period. It is also important to emphasize that the proportion of female researchers in Bosnia and Herzegovina, Croatia and Serbia is much higher than the EU average, which is 33.7%. Considering the number of researchers per million inhabitants, it is clear that Slovenia and Croatia are the leaders in the region. They are followed by Serbia with 2,207 researchers per million inhabitants, North Macedonia with 744, and Bosnia and Herzegovina with only 443 (Table 1).

Table 1. Researchers FTE (total, % of female, per million inhabitants)

	Researchers FTE		Female researchers FTE (%)		Researchers FTE per million inhabitants	
	2013	**2022**	**2013**	**2022**	**2013**	**2021**
Bosnia & Herzegovina	829	n/a	36	50	n/a	443
Croatia	6,529	9,913	50	48	1,623	2,331
Montenegro	404	n/a	45	n/a	n/a	n/a
North Macedonia	1,402	n/a	n/a	n/a	527	744
Serbia	12,342	15,971	50	53	1,503	2,207
Slovenia	8,707	11,409	35	34	3,755	5,223

Source: Eurostat, UNESCO Institute of Statistics

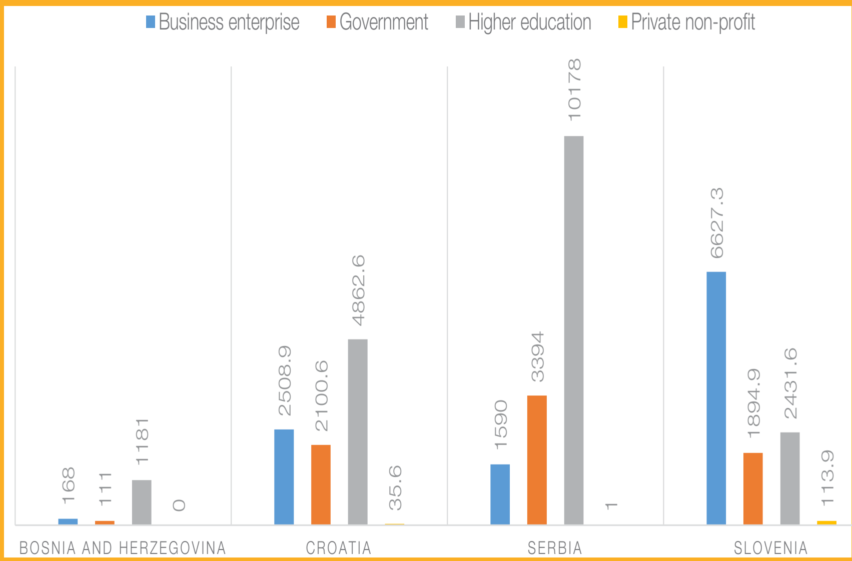
Researchers in SEE-6 countries are predominantly employed in the higher education sector – in all countries with the exception of Slovenia, where more than 6,000 researchers work in the business enterprise sector (Figure 4). In Bosnia and Herzegovina, Croatia, North Macedonia, and Slovenia, the majority of researchers work in engineering and technology. In Serbia, most researchers work in the field of natural sciences, followed by engineering, technology, and social sciences (Table 2).

Table 2. Researchers FTE by fields of R&D

	Bosnia and Herzegovina	Croatia	North Macedonia	Serbia	Slovenia
Natural sciences	188.4	1,387.9	254.0	3,927.7	3,218.2
Engineering and technology	560.9	3,163.2	512.9	3,731.3	4,896.6
Medical and health sciences	61.5	1,816.6	243.7	1,984.7	1,223.5
Agricultural sciences	149.2	578.7	115.9	1,179.7	435.2
Social sciences	306.1	1,291.1	305.7	2,473.9	629.7
Humanities	216.8	875.0	206.7	1,594.1	441.9

Note: Data for Montenegro are not available.
Source: Eurostat

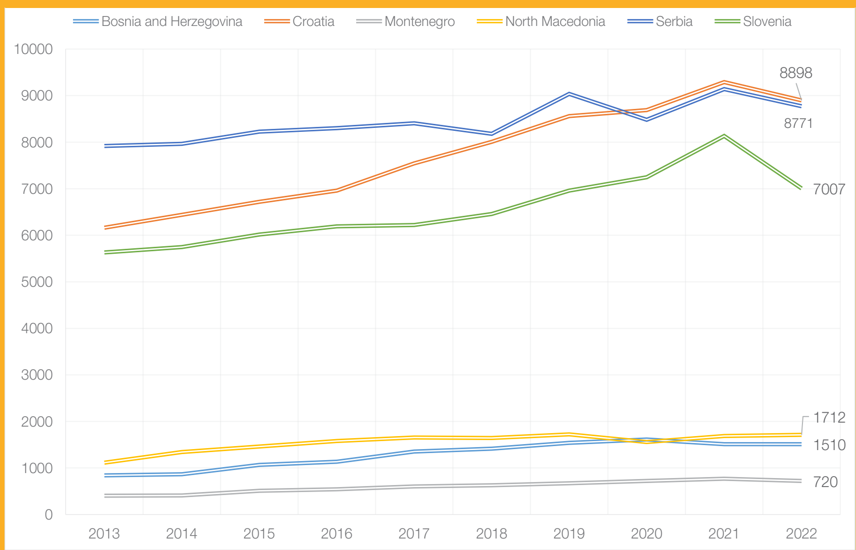
Figure 4.
Researchers FTE by sector of performance in 2021



Note: Data for Montenegro and North Macedonia are not available.
Source: Eurostat

An upward trend in scientific publications can be observed in all SEE countries, indicating increased scientific activity by researchers and institutions (Figure 5). Although the total number of scientific publications in 2022 was highest in Croatia, a comparison with the number of inhabitants shows that Slovenia has the highest scientific output in the region, with 3,325 publications per million inhabitants. It is followed by Croatia with 2,304 publications per million inhabitants and Serbia with 1,290 (Figure 6).

Figure 5.
Scientific publications



Source: Web of Science

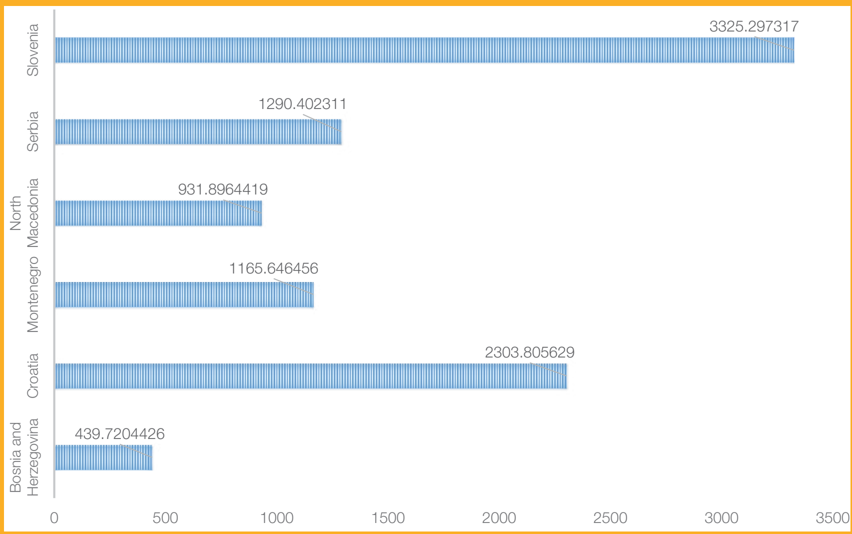


Figure 6. Number of scientific publications per million inhabitants in 2022

Source: Web of Science and Eurostat

The share of high-tech exports is an economic indicator that largely depends on the application of R&D results in practice and is therefore treated as an impact indicator of scientific and technological activities. High-technology exports are products with high R&D intensity, e.g. in the fields of aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery. According to the World Bank, Croatia (9.6%) and Montenegro (9.4%) had the highest share of high-tech exports in total manufactured exports in 2021 (Figure 7).

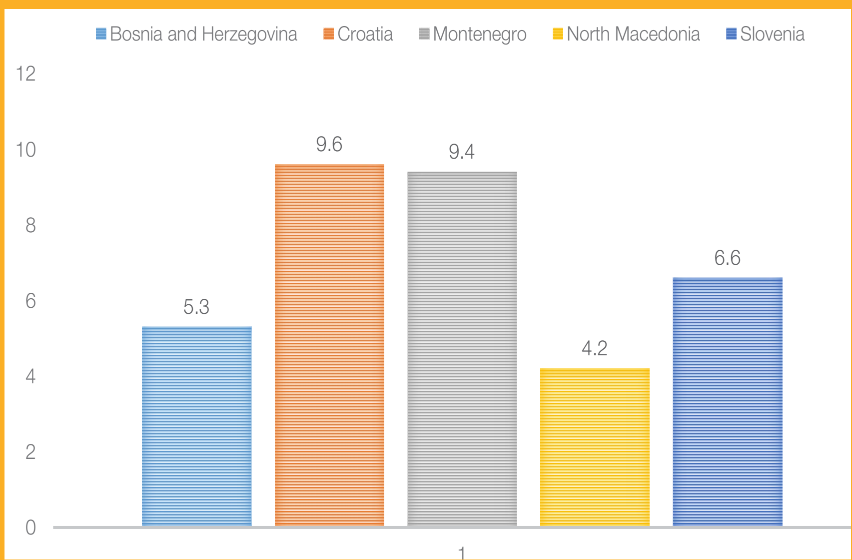


Figure 7. High-technology exports (% of manufactured exports) in 2021

Note: Data for Serbia are not available
Source: World Bank Development indicators

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