From the Editor

Since the appearance of the current inflation in the first half of the previous year, the issue of causes behind it has been the subject of political and professional discussions. Representatives of central banks, governments, international financial organizations and many economists have argued that inflation is entirely or almost exclusively a result of the supply-side problems, i.e. problems due to temporary stagnation in production and trade because of the introduction of epidemiological restrictions. Accordingly, they predicted that inflation would disappear spontaneously with the elimination of these disturbances. Difficulties in restoring production to pre-pandemic levels resulted in insufficient product supply, which could have affected price growth. This mechanism is especially relevant in the case of complex products such as cars, computers, equipment, etc. in the production of which a large number of manufacturers located in different parts of the world participate. However, during the first half of the previous year, the prices of energy, food, metals, wood, etc. began to rise, the growth of which can hardly be explained by supply-side disruptions. In addition, even before the beginning of the growth of product prices around the world, there was an increase in the price of various types of real and financial assets, such as real estate, gold, stocks, cryptocurrencies, etc.

Therefore, even then, the question arose whether the growth of product prices (inflation) and assets, apart from problems on the supply side, was influenced by expansionary monetary and fiscal policy, which has been applied worldwide with occasional slowdowns and interruptions since the previous great financial crisis. During the coronavirus pandemic, monetary and fiscal stimulus reached record levels in recent economic history. The result of monetary and fiscal expansion during the pandemic period was an enormous increase in the debts of states, companies and citizens, which during 2020-2021 increased by about 30% of world GDP. The growth of debts was stimulated by interest rates that were at the historical minimum and realistically negative over a longer period of time. The expansiveness of fiscal policy over the past two years has reached a historic high. According to the IMF, realized government expenditures in the period 2020-2021 increased by about 10% of world GDP, and potential expenditures in the form of loan guarantees, recapitalizations, etc. amounted to an additional 6% of world GDP. The countries that have the greatest impact on the world economy were in the lead in terms of the amount of stimuli.

Therefore, the question arises as to why the representatives of central banks and international financial organizations ignored the impact of monetary and fiscal expansion on inflation? Part of the explanation is probably that in developed countries there was a belief that strong fiscal and monetary stimulus would not affect inflation growth, as it did not during and after the great financial crisis. This belief was based on the assessment that citizens and the economy are ready to keep large amounts of money or invest it in real and financial assets, so a large increase in money supply will not significantly and long-term affect the growth of product prices. Another, probably more important reason for persistently repeating the claim that monetary and fiscal expansion do not affect inflation is of a practical nature. Recognition that inflation is largely a consequence of fiscal and monetary measures implies abandoning stimulus and moving to restrictive policies. However, the application of restrictive monetary and fiscal policies would slow down the recovery of economies, including the most developed ones, most of which did not reach the pre-crisis level of economic activity in 2021.

However, the persistence of inflation and its acceleration have led some central banks to raise interest rates at the end of last year and apply other restrictive measures, and most central banks have raised interest rates in the past part of the year. The European Central Bank was late in introducing restrictive measures compared to other central banks, although it reduced the volume of securities purchases and announced an increase in interest rates during the third quarter of this year. The very announcement of the increase in interest rates of the ECB influenced the increase of the interbank interest rate (Euribor), which will affect the growth of interest rates in Serbia, because a significant part of loans to businesses and citizens is contracted at variable interest rates related to Euribor.

Representatives of the authorities in Serbia, similarly to other countries, claimed during the previous year that inflation was temporary, and that it was a consequence of supply-side disruptions, so that monetary and fiscal measures were not needed to curb it. In addition, the representatives of the NBS and the Government emphasize that the largest part, i.e. about 2/3 of inflation in Serbia, was imported, i.e. that it is a consequence of the growth of prices on the world market. Estimates that a large part of inflation is imported to Serbia are in line with the high growth of import prices, which in the first quarter of this year in euros was 25% higher than a year ago, but also with high import dependence of the Serbian economy, where the value of imported goods is about 50% of GDP.

In the case of Serbia as well, the question is whether the expansive fiscal and monetary policy affected inflation? In answering this question, it is relevant that Serbia was in the lead among the countries of Central and Eastern Europe in terms of the scope of fiscal and monetary expansion during the pandemic period. According to IMF data, in 2020 and 2021, Serbia had direct incentives in the amount of 12.2% of annual GDP, and indirect incentives in the amount of 3.2% of GDP, making it the number one country in Central and Eastern Europe. Also, Serbia was in the lead in terms of real growth of loans to businesses and citizens in the mentioned period. Expansive fiscal and monetary policy, along with a favorable economic structure and relatively loose epidemiological measures, have contributed to Serbia being among the countries that achieved the best results in terms of GDP dynamics during the pandemic period. However, these measures had their other side, they encouraged faster growth of demand compared to supply, which affected the growth of inflation. One of the signals of "overheating" of the Serbian economy, i.e. excessively fast growth of demand, which the supply could not follow, is the high growth of real estate prices, whose prices grew even in the recession year 2020.

Therefore, it can be reasonably argued that high inflation in Serbia is partly the result of expansionary fiscal and monetary policies during 2020 and 2021. It follows from the above that in order to combat it, in addition to calming the situation on the world market, it is necessary to apply restrictive measures, such as increasing the reference interest rate of the NBS and reducing the fiscal deficit. The NBS, probably with a certain delay, started raising the reference interest rate in March this year, and it is expected that such a policy will continue in the future. Regarding fiscal policy, there is much more uncertainty due to potential risks, such as taking over the debts of public companies, and due to frequent changes in fiscal policy, such as the announced increase in pensions by 18-19%.

An eventual increase in pensions by 18-19% would negatively affect plans to bring down inflation in several ways. First, high growth in pension expenditures would increase total public expenditures, and thus the fiscal deficit, consequently maintaining a high gap between supply and demand. Secondly, the announcement of high pension growth raises expectations regarding future inflation, so businesses will base their decisions and plans for next year on significantly higher inflation than planned by the NBS. Finally, high pension growth will be an argument for demands for a high increase in other incomes, such as public sector wages, subsidies, etc. If states give in to these demands it would result in a greater imbalance between production and income, and the manner to eliminate these imbalances would depend on what monetary policy would be pursued. If the NBS would occasionally issue dinars, for example by buying corporate or government securities and keeping the reference interest rate low, inflation in the next year would be significantly higher than planned, and the result of this would be that real growth of pensions, wages, etc. would be significantly lower than promised by the state. This could again encourage pensioners and public sector employees to seek further increases in pensions and salaries, and if the state meets such demands, the consequence would be a spiral between wages and pensions on the one hand and inflation on the other, with higher inflation in each iteration.

The impact of expansionary fiscal policy on inflation would be smaller if the NBS pursued a restrictive monetary policy. In this case, an expansive fiscal policy would affect the growth of external deficits, while inflation would depend on exchange rate movements and capital inflows. If the inflow of capital would be greater than the current account deficit, the NBS would issue dinars through net foreign exchange purchases, which would cause inflation to be relatively high, but lower than in the case NBS issues money through the purchase of securities. If the inflow of capital would be less than the current account deficit, the NBS would withdraw dinars through net sales of foreign exchange, which would cause inflation to be relatively low. However, the withdrawal of the dinar would affect the growth of interest rates, lower credit growth, less investment and a decline in the purchase of real estate and durable consumer goods, and thus it would slow down economic growth. Therefore, it is estimated that in the conditions when it is planned to bring down inflation, it is more appropriate to pursue a more restrictive fiscal and monetary policy, and that means to plan a moderate increase in pensions, wages and other incomes.