From the Editor

In the first part of the year, inflation accelerated in Serbia, similarly to other European countries, while economic activity continues to achieve solid results. Year-on-year inflation reached 13.2% in August, and GDP growth in the first half of the year was 4%. For now, there are no signs of a slowdown in inflation, but there are more signals that economic activity is slowing down, despite the solid results achieved during the first half of the year. Signals of the economic slowdown in Serbia are the slowdown of investments, the decline in the volume of construction activities, the decline in industrial production since April this year, etc. Similar tendencies have been realized in the world, and additional signal of the slowdown of the world economy and a possible recession is the drop in metal prices. The movement of inflation and economic activity in the coming period depends on a large number of factors, among which are key economic policy measures and the development of the geopolitical situation. The results of the Serbian economy in the coming period will depend both on the economic policies implemented in the country, and on economic policies and economic trends in the world.

For now, it is estimated that Serbia, as well as the world, will choose the reduction of inflation as a short-term economic policy priority. The reason for this is that inflation has reached a level after which it negatively affects economic activity, the standard of citizens, but also people's well-being. Empirical research mainly shows that inflation of up to 6-7% on an annual level negatively affects highly developed economies, while in the case of developing countries, the negative impact begins when inflation exceeds 10%. High inflation has a negative impact on savings and investments and arbitrary redistributes income and assets. Returns on savings in banks, as well as returns on long-term savings in pension funds in conditions of high inflation, are mostly negative, which has the effect of reducing the real value of financial assets, which in turn reduces savings. The well-being of people is particularly negatively affected by the reduction of the real value of long-term savings, such as: savings for old age, savings for housing or savings for children's education. Real losses on financial assets encourage owners to invest these assets in real assets, such as real estate, which encourages the growth of their prices.

On the other hand, negative real interest rates on loans bring inflationary profits to debtors, which means that inflation redistributes wealth from savers to debtors. Negative real interest rates on deposits and loans sent the wrong signals to citizens, the economy, and states, because they dissuaded them from saving and encouraged long-term unsustainable borrowing and investments that are not profitable in the long term. A decrease in savings at the macroeconomic level results in a decrease in investments, and thus a slowdown in economic growth in the future. Inflation leads to large changes in relative prices, due to which the profitability of implementing new projects changes suddenly and unpredictably - investment projects that were profitable until recently become unprofitable due to changes in relative prices, which encourages investors to postpone the launch of new projects.

Although the increase in interest rates has negative consequences, we estimate that central banks will increase interest rates in order to reduce domestic demand until inflation starts to decline, which could happen at the end of this year or during the first half of next year. The increase in reference interest rates of central banks will affect the general growth of interest rates, which will probably remain at a high level even after inflation starts to decline. A reduction in interest rates of central and commercial banks could be expected only when inflation enters the target corridor. It is estimated that the interest rates of commercial banks will remain at a high level for a long period of time, that is, that they will not return to the low level at which they were during the last few years in the foreseeable future.

Although high interest rates will have a negative impact on investments and increase the costs of debt servicing by the state, citizens, and the economy, they will also have positive effects in the form of increased yields on various forms of savings, the growth of which will create conditions for the recovery of investments and economic activity. Therefore, the increase in interest rates and other measures to suppress inflation will have both positive and negative consequences, whereby in the short-term negative consequences will dominate, such as a drop in investments and an increase in loan repayment costs, while in the medium term positive consequences will dominate, such as are sustainable savings and investment growth, low inflation, etc. In this sense, the application of restrictive measures to suppress inflation is justified, because high and long-term inflation would have a negative impact on the economy in a long period of time, and in the end restrictive measures would still be applied in order to suppress inflation.

The speed of the increase in interest rates and other measures to reduce inflation will depend on the character of the fiscal policy as well as on the removal of disturbances on the supply side. The reduction of inflation will be faster if the restrictive monetary policy is supported by the fiscal policy and if the problems on the supply side are eliminated in the short term. In that case, inflation would begin to decline earlier, so the increase in interest rates could be lower, while their reduction would begin earlier, so in that case the recession would be relatively short-lived, followed by economic recovery with low inflation. In the opposite case, if the disruptions on the supply side, which are largely the result of geopolitical conflicts, were to last longer, and governments continued with an expansive fiscal policy, inflation would remain high for a longer period, while the recession would be deeper and longer lasting.

The possible causes of the slowdown, and perhaps the decline of economic activity in Serbia, in the coming period are multiple, among which the following are particularly significant: high inflation, restrictive monetary policy measures, the economic war between Russia and the West, etc. As already stated, high inflation reduces the real the value of fixed incomes (salaries, pensions, etc.), discourages saving and leads to sudden and large changes in relative prices, all of which negatively affect economic activity. Restrictive monetary policy measures, such as an increase in interest rates, have a negative impact on investments, the funds for interest payments increase, which leaves less funds for the purchase of other products, which also negatively affects economic activity. The economic war between Russia and the West led to a large increase in the price of energy, food, etc., which negatively affects economic activity in various ways. The high increase in energy prices affects the reduction or even suspension of production in companies that are highly energy dependent, and which cannot let the price increase pass on to consumers without a large drop in demand. The high growth of energy prices for households reduces their income available for the purchase of other products, which negatively affects economic activity. A possible gas shortage and restrictions in the provision of electricity would probably represent a trigger for a decline in economic activity in Serbia. The slowdown of economic activity in Serbia will be influenced by the slowdown or decline in economic activity in European countries, Serbia's main economic partners, such as Germany and Italy. The deterioration of the economic performance of European countries will slow down the growth of exports from Serbia, as well as the inflow of direct investments from the aforementioned countries. The growth of interest rates on the world market will worsen the borrowing conditions of the Serbian state, domestic banks and companies, and will also affect the decline of foreign direct investments.

Forecasting inflation and economic activity in these conditions is extremely conditional and uncertain because it depends on many factors, such as geopolitical trends, which are difficult to predict. High uncertainty in forecasting economic activity is manifested in frequent and large changes in forecasts by international financial institutions, the EU and private institutes and companies. If interest rates will increase in Serbia and the world, at least in the next two to three quarters, and the fiscal policy will be moderately restrictive, that energy prices will remain approximately at the current level or will decrease, and that there will be no shortage of energy sources, it is possible to provide indicative forecasts of inflation and economic activity for this year.

Under the previous assumptions, it is expected that inflation will continue to rise in the next few months, due to the direct and indirect effects of the latest increase in energy and food prices, as well as the fact that interest rates are still not at a level at which they would significantly reduce domestic demand, and restrictions on the supply side are still very strong. Inflation at the end of the year could reach an annual level of around 15%, while the average inflation this year compared to previous year would be around 11%. In this case, inflation growth would probably be stopped at the end of this year and the beginning of next year, after which a gradual decline would occur. Under the same assumptions, economic activity in the third and fourth quarter would decline significantly, so that in the second half of the year the year-on-year GDP growth would amount to around 2%, which implies a growth at the level of the whole year of around 3%. Economic activity in the fourth quarter would have a year-on-year growth of around 1%, which implies that we would enter next year with weak growth, and this means that even if inflation is successfully curbed and the international circumstances improve during the first half of the next year, GDP growth in the next year would not be high.

If international conditions worsen and if this leads to additional jump in energy prices as well as to their shortage, the results in the second half of the year would be weaker, which means that in that case inflation would be higher this year, and in the fourth quarter we would probably enter a recession. In that case, the results at the level of the whole year would be weaker, and the following year would be entered with high inflation and recession, which is why inflation would be high in the following year, and economic growth would be modest.