From the Editor

During the previous year, there were signs of a weakening of inflation in the world, such as a fall in the prices of primary products, a halt in growth or a fall in real estate prices, a reduction in unit labor costs, etc. The reduction in inflation in a large number of countries shows that restrictive monetary and fiscal policy measures were effective, but still high inflation in most countries, as well as its fluctuations, indicate that it is necessary to continue with such a policy in the coming period.

The first important signal of the weakening of inflationary pressures was the drop in world prices of primary products, energy, metals and food during the previous year. Metal prices, which largely depend on current and planned investments, began to decline during the second quarter of the previous year, which sustained the postponement and abandonment of investments during the period of rising interest rates and increasing geopolitical risks. However, in December of last year and in January of this year, metal prices began to rise again, which is associated with the easing of epidemiological restrictions in China and the expected growth of the Chinese economy, as well as improved prospects for the world economy. Food prices had a significant drop between April and August of the previous year, after which they remained at a stable level. Energy is used in all economic activities and has a significant share in household consumption, so the movement of its prices significantly affects inflation. The drop in energy prices only started in September last year, and continued until the end of the previous year and in the first months of this year. The unstable geopolitical situation, which may develop in different directions in the coming period, may once again trigger the growth of energy and food prices, which would prolong the period of high inflation.

The second important signal of the weakening of inflationary pressures is the slowdown in the growth of real estate prices in most countries, while in some countries real estate prices have already started to decline. The slowdown in growth or the fall in real estate prices is directly related to the rise in interest rates, but it also reflects a reduction in the imbalance between supply (production) and demand (income), which triggered inflation during the previous two years. On average, real estate prices in the EU slowed down significantly, while in the US they fell in the middle of the previous year, after which they stagnated. Real estate prices in Serbia, due to high demand, continued to grow strongly throughout 2022, but at the end of last year and at the beginning of this year, the volume of sales decreased, which is a signal of slowdown of price growth.

Wages affect inflation from the cost side, but also from the demand side. Both mechanisms of influence are macroeconomically significant, as wages contribute to GDP with around 60%. Slower wage growth than GDP growth in almost all European countries during 2022 reflects the reduction of cost pressures on price growth, but also the harmonization of demand with production. Nominal wages in the EU in the first three quarters of last year increased by an average of 4.8%, while inflation in the same period in the EU amounted to 8.5%, which means that real wages decreased by 3.4%. Wages in Serbia increased by 1.7% in real terms last year, but they decreased during the year, as a result of which they were 1.5% lower in real terms in the fourth quarter than in the same period in 2021. The fall in real wages during the last year represents a kind of compensation for the faster growth of real wages than the growth of productivity during the previous few years in almost all European countries. The consequence of faster wage growth than productivity growth is an increase in unit labor costs, which in the EU just in the period 2020-2021 increased by over 8%, which means that the share of labor costs in the price of the product has increased. The growth of unit labor costs, which was a consequence of the labor shortage in Europe, directly affected the growth of business costs, but also the faster growth of demand than the growth of production.

Signs of weakening inflation in the US were registered in the middle of the previous year, when prices began to decline or stagnate compared to the previous month. The result was a drop in annual inflation in the US from 10.1% in June last year to 6% in January this year. Inflation in the EU slowed down significantly in November, when price growth compared to the previous month amounted to only 0.1%. This was followed by a drop in prices in December and an increase in January, which resulted in annual inflation falling from 11.5% in October last year to 10% in January this year. Inflation started to decline in the US few months earlier than in the EU, which can be directly linked to the earlier implementation of restrictive monetary policy in the US. The maximum value of annual inflation in China in the previous two years was reached in September of last year when it amounted to 2.8%, after which it began to decline so that in January of this year it amounted to only 1%. In the countries of Central and Eastern Europe, annual inflation reached its maximum value of 17.7% in November last year, after which it began to decline, and in February this year it was 15.9%. Based on the above we can conclude that inflation in most countries began to decline during the second half of the previous year, but that it is still high in almost all countries, except China.

The maximum inflation in Serbia last year was reached in December, when it amounted to 15.1%, which was higher than the maximum inflation in the EU (11.5% in October), but less than the maximum inflation in the countries of Central and Eastern Europe (17,7% in November). In contrast to European countries, inflation in Serbia continued to rise in the first two months of this year, so that year-on-year inflation reached 16.1% in February. The difference in the dynamics of inflation between Serbia and other European countries is largely the result of differences in energy prices during the last year and this year. During the last year, most European countries raised the prices of energy products in accordance with the movement of their prices on the world market. In contrast, Serbia minimally increased energy prices during the previous year, which directly influenced inflation to be lower compared to the one that would have been achieved if energy prices had risen similarly to other countries. In Serbia, instead of consumers, part of the energy costs was paid by the state, which directly affected the growth of fiscal deficit and public debt, which means that part of the energy costs were passed on from consumers to taxpayers. It is obvious that this kind of policy, which results in the growth of public debt, is not sustainable in the long term, so raising energy prices is one of the key elements of Serbia's agreement with the IMF. The increase in energy prices already started during the second half of the previous year, and will continue during this and the following year, which will result in longer period of high inflation in Serbia compared to other European countries.

Although inflation in the world is decreasing, there is still great uncertainty regarding its trend in the coming period. Part of the uncertainty stems from geopolitical factors such as the war in Ukraine and the deterioration of relations between the West and China, which in the short term can lead to a re-increase in the prices of primary products, such as food and energy, which would lead to an increase in inflation at the world level. The long-term consequence of worsening geopolitical relations could be the fragmentation of the world market, i.e., a reduction in the mobility of capital, products and labor, which would result in an increase in business costs and thus an increase in inflation.

Another potential reason for a slower decline in inflation could be the spread of the crisis in the banking sector and the approval of a large amount of loans for liquidity to banks in trouble in the USA and Switzerland (for now), which partially neutralizes the effects of restrictive monetary policy. The approval of loans for liquidity could slow down or even temporarily increase inflation, only if it is a long-term large-scale intervention. For now, it is more likely that the scope of the intervention will not be macroeconomically significant, as well as that it will be short-lived, which means that it should not significantly affect inflation trends.

Having in mind the dynamics of inflation during the previous few months, it is estimated that it is justified for central banks, including the NBS, to continue with the application of restrictive monetary policy, i.e. with an increase in interest rates in the coming period. Such a policy will have a stronger impact on reducing inflation if it is supported by a restrictive fiscal policy, that is, a low fiscal deficit policy. Applying a restrictive monetary and fiscal policy increases the chances of a relatively quick reduction in inflation. A rapid reduction in inflation is of crucial importance in order to prevent the start of a spiral between inflation and wages. Last year, real wages fell in most countries which contributed to reducing inflation, but such a policy will not be feasible in the long term. If inflation lasts longer, the resistance against the reduction of real wages will be stronger, which means that employees will demand that their wages follow inflation and probably that they grow in real terms, which could lead to the start of a spiral between wages and inflation.

Another argument in favor of the rapid reduction of inflation is the possibility to start reducing interest rates earlier, which would encourage investments and economic growth. A less restrictive monetary and fiscal policy would result in a prolonged period of high inflation and high interest rates. From the point of view of long-term economic growth, short-term application of a strong restrictive policy is more desirable than long-term application of a moderately restrictive policy.

The third argument in favor of the strategy of rapid reduction of inflation is the prevention of incorporating high inflation into inflationary expectations. The longer inflation lasts, the more and more businesses will factor high inflation into their plans. When expectations of high inflation are prevalent, then in order to reduce inflation, it is necessary to apply a more restrictive monetary and fiscal policy, which implies greater losses in terms of economic growth and employment.

It is estimated that the USA and the EU have decided to quickly reduce inflation, which is manifested through the growth of interest rates of central banks, but also the reduction of fiscal deficits. The effects of such a policy will be somewhat weaker if the central banks approve a larger amount of loans for liquidity in order to prevent a banking crisis, or if there is a renewed increase in the prices of primary products. However, a restrictive monetary and fiscal policy would be effective in reducing inflation even in such circumstances, but the costs of such a policy in terms of economic activity and jobs would be higher. Similar to other countries, the reduction of inflation in Serbia requires the continuation of a restrictive monetary policy, but it would be desirable to achieve a low fiscal deficit, which means that additional extraordinary programs to help citizens and the economy or extraordinary increases in wages, pensions and other income paid by the state should not be implemented in this year.