From the Editor

In the first half of 2023, economic activity in Serbia was slowing down, and inflation was still high, which is currently a key macroeconomic challenge. For several decades, in scientific and expert economic analyses, the issue of inflation has been considered mainly from a phenomenological perspective, since inflation has been low and relatively stable for a long time in developed economies. Practically since the mid-80s of the 20th century, the inflation rate in developed economies has been below 5% per year, with relatively small annual variations. Since then, episodes of high inflation have been characteristic primarily of certain developing countries, including the countries of Southeast Europe. Nevertheless, from the middle of 2021, developed countries, as well as most others, including Serbia, have been facing a strong increase in inflation. At the beginning of inflation growth in 2021, a significant number of economic analysts indicated that the causes of inflation were predominantly related to factors on the supply side, i.e. problems in global supply chains caused by the COVID-19 pandemic. From this, the conclusion emerged that the normalisation of the functioning of supply chains will automatically lead to the return of inflation to the pre-crisis framework. However, since this did not happen, it became clear that the causes of this episode of high and widespread inflation are more complex, and that in addition to supply-side factors, i.e. problems in the functioning of supply chains, also include factors related to overheated demand, which were significantly influenced by economic policy measures. Namely, since the start of the Global Financial Crisis in 2008, and in Europe especially since the start of the public debt crisis a few years later, large central banks have started implementing expansionary monetary policy measures, in the form of increasing the money supply and lowering interest rates, which had not been recorded to that extent in the world economy. The outbreak of the crisis caused by the COVID-19 pandemic led to the need for strong additional intervention by the state, in order to ensure the liquidity and solvency of the economy and citizens, both through additional monetary expansion and a very strong expansion of fiscal policy. The pronounced expansion of monetary and fiscal policies in developed countries, especially since the second quarter of 2020, had a significant impact, with a time lag of about a year, on the growth of inflation, via the demand channel. This was compounded in the first half of 2022 by the additional negative impact of supply-side factors, caused by the global turbulence associated with the war in Ukraine, which caused inflation to last longer than expected.

In order to reduce inflation, in 2022 central banks began to increase the restrictiveness of monetary policy, through the reduction of the money supply and the increase of interest rates. In addition, after a large fiscal expansion in 2021 and 2022, developed (European) countries began tightening their fiscal policy in 2023 - the projected fiscal deficit in developed European countries of on average over 4% of GDP in the period 2020-2022, was halved in 2023. In this way, developed countries, in addition to ensuring the long-term sustainability of public finances, use fiscal policy measures to support monetary policy in solving the problem of inflation. As a result of the coordinated action of fiscal and monetary policy and the stabilisation of factors on the supply side, the trend of inflation growth was stopped in the Eurozone countries at the beginning of the last quarter of 2022, and soon after a similar reversal was recorded in most of the countries of Central and Eastern Europe.

Under the influence of similar factors as in other countries, inflation growth in Serbia also began in 2021, to be further accelerated in 2022, and the inflation growth trend was stopped only at the end of the first quarter of 2023. The average rate of inflation in Serbia in 2022 was about 11.9% (and the year-on-year inflation at the end of the year was 15.1%), which was a few percentage points lower compared to inflation in CEE countries. This difference is primarily attributed to the political decision not to increase energy prices in Serbia in 2022, despite the increase in prices on global markets, but rather cover the cost of the price difference from the state budget through a larger fiscal deficit, while in most CEE countries price correction occurred during the last year. The increase in energy prices in Serbia occurred in the first half of 2023, as a result of which the trend of inflation growth in Serbia was stopped almost half a year later than in most European countries - in March 2023. According to the official projections, on the basis of which the framework of the economic policy was conceived, in 2023 it is planned that the year-on-year inflation will drop to around 8% (and average annual inflation to around 12%).

In order to curb inflation, the National Bank of Serbia started increasing the restrictiveness of monetary policy at the beginning of 2022 - through multiple and significant increases in the reference interest rate, from 1% at the end of the first quarter of 2022 to 6.25% at the end of the second quarter of 2023. and application of other monetary policy instruments. Nevertheless, inflation trends in the first five months of 2023 indicate that the drop in inflation in Serbia, despite the significant drop in global prices of food, raw materials, metals, and energy, the normalisation of the functioning of supply chains, and the tightening of monetary policy by the NBS (and ECB) - was slower than expected and that there is a solid probability that inflation by the end of the year will be above the mentioned planned scope. Since the effects of most factors on the supply side, as well as one of the two major factors on the demand side (expansionary monetary policy), have been removed or mitigated to a large extent, as well as the fact that a relatively quick and significant reduction in inflation in Serbia did not happen, it is estimated that the reasons for that should primarily be looked for in the remaining factors on the demand side - prolonged fiscal policy expansion.

In the period of the pandemic crisis, from 2020 to 2022, the fiscal deficit in Serbia averaged about 5.1% of GDP, which was above the average of developed European countries (4.1% of GDP), CEE countries (4.9% of GDP) and the Western Balkans (4.6% of GDP). Unlike the majority of developed European countries, Serbia continued with the policy of a relatively large fiscal deficit in 2023, which is projected at the level of 3.3% of GDP for the current year. Current fiscal trends, and above all a strong real drop in public spending due to inflation and savings on energy costs thanks to a mild winter and a drop in energy prices, as well as a solid collection of public revenues due to higher-than-expected inflation at the beginning of 2023, have created assumptions that the fiscal deficit in Serbia in 2023 will be smaller than planned, which, in addition to having a positive impact on the sustainability of public finances, would also have anti-inflationary effects. However, the implementation of the announced measures of financial assistance to citizens (children up to 16 years of age), as well as the out-of-the-ordinary increase in wages for part of the employees in the public sector, and a significant increase in spending on agricultural subsidies, will affect the growth of public spending in Serbia by over EUR 200 million by the end of the year, i.e. by more than EUR 500 million annually, which will make the fiscal deficit larger than it would have been if this episode of fiscal expansion had not occurred. The announced fiscal policy measures deviate from the fiscal rules adopted at the end of 2022, and in addition, these measures, aimed at increasing current consumption, directly affect the heating of aggregate demand, which has inflationary effects. In this way, expansionary fiscal policy measures partially neutralise the effects of restrictive monetary policy measures in terms of reducing inflation. In other words, due to the additional fiscal expansion, an additional tightening of the monetary policy will probably be necessary in order to bring down inflation. This is indicated by the additional increase of the reference interest rate by the NBS in June 2023. Such developments point to the absence of adequate coordination of fiscal and monetary policy in the achievement of macroeconomic goals, and above all in terms of reducing inflation.

Reducing inflation by means of restrictive monetary and fiscal policy measures has a negative impact on the drivers of economic growth in the short term, as evidenced by the slowdown in economic activity in a large number of European countries. Nevertheless, a relatively quick and effective reduction of inflation, even at the cost of a temporary slowdown in economic activity, represents a better solution from the perspective of medium-term prospects for economic growth. Keeping inflation at a relatively high level for a long period of time leads to the devaluation of real incomes and consumption, and is a generator of uncertainty, which has a negative impact on economic activity. In addition, its reduction primarily by monetary policy instruments implies the need for interest rates to remain high for a longer period of time, which has a negative impact not only on consumption but also on investments, thus undermining medium-term development perspectives. If, on the other hand, the reduction of inflation is carried out faster and more efficiently, through the coordinated action of monetary and fiscal policy, the chances are that the reduction of interest rates and the growth of real incomes and consumption will come faster. Therefore, in the sense of improving the perspective of medium-term growth of the Serbian economy, it is justified to set a quick and effective reduction of inflation as a priority of economic policy, i.e. that coordinated measures of (more restrictive) fiscal and monetary policy are used to quickly and efficiently bring down inflation, within the corridor defined by the monetary strategy (1.5-4.5%). Therefore, from this perspective, it would be justified for the state, primarily through savings in some of the categories of current public spending, to achieve already this year a fiscal deficit that would be significantly smaller than planned, and to further reduce it to around 1% of GDP in the following year.

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