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Serbia economy briefing:
Economic Policy and Inflation

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Economic Policy and Inflation

Summary

Economic policy in the Republic of Serbia gave an adequate response to the crisis caused the coronavirus pandemic. Two years of struggle on the health and economic front gave satisfactory results. Thanks to the previously achieved macroeconomic stability, space has been created for the response of the economic policy to be adequate in scope and structure. Fiscal policy provided a comprehensive package of assistance to the economy and the population and its positive effects were reflected in macroeconomic indicators. But, with unexpected worsening of relations between Russia and Ukraine that finally led towards the hostilities, Serbia suddenly got faced with another economic challenge. There is an open question if Serbian authorities will be able to address new wave of economic turmoil.

Impacted by high-cost pressures mainly from the international environment, inflation in Serbia continued to move upward. The intensification of geopolitical tensions and less favorable agrometeorological conditions led to higher growth of food and energy products prices than expected. As the Republic Institute of Statistics recently announced, year-on-year inflation in Serbia in September 2022 was 14 percent. While electricity for households, as well as gas, rose in price by 10.7 percent in a year, solid fuels - which include coal, pellets and wood - are more expensive, according to official statistics, by as much as 49.6 percent, |while district heating has become more expensive by 1.6 percent.

Introduction

The target inflation rate in Serbia is determined by the National Bank of Serbia (NBS) in cooperation with the Government, based on the analysis of current and expected macroeconomic trends and the medium-term price correction plan on which the Government has a direct or indirect influence.

The inflation target is determined in advance, in order to define the framework for deciding on monetary policy in the medium term and to anchor inflation expectations. The decision on the inflation target is made three years in advance, until the process of nominal, real and structural convergence towards the European Union. Since that process is still ongoing, the inflation target is slightly above the quantitative definition of price stability and the level of target inflation in developed countries (2.0% or 2.5%). Thus, at the end of 2019, the target inflation rate until December 2022 was determined at the level of 3.0%, with a permissible deviation of ± 1.5 p.p.[1] It should be borne in mind that the inflation target is a medium-term goal, i.e. accomplished inflation may deviate from the target in the short term due to exogenous shocks.

The National Bank of Serbia strives to achieve the target inflation rate by changing the reference interest rate, which is applied in the implementation of the main operations on the open market. That interest rate is the basic instrument of monetary policy, and decisions on its level are made based on the analysis of the economic situation, assessment of future developments and medium-term inflation projections. When deciding on the reference interest rate, the time lag between the decision on its level and the manifested effects on the ultimate goal is important, i.e. inflation, which in the case of Serbia amounts to about a year.

Other instruments of monetary regulation have an auxiliary role - they contribute to the smooth transmission of the influence of the reference interest rate on the market, as well as to the development of the financial market without jeopardizing the stability of the financial system.

Serbian economic response to the international developments

Under the influence of high cost pressures mainly from the international environment, inflation in Serbia continued to move upward and in July, it was 12.8% year-on-year. Share of about 70% came from rising food and energy prices.

About 70% of inter-annual inflation was still determined by factors that monetary policy cannot influence to a large extent - food and energy prices. The key projection risks originate primarily from conflict in Ukraine due to disruptions in global supply chains and effects on the prices of energy, grains, other primary products, prices of metals, and other raw materials. Risks are also related to the domestic market - the agricultural season and the movement of government-regulated prices.

One additional domestic inflatory pressure is related to the de facto fixed fx rate of Dinar to Euro. It is not realistic to expect that the 117-118 RSD/EUR peg can be maintained indefinitely. Overall, the projection risks are perceived as asymmetric to the upside. After peaking in the third quarter, inflation will decline, returning to the target range in Q2 2023.

[1] Memorandum of the National Bank of Serbia on target inflation rates until 2022, which was adopted at the session of the Executive of the Board from December 12, 2019, available at: https://www.nbs.rs/export/sites/NBS_site/documents/monetarna-politika/memorandum_ciljevi_do_2022.pdf

Government measures to limit the export of grain, freeze the prices of basic food items, and reduce excise duties on fuel contribute to reducing the effects of rising world prices on the domestic market. The expected return of inflation to the target limits in Q2 2023 will be possible by the weakening cost pressures, and the effects of the previous tightening monetary measures.

Government's economic measures aimed at limiting prices of basic foodstuffs and energy sources the domestic market continue to act in the direction of alleviation of inflationary pressures and prevention greater negative effects on living standards citizens and companies business activities. Thereby, effects of reduced excise duties on petroleum products for 15–20% were neutralized by the growth of income by others fundamentals, which contributes to a lower general deficit of the state, which in the first half of the year amounted to 15.6 billion dinars and was lower by about 60% than in the same period of the previous year. It opens up space for the reaction of the fiscal policy in case of further aggravation of the energy crisis at the global level. The new medium-term fiscal plan, which is made on the basis of macroeconomic projections from the first half of this year, a decrease in participation is projected deficit of the general government in the gross domestic product at 3% this year, and then until the end of 2025 its lowering to 0.5%, which will ensure that the public debt has down ward trajectory and drops to a level of around 51% by the end of 2025[2].

From the other hand, basic inflation, which is most affected by monetary policy measures, moved as expected. It reached 7.5% year-on-year in July and to the greatest extent it reflected the further growth of inflation in the euro zone[3].

In forthcoming period, fiscal policy will, in accordance with available fiscal space, be focused on further reduction of the total of the tax burden of salaries, which additionally relieves the economy and increases its competitiveness. On the expenditure side, priority will be given to infrastructure and capital projects (state allocations for capital investments are projected to approximately 6 – 7% of gross domestic product per year), as well as pension and salary policy. Related to the later, their calculations should be conducted carefully in order to avoid their over increase that would easily lead towards higher inflationary pressures.

Despite the fact that interest rates on loans were rising during the second quarter, borrowing conditions on domestic market can still be rated as favorable from the point of view of credit support activities, and thus economic growth. Annual growth rate of non-monetary

[2] "Izveštaj Narodne banke Srbije", Narodna banka Srbije, https://www.nbs.rs/export/sites/NBS_site/documents/publikacije/ioi/izvestaji/ioi_08_2022.pdf, accessed on: 28/10/2022.

[3] "Trendovi Q1, Q2, Q3", Republički zavod za statistiku, https://publikacije.stat.gov.rs/G2022/Pdf/G20228003.pdf, accessed on:28/10/2022.

loans sector in June was further accelerated compared to March and amounted to 13.1%, with a still greater contribution from loans economy compared to loans to households. The share of problem loans in the total loans in June dropped to a new low-level so far of 3.26%, indicating that the quality bank assets did not deteriorate even after the termination implementation of state economic assistance measures and that no represents an obstacle to continued credit growth activities.

Import of energy products, primarily due to their growth price on the world market, impacted the growth deficit of the current account of the balance of payments, which is in in the first half of this year amounted to 2.7 billion euros. The import of energy products amounted to 3.1 billion euros and it is higher by 2.1 billion euros compared to the first half of 2021.

High energy imports is the key reason for revision of current deficit in gross domestic product to 9.4%. In the medium term, growth of export capacities, with an expected decrease negative effects of external demand and unfavorable of the exchange rate, should contribute to the gradual reduction of the current account deficit and conservation external sustainability.

Conclusion

Inflation in most countries continues to grow above expectations, which is primarily reflected in the increase in energy and food prices, which was additionally intensified by the outbreak of the conflict in Ukraine. In some countries, inflation growth is influenced by overheated domestic demand and factors from the labor market. In addition, although the costs of international overseas transport are falling, pressures on global inflation continue to stem from disruptions in global supply chains and shortages of certain raw materials in production. Due to such a combination of factors, inflation in many developed countries has reached multi-decade highs in recent months.

In such conditions, central banks and international institutions continue to revise upward inflation projections for the next period. Nevertheless, the majority of central banks and international institutions estimate that in the coming period, a gradual calming down of the situation on the markets of primary products can be expected, which should also result in a gradual slowing down of global inflation. Likewise other central banks, the National Bank of Serbia is focused in adjusting its policy in addressing ongoing challenges.