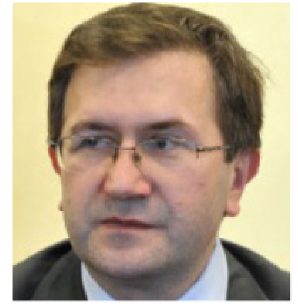
From the editor



Since the beginning of last year, Serbia has significantly reduced inflation, but it still remains above the midpoint of the target range and is somewhat higher than in European countries. In the first eight months of this year, year-on-year inflation in Serbia was 4.9%, while in August it stood at 4.3%. In terms of year-on-year inflation in August, Serbia ranked fifth in Europe — higher inflation was recorded in Turkey, Belgium, Romania, and Iceland. Although inflation this year is significantly lower than at the end of 2022 and the beginning of 2023, its decline has slowed both in Serbia and in Europe. Year-on-year inflation in Serbia decreased from 6.4% in January to 4.3% in August, while in the EU it decreased even more slowly — from 3.1% in January to 2.4% in August. The decline in inflation in most countries this year has not been continuous month by month, as there have been occasional minor accelerations in inflation. For example, in Serbia, inflation in July and August compared to the previous month was 0.4%, representing an acceleration compared to May, which cannot be explained by seasonal factors.

The slowing of inflation's decline as it approaches the target level, known as the "last mile" problem, has sparked a debate over whether this is due to temporary or systemic factors. If it is caused by temporary factors, such as spikes in global market prices, governments might choose to wait for these effects to pass or implement short-term measures, such as price reduction campaigns or administrative price controls. After a sharp increase during 2021 and 2022, the prices of primary products on the global market fell significantly during the first half of 2023 and then continued to decline slightly. This suggests that the slowdown in inflation's decline is not driven by temporary disruptions in the global market.

As a way to reduce inflation and temporarily improve the standard of living, the Serbian government launched a price reduction campaign at the beginning of September, called "Best Price." The campaign involves lowering the prices of 81 essential products, encompassing over 700 items, for a duration of two months. Major retail chains, which operate around 2,500 stores, are participating in the initiative. According to government officials, the agreed-upon price reductions average 27%. This raises questions about how much the campaign will contribute to reducing inflation and improving citizens' standard of living, as well as whether such a campaign is appropriate in a market economy.

The fact that the campaign is limited to two months suggests that its impact on inflation will be temporary, as the prices of most products are likely to increase once the campaign ends. The influence of the campaign on reducing inflation during its duration will be less than what might be expected based on the share of these products in the consumer basket and the agreed price reductions. Due to the relatively large price cuts for the 81 products, retail chains are likely to refrain from offering discounts on other products. Additionally, there is a possibility that they may raise the prices of other items to compensate for lost revenue and profits—this likelihood increases if the campaign is extended. Since the price reduction is not mandatory, some retail chains may not adhere to the agreement, and the probability of this happening will also increase if the campaign is prolonged. Finally, the "Best Price" campaign's effect on inflation will be reduced by the fact that not all retail businesses and stores are participating.

The impact of the campaign on living standards will be temporarily positive, though smaller than expected based on the share of the 81 products in household consumption and the agreed price reductions, for similar reasons that will also limit the campaign's impact on reducing inflation. Another reason the effect on living standards will be reduced is the possibility that the discounted products may not always be available in stores. From the perspective of both the impact on citizens' living standards and issues of fairness and economic inequality, it is relevant that the price reductions will not be available in all stores and locations. It is likely that the discounts will not be available in rural areas, where poorer populations predominantly live. In terms of fairness and economic inequality, it is problematic that the lower prices will be equally available to all citizens, regardless of their income. As a result, the benefit for poorer citizens will be smaller than the losses experienced by retailers and producers, since wealthier citizens will also take advantage of the discounts. By providing targeted cash transfers to poorer citizens, the same results in poverty reduction could be achieved with significantly less money.

Although such campaigns are not part of standard market instruments, they are occasionally used in developed market economies. It is important to note that this is not an administrative price cap but rather an agreement between the government on one side and retailers on the other. To the extent that there may have been pressures, conditions, or similar influences from the state during the negotiations, these measures could resemble administrative forms of price control. Regardless of whether the price reduction is voluntary or imposed, the effects on lowering inflation and improving citizens' living standards are limited in scope and temporary in duration.

As a reason for initiating the price reduction campaign, government representatives publicly claimed that trade margins in Serbia are “unjustifiably high,” citing examples of products whose prices are higher in Serbia than in neighbouring countries and developed nations. While trade margins and profits in retail were relatively high in Serbia last year, this is a temporary cyclical phenomenon present in other sectors and countries as well. Higher prices for certain products in Serbia may result from a lower level of competition due to monopolies and agreements between producers and retailers, or from some form of institutional rent for specific importers or manufacturers. The issue of limiting competition cannot be resolved through negotiated or administrative price reductions, but rather through sanctioning companies that restrict competition by the Commission for Protection of Competition. Meanwhile, the problem of institutional rent should be addressed by sanctioning the politicians and bureaucrats who enable such rents.

Given that the prices of primary products have not increased over the past year and there have been no major disruptions in other markets, the reasons for the slowing decline in inflation are found in systemic factors, such as rising incomes or increasing domestic demand. If inflation is a result of systemic causes, then key roles in reducing it are played by income policy, as well as monetary and fiscal policies.

There is empirical evidence from several European countries that the slowdown in inflation during the second half of 2023 and the beginning of 2024 was influenced by rising labour costs. Relatively high inflation in 2021 and 2022 reduced the real value of wages in most countries. In response to inflation, nominal wages began to rise in 2022, but in that year, they grew more slowly than inflation in most countries. Wage growth during 2023 and early 2024 has been relatively high, even though inflation has significantly decreased, leading to real wages growing faster than productivity. Faster growth of real wages compared to productivity increases business costs, which can reduce profits and/or lead to rising inflation. There is evidence that the increase in labour costs during 2023 and 2024 was partially achieved at the expense of profits, and there was room for such redistribution because profit rates were high in most countries during 2021-2022. In this sense, the redistribution of income from profits to wages over the past two years represents a kind of “compensation” for the reverse process that occurred during 2021-2022. Numerous analyses indicate that labour costs during 2023 and early 2024 have contributed to the slower decline of inflation in the EU. An indirect confirmation of the impact of labour costs on inflation is the faster growth of service prices compared to goods prices. Labor costs in the European Monetary Union have been slowing down in the second quarter of this year, and it is expected that this trend will continue in the second half of this year and into next year, meaning that labour costs in the EU will rise in line with productivity and will not be a driver of inflation in the near future.

In Serbia, real wages experienced modest growth during 2022 and 2023, but productivity growth was even slower, resulting in an increasing share of labour costs in income and prices. This year, because of high nominal wage growth and falling inflation, real wages are expected to see significant growth that exceeds productivity gains, leading to an increased share of labour costs in income and consequently in prices. In the first half of the year, real wages increased by 9.2%, while productivity growth during the same period was 2.5%, which consequently rises share of labour costs in income and therefore creates rising cost pressures on inflation. It can be assumed that part of the wage growth this year in Serbia has come at the expense of profits, alleviating some cost pressures on inflation. The faster rise in service prices, where labour costs have a high share, signals the influence of wages on inflation in Serbia. In August, service prices were up 6.9% compared to the same month the previous year, which is double then 3.5% increase in goods prices. Therefore, for inflation to be reduced to the target level, it is important that real wages grow in line with productivity in the coming years. The state, as the largest employer in the country, should determine wage increases in the public sector for the next year based on expected inflation and productivity growth, sending a crucial signal to the private sector. Any prolonged faster wage growth than productivity would likely result in inflation in Serbia being higher than in the EU. Under a fixed exchange rate regime, this means that prices in Serbia would relatively quickly converge to prices in developed European countries, which is not in line with the country’s level of development. Additionally, aligning real wage growth with productivity is an important instrument for maintaining the competitiveness of the economy, especially considering that Serbia has been effectively following a fixed exchange rate policy for several years.

To reduce inflation to the target level, it is essential for domestic demand to grow in line with economic activity. Aligning the growth of incomes, wages, pensions, and similar factors with economic growth is an important tool for controlling domestic demand. In addition to income growth, it is crucial for the fiscal deficit to remain at a relatively low level. In Serbia’s case, this means that the fiscal deficit in the coming years should be approximately at the level planned by the revised fiscal strategy, around 2.5% of GDP. A significantly larger fiscal deficit would stimulate domestic demand, creating inflationary pressures and impacting the growth of the trade deficit.

Monetary policy plays an important role in aligning the growth of domestic demand with economic activity by influencing credit activity through interest rates and other liquidity control measures. Given the announced significant increases in wages and pensions for the upcoming year, as well as the possibility of a larger fiscal deficit than planned and the presence of global risks that could lead to a spike in energy prices and other primary products, caution is necessary when considering any reduction in the restrictiveness of monetary policy.