

Analysis of the determinants of the current account of the balance of payments of Serbia in the long term

Analiza determinant tekućeg računa platnog bilansa Srbije u dugom roku

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Article info

Review paper/ Pregledni rad

Received/ Rukopis je primljen:

7 February, 2023

Revised/ Korigovan:

14 April, 2023

Accepted/ Prihvaćen:

26 April, 2023

Published online: 16 December, 2025

DOI:

<https://doi.org/10.71159/bizinfo250026M>

UDC/ UDK:

339.5:336.748

Abstract

One of the most complex tasks in conditions of rapid growth and constant structural changes is balancing between internal and external balance. Violation of the external balance is considered justified only if the attracted foreign capital aims to bridge the resource gap by investing in economic development at the expense of future debt repayment. In order to identify the sources of external imbalances, it is necessary to determine the factors that determine the movement of the current account of the balance of payments, which is what these paper deals with. The paper is structured to follow the development and analyze the determinants of Serbia's foreign positions during the period from 2005 to 2021. In addition, the analysis builds on theoretical and empirical achievements with the aim of providing answers to some current questions in this area. The balance of payments as a key indicator of the economic performance of an open economy plays a crucial role in defining the macroeconomic policy of a country. The results of the research will also have a practical dimension because they should show when adjustments are necessary in the management of the country's economic and development policy.

Keywords: current account, balance of payments, foreign trade, macroeconomic policy, external imbalance

Sažetak

Balansiranje između interne i eksterne ravnoteže prouzrokovano brzim rastom i stalnim strukturnim promjenama postaje jedan od najsloženijih zadataka. Eksterna ravnoteža se može opravdano narušiti jedino s ciljem da se privučenim stranim kapitalom premosti resursni gap ulaganjem u privredni razvoj na konto buduće otplate dugova. Da bi izvori spoljnih neravnoteža bili identifikovani potrebno je utvrditi faktore koji određuju kretanje tekućeg računa bilansa plaćanja, čime se bavi ovaj rad. Rad je strukturiran tako da prati razvoj i analizira determinante spoljnih pozicija Srbije u periodu od 2005. do 2021. godine. Pri tome, analiza se nadovezuje na teorijska i empirijska dostignuća sa ciljem da pruži odgovore na neka aktuelna pitanja u ovoj oblasti. U određivanju makroekonomske politike ključnu ulogu ima platni bilans u svojstvu glavnog pokazatelja ekonomskih performansi otvorene privrede jedne zemlje. Rezultati istraživanja treba da ukažu na mogućnosti praktične primene u uslovima neophodnog prilagođavanja u vođenju ekonomske i razvojne politike zemlje.

Ključne reči: tekući račun, platni bilans, spoljna trgovina, makroekonomska politika, spoljna neravnoteža

1. Introduction

It is a generally accepted view that measures to balance the balance of payments should be accepted according to the causes of imbalances. Balance of payments deficits differ from each other in terms of: the causes of their occurrence, the manner of their manifestation, according to the state of the internal economic balance at the time of their occurrence, and their duration (Kovač, 2002;

Behringer & van Treek, 2018). The causes of the imbalance are divided into deficits caused by monetary factors and those arising from structural reasons. The deficit in the way it manifests can have the character of a one-time change in the fund (due to changes in the preferences of security holders in favor of foreign currency, to the detriment of domestic securities) or the character of a flow that appears as a continuous process of aggregate spending greater than the domestic newly

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created value. According to the manner of manifestation, the deficit can be of a short-term character that appears in certain phases of the business cycle process.

The balance of payments imbalance is determined as actual and potential. The actual imbalance of the balance of payments occurs when, in order to eliminate the imbalance, the country carries out balancing by the movement of foreign exchange reserves, i.e. world money, unilateral transfers, or by borrowing abroad through short-term and medium-term loans (Ćirović, 1980.). Potential imbalance is the state of the balance of payments when there is a possibility of creating an external imbalance if the country does not take measures and mechanisms to eliminate it.

Internal or endogenous factors of the balance of payments imbalance are caused by errors in the conduct of the country's economic policy, especially development policy (Babić, 2000; Murai, 2021). Excessive consumption, negative interest rate policy, overvalued exchange rate policy can be classified as endogenous factors. Personal overconsumption predisposes to a deterioration in the trade balance. Low interest rates condition the inflow of capital, the growth of investments, reduced savings and, as a result, a deficit on the current account. If it is about large investment spending, it means low savings at home, and the financing of those savings abroad through a current account deficit. When an economy is reliant on technology and its exchange rate is overvalued due to the import of equipment, external factors such as deteriorating exchange conditions, oil shocks, increased foreign demand for certain products from developing countries, and fluctuations in international interest rates will further strain the capital market along with other economic and political reasons originating from outside factors, as explained by Schuler and Sun (2022).

2. Theoretical and empirical approach to external imbalance

We structure the issue of external balance depending on the economic theories on the subject developed over time. The explanation for the current account deficit varies depending on the prevailing economic conditions, as each theory is specific to a particular economic situation. Among the first theories dealing with equilibrium in the platinum balance is the mercantilist theory. The basic idea of the mercantilist doctrine is based on the accumulation of reserves through a positive trade balance. Levels of external imbalances were very modest during this period, given the official restrictions on international capital movements and the fact that most industrialized countries' currencies were not convertible. In the aftermath of World War II, the amount of foreign capital flowing into most countries was restricted. Hence, the analysis of the current account balance of payments mainly centered around the foreign trade balance, making the impact of global prices critical. Based on this theory, for a sustainable external position, it is necessary to apply the principle of elasticity, i.e., price elasticity and exchange relations of the considered economy. Of course, even today these factors

affect the current account, so they were considered in the first part of the paper.

In the second part of the paper, the key factors that affect the imbalance from the point of view of the Keynesians are considered, i.e., monetary and fiscal policy. Apart from considering the impact of the mentioned policies in Mandel Fleming's model, the twin deficit theory that appeared in the 1980s becomes very relevant last century in an attempt to explain America's then current account deficit. According to Bird et al. (2019), the twin deficits hypothesis suggests that there exists a cause-and-effect relationship between the fiscal deficit and the current account deficit. The correlation between the two deficits remains current (Catik, 2015; Furceri & Zdzienicka, 2018). These scientific studies, especially the first two listed, were created after a period of exceptional fiscal expansion with the aim of changing the structure of expenditures, i.e., aggregate demand is optimized by external balance. In contrast, contemporary theories posit that current account deficits and surpluses are predominantly a consequence of personal choices regarding savings and investments, rather than an active response to external factors. Neoclassical economists view the level of savings and investments as individual decisions, so the microeconomic theory of savings would correspond to the regular theory of global imbalances. The current account balance, as defined, is the outcome of the strategic decisions made by forward-looking individuals and businesses over time. It reflects the disparity between the total savings and investments made by the economy. In practice, this method seeks to compute a current account sequence for the balance of payments that aligns with the optimal long-term consumption plan, as outlined by Shiller (1987). By doing so, the identical variables can then be applied to explicate both the investment and saving choices and the present disparities in trade between nations. Some authors (Engel, 2006, Beirne et al., 2020) prove that expectations of relative growth of the economy can be used to explain the fluctuation of savings and therefore the deficit on the current account. Rational expectations are those that reflect all the information necessary to create decisions for one's model of behavior in the future. If residents expect real GDP growth in the future, the current account deficit should follow that optimistic forecast. Therefore, recent research (Gourinchas, 2014) points out that the current account is becoming less and less a perfect measure of external imbalance (Obstfeld, 2012; Beckmann et al., 2021), especially in developed economies, so they redirect the analysis to the international investment position (which includes the accumulated international assets and liabilities of the country) and apart from of trade, the channel of financial adjustment is introduced.

3. Trade relations of the Serbian economy and the impact on the current account

During the initial stages of a country's opening up to foreign trade, international trade becomes increasingly important. As these changes occur, the trade balance tends to be negative, with the primary challenge being the alignment of the foreign trade exchange structure with

shifts in the global market's demand structure. Exchange rates can influence the current account balance, which is essentially the difference between a country's exports and imports. The exchange rate is the percentage change in the unit value of a country's imports and exports of goods in relation to the US dollar. It is well-established that it is more advantageous for a country's trade relations to export

finished goods and import raw materials and resources. In the case of our country, the Serbian economy would become competitive in the long term with an increase in exchange in the sectors of technologically intensive products.

Figure 1. Coverage of imports by exports 2007-2021 (in millions of euros)



Source: Author according to NBS data

During the entire observed period, a high share of raw materials and semi-finished products was recorded in exports, over 50%, followed by the share of consumer products, and the share of equipment is less than 10%. Also, the structure of exports by product purpose is unfavorable, because mostly products are exported with little added value and for which less money is obtained on the world market, and unfortunately, they exceed half of the total exports. The consumption of foreign goods through imports is significantly influenced by the country's domestic income level. An increase in domestic income would correspondingly lead to a rise in the demand for both local and imported goods, including foreign products. There are also no significant changes in the structure of imports by product purpose for the observed period; the most represented are products for reproduction (a certain percentage of products for reproduction are used, actually in mass consumption) and goods for mass consumption.

The improvement in the coverage of imports by exports was influenced by both improved trade relations and the income shock after the global economic crisis and the corona virus pandemic, as well as an increase in export-oriented investments. A more visible increase in exports occurred at the end of the observed period. Export growth is usually positively correlated with foreign income, foreign direct investment and the real exchange rate (Blanchard, 2022). It is worth considering that the link between Foreign Direct Investment (FDI) and the trade account is uncertain, as investments impact both exports and imports. While FDI supports the expansion of exports and facilitates a decrease in the trade account deficit over time, it can also have a direct adverse effect depending on the equipment imports related to it and the extent of repatriation of profits, as noted by Ghalib (2020). Sometimes FDI can lead a developing country into a poverty trap through export specialization that leads to a

decline in terms of trade, and indications of specialization exist in the Serbian export structure (Habib et al., 2016). FDI can negatively affect exchange relations through transfer prices, both during import and export. Capital flows out of Serbia through transfer prices, and intercompany loans also create a problem. Head offices of foreign companies grant subsidiary companies in Serbia loans that require them to be repaid, instead of giving them additional capital, which would change the structure of FDI. Nevertheless, transnational companies are expected to offer products with a higher degree of processing, thus improving the terms of trade (Wacker, 2014). FDI should lead to greater home purchasing power, but when the marginal propensity to spend on foreign goods is higher, the terms of trade will deteriorate. The marginal propensity of the Serbian economy towards imports is one of the limiting circumstances for increasing income due to the low foreign trade multiplier (Todorović, 2009). According to Mencinger (2008), if the principal reason for a firm's entry into a host country is the availability of inexpensive labor, this is likely to have a favorable impact on the country's trade balance. However, if the objective of the new foreign investments is to gain access to new markets, the outcomes are likely to be negative for the trade balance. One of the direct benefits of FDI is the reinvested earnings that will be reflected in the country's current account (Kose, 2009). In any case, foreign direct investments represent the best option for restructuring the economy towards an export-oriented economy. Their inflow in the future due to low domestic savings is the main factor in the stability of the balance of payments (Marčetić, 2018).

4. The exchange rate's role in determining the trade balance

It is well-established that imports and exports are influenced by the real exchange rate. An increase in the

value of the exchange rate can result in reduced export production, but also in a drop in the cost of imported capital. In addition, on the other hand, the appreciated exchange rate improves foreign currency balances and thus relaxes capital lending (Cuestas & Regis 2016). The subsequent discourse will investigate whether the appreciated exchange rate is solely responsible for the external imbalance and whether devaluation of the exchange rate would be the most effective approach to reducing the imbalance. For the trade balance to improve, the value of exports in domestic currency should surpass the percentage of actual depreciation, which would be true if the elasticity of exports exceeds unity. Also, there should be substitution domestic production of imported products, where the curves of export supply and import demand have a higher slope of elasticity than the curves of domestic demand and supply. Therefore, depreciation is successful if the value of production is greater than the value of total demand or absorption. The Serbian economy failed to direct absorption from imported to domestic products during the entire observed period, so a depreciated exchange rate would worsen the internal balance by making imports more expensive. In this regard, exports, as a rule, are not a growing amount of either income or depreciation in foreign currency if the export capacity of the economy and its competitiveness on the world market cannot meet the demands of customers, etc. Only in countries with strong price competition that have comparative advantages in exports, depreciation can play the role of strengthening the export position. Nonetheless, countries that have inelastic imports in their import sector, and whose export surplus is founded on primary products, face a situation where devaluation does not produce the anticipated effects. Moreover, if we factor in that the supply of inputs is reliant on imports, devaluation-induced increases in import prices can create additional cost pressures (Grubišić & Marčetić, 2013a).

Looking back at another characteristic of our economy - the strong position of the import lobby, it can be expected that importers will be ready to give up a part of the margin in order to maintain profits and positioning on the market. And as a last argument against, it would be that in our highly euroized economy, exchange rate changes would affect the creditworthiness of clients and the state of indebtedness (Harkmann, & Staehr, 2021).

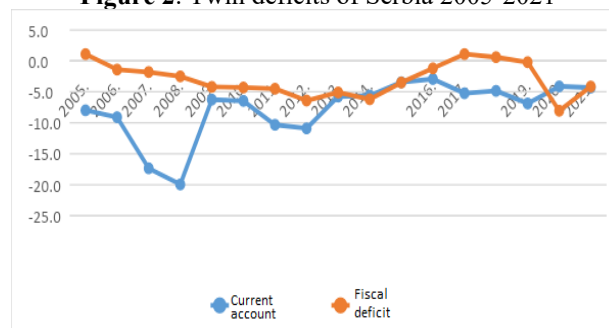
According to the study we referenced in the paper (Tasić, 2008), exports are more responsive to changes in global demand than to changes in the real effective export exchange rate over the long term. In addition, imports are even less sensitive to the real exchange rate and are mainly influenced by pension and salary funds over the long term. Furthermore, imports exhibit minimal sensitivity to changes in the real effective import exchange rate and domestic production over the long term. Due to the high marginal propensity to import, the effect of depreciation would level off already in the second interaction due to the effect of the effect of the foreign trade multiplier. In the end, it was underlined that the exchange rate policy should not be sacrificed for the sake of promoting exports because it will not bring the expected results in the long term (Marčetić, 2012).

5. The effect of fiscal policy on the external imbalance

During the post-war period, initial Keynesian studies concentrated on the function of fiscal and monetary policies in achieving a state of external balance. In order to consider the theoretical basis of these deficits, it is necessary to pay special attention to two transmission channels that are traditionally in the debate, namely the static and intertemporal channels. The current account can be indirectly affected by the fiscal deficit in two ways. Fiscal expansion affects the rise of interest rates, which stimulates the inflow of capital and thus appreciates the domestic currency, causing reduced competitiveness of the economy. Another danger from constant fiscal deficits is the loss of confidence among investors and the decline of investments in government bonds, as well as the withdrawal of short-term capital (Bussiere, 2005). In a simple intertemporal model, fiscal expansion, which was not caused by tax reductions but by increased government spending, reduces the resources with which the private sector can initiate an external deficit (Grubišić and Marčetić, 2013b). Consumers borrow in the international market to smooth consumption between disposable income and fixed income against wage fluctuations. A dynamic argument prevails here, which initiates a response to endogenous changes in the intertemporal price of consumption through savings and investment decisions (Schnabl, 2018).

One of the current economic topics is the identification and definition of the concept and phenomenon of the twin deficit. The twin deficit can be defined as the positive long-term relationship between the budget deficit and the current account deficit of a country's balance of payments, along with some other factors (Thomson, 2021). The graph below illustrates the trend of twin deficits in Serbia over the long term. In conclusion, it can be inferred that fiscal benefits had little impact on the creation of a current account deficit.

Figure 2. Twin deficits of Serbia 2005-2021



Source: Author according to NBS data

The results of studies on twin deficits are often divergent, but this does not exclude their common cyclical dynamics (Corsetti, 2005). The transmission of the budget deficit is primarily determined by the openness of the economy and the duration of fiscal shocks. A longer period of time with a more closed economy leads to a greater crowding-out effect on investment and a deterioration of the current account for a given repetition of a fiscal shock. However, if there is reduced liquidity or unemployment with

potential output expansion, the crowding-out effect may be avoided. The business cycle can also contribute to the transmission effects of the fiscal deficit on the current account deficit (Kimb, 2007). Empirical findings have suggested that the budget deficit can have short-term effects of improving the current account deficit and depressing the exchange rate. An IMF study by Kumhof (2009) investigates the potential implications of the current account on permanent fiscal stimuli not only in the short term but also in the medium and long-term using a suitable fiscal-monetary model. However, it may take several decades to detect the effects of changes in the fiscal deficit due to the capital flow dynamics. The results show that a permanent 1% of GDP increase in the fiscal deficit, without a fiscal deficit in the rest of the world, leads to a current account deficit of 0.5% in the short term, 0.75% in the long term for countries similar in size to the USA, and 1% for smaller economies.

6. The impact of monetary policy on external imbalance

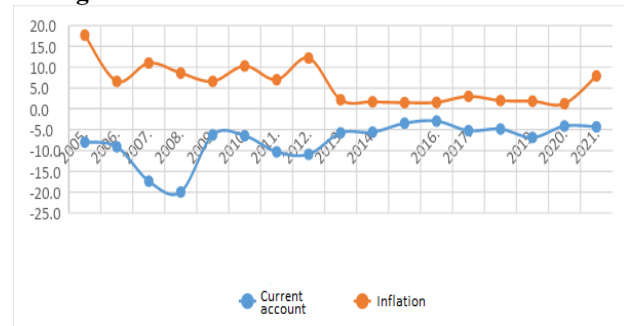
Distinguishing between the real and monetary factors of the balance of payments imbalance can be challenging, particularly when considering that any deficit is ultimately expressed as a monetary phenomenon. The balance of payments cannot be balanced without the implementation of the monetary mechanism, except in cases of long-term structural imbalances where resource and production relocation policies are required. Additionally, the pursuit of full employment through monetary and fiscal policies may hinder the automatic balancing mechanism of the balance of payments, resulting in a further deterioration of the deficit. The monetary approach views the deficit as a surplus of domestic money flowing abroad, while the monetary model posits that the current account deficit is entirely offset by the inflow of foreign private capital. This would be achieved if there were no restrictions on the degree of indebtedness. Another objection would be that the monetary approach ignores the real factors of the balance of payments, but also views the deficit as short-term and necessary.

The monetary cause of the balance of payments imbalance arises when accelerated economic growth is accompanied by the appearance of inflation. A country will face balance of payments difficulties if prices rise faster in one country than in another. If a country's growth is driven by productivity gains, the country's general price level should decrease relative to slower-growing countries, which could improve the balance of payments (assuming the sum of price elasticities is greater than one). From these points, it can be inferred that inflation complicates the balance of payments adjustment process. Furthermore, significant fluctuations in exchange rates can impact the prices of necessary imported inputs used in the production process, leading to "cost-push" inflation and reducing aggregate supply and economic activity.

In the period of choice between exchange rate depreciation and low inflation, the trade off in Serbia was low inflation. In transition economies, it is mostly a choice, because the current account deficit is considered part of the

fundamental changes (Cuestas, 2013). A different choice would probably, due to the high inflationary expectations of market participants, trigger an increase in wages and prices (through the action of the Pazos-Simonsen mechanism), increase demands for higher compensation for savings deposits, which as a result leads to higher long-term interest rates and a slowdown in growth. The following graph shows the movement of the inflation curve and the current account deficit curve.

Figure 3. Inflation and current account 2005-2021



Source: Author according to NBS data

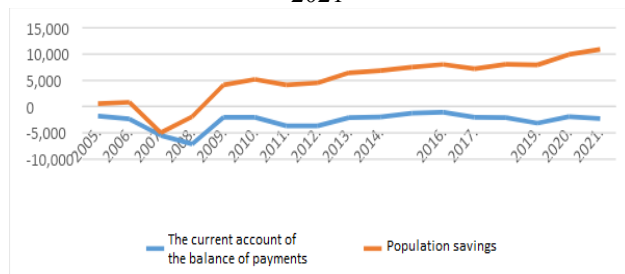
The factors that influence inflation growth, such as the expansion of aggregate demand, also impact the variation of the current account deficit. The growth in demand can be caused by an increase in the level of production above the trend or a high influx of foreign capital. In Serbia, the expansion of aggregate demand was driven to a lesser extent by fiscal expansion and more so by the high influx of foreign capital. Namely, the population in Serbia can be considered a generator of inflation due to a larger item on the expenditure side instead of on the income side (increase in health and pension insurance costs, etc.). Fiscal consolidation led to a contraction of fiscal benefits. In the greater part of the second observed period, inflation was within stable limits. Several factors can be cited as the causes of inflation in Serbia. The generator of inflation in Serbia is still insufficient production because the growth model is based on the growth of domestic consumption, primarily of the public sector and the population, and not investment in the production (productive) sectors and exports, which is a ballast for the current account as well. Based on a panel study (Petrović, 2008), the current exchange rate, political elections, etc., are the triggers of inflationary episodes in Serbia, in addition to the above. The increase in prices of industrial-food products was one of the causes of inflation growth during the entire period, but in 2021, the energy factor appears and contributes to its growth (Adžić, 2008). Therefore, the anti-inflationary policy cannot be conducted independently of the development policy of increasing production activity, as well as expanding the investment base. A more permanent elimination of cyclical inflationary shocks can be achieved by means of an active exchange rate policy, so that every nominal change leads to a real change. By implementing an economic policy that promotes production and exports, the current balance can be improved. This policy must be accompanied by a disciplined fiscal and income policy. However, fiscal and monetary policies may not always lead to significant adjustments and may only correct the balance of payments. This correction can be considered

equivalent to financing. To completely eliminate the deficit, there must be a reallocation of resources in the national economy, changes in the production structure and cost scales, and changes in import and export structures. Ultimately, a long-term development policy that is meaningful can have positive effects on the balance of payments in the long run.

7. Intertemporal current account models

The theory of intertemporal adjustment of consumption explains higher private consumption than private savings in the initial phase of the transition, at the expense of expected future growth (Coleman & Cuestas, 2023). Households believe that they will be able to compensate for current consumption based on the future expected growth of income in the period when the economic situation stabilizes (Boljanić, 2017; Kilian & Stähler, 2020). Aguiar and Gopinath (2004) believe that subjects in economically developed countries and in transition countries react differently to sudden economic growth. When developed countries achieve economic growth, subjects perceive this as a positive change in transitory income and therefore raise the level of savings, which is in accordance with the intertemporal theory of consumption adjustment (Ghassan, 2016). However, when economic growth occurs in transition countries, subjects do not perceive it as a transition shock, but as an indication that long-term economic growth is likely to occur and therefore raise their level of consumption (Olczyk & Kordalsk 2018). In both cases, subjects tend to adjust their spending over time, but the key difference is how subjects interpret recent growth and how they form expectations about long-term economic growth. This theory explains higher private consumption than private savings in the initial phase of the transition in Serbia. Namely, after 2000, the population's expectations regarding growth and development increased, expecting a rapid increase in standards.

Figure 4. Household savings and current account 2005-2021



Source: Author according to NBS data

It can be noted that savings have a more or less permanent flow, despite the slight increase in income, as well as that it does not represent a sufficient shock absorber for the growing deficit. Increasing domestic savings for developing countries is as important in the development process as their ability to attract foreign capital. Foreign funds intended for financing have no interest in taking into account the development needs of the state. The ability to increase domestic savings and the rate of economic

growth is contingent upon the government's willingness to implement appropriate measures to address developmental challenges. Encouraging domestic savings through a well-crafted macroeconomic policy for economic growth can result in a favorable long-term trend on the current account.

8. Conclusion

Fundamental development needs are the primary reason for the observed current account deficit during the period. The imbalance also has the property of a flow that manifests itself as a continuous process of aggregate spending greater than the domestic newly created value. To a large extent, external imbalances in transition countries are the result of internal macroeconomic imbalances as well as real factors. As the economy grows, domestic demand outstrips domestic product, resulting in an expansion of the current account deficit. Additionally, the high aggregate demand at the start of the observed period led to an increase in inflation. At the same time, a stable connection between this monetary phenomenon and the current account deficit can be clearly observed. Pronounced consumerism stimulated by strong credit policy certainly influenced the growing deficit in the initial phase, but fiscal adjustment meant that the twin deficits had no significant comparative relationship.

Overall, we can consider the deficit as a consequence of inconsistency with the strategic goals of development. In the effort and forcing of the economy towards openness with the aim of increasing exports, there was an explosive growth of all types of consumption. As a result of this redistribution of the social product, there was a lag in the growth of accumulation and savings, which further negatively affected the current account. During the initial years of the observed period, the expansion of the financial market led to an increase in available sources of financing, which in turn stimulated investment growth. However, this also contributed to a further deterioration of the current account balance due to high import dependence. On the other hand, the high import dependence of the economy caused the creation of structural disproportions and led to the inelastic response of import demand to changes in relative prices that would be induced by eventual depreciation. Furthermore, in addition to the aforementioned reasons, a long-term factor contributing to the trade balance deficit is the lack of competitiveness in exports. This is due to the traditional production structure not aligning with global import demands. In addition, Serbia could face an additional worsening of the current deficit due to extremely high energy prices and a drop in external demand.

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