From the Editor

The decline in inflation, moderate economic recovery, and reduction of the trade deficit are the most important trends in the Serbian economy during 2023. The fundamental trends are similar to those in European countries, with the distinction that inflation in Serbia is higher, but GDP growth is faster. The performance of the Serbian economy in the coming year will depend on developments in the international environment, domestic economic policy (especially fiscal and monetary policies), and the institutional environment in which the economy operates. In the coming year, a continued decline in inflation is expected, along with a somewhat faster growth in economic activity, a slight improvement in the labour market, and a moderate increase in external deficits.

The forecasts for economic trends in the coming year are highly uncertain due to current geopolitical conflicts, which strongly impact the economy and for which it is currently impossible to reliably predict whether they will move towards resolution or further escalation. A potential high rise in global prices of energy and other primary products, as a result of the intensification of geopolitical conflicts, would create new inflationary pressure, slow down the economic recovery, and worsen Serbia's balance of payments position. The uncertain pace of recovery of major European economies, such as Germany and Italy, with which Serbia is strongly connected through trade and capital flows, also complicates the forecast of economic movements in Serbia. Besides risks, there are positive factors, such as the faster-than-expected decrease in inflation in Europe. If the reduction in inflation continues in the next few months, the ECB and the Fed are likely to start reducing interest rates earlier than planned. A reduction in global interest rates would stimulate global demand, thereby facilitating Serbian exports, reducing borrowing costs, and encouraging foreign investments, which would accelerate Serbia's economic recovery.

The overall fiscal framework for the upcoming year is solidly established. The planned fiscal deficit of 2.2% of GDP is appropriate given Serbia's relatively high public debt, which is the result of the highly expansionary fiscal policy implemented since 2020. Achieving the planned deficit, assuming that forecasts for GDP growth, inflation, and exchange rates are approximately met, would enable a slight reduction in the share of public debt in GDP. Halting the growth of public debt relative to GDP is crucial, as interest rates in the coming years will be high, meaning that the costs of financing the public debt will increase even at the existing debt-to-GDP ratio. Of course, from the perspective of fiscal sustainability, it would be better if the fiscal deficit for the next year was smaller, and an opportunity for its reduction will arise during the budget revision following the formation of the new government.

The main focus of fiscal policy in the coming years, in addition to continuing the reduction of the fiscal deficit, should be on enhancing its fairness and efficiency. For improving fairness, it is crucial to further increase the progressivity of personal income taxation, increase expenditures for social assistance, and introduce social pensions for elderly individuals without income. Creating conditions for rapid economic growth and gradual catching up with countries in Central and Western Europe requires an increase in productive expenditures as a share of GDP. Serbia has significantly increased public investments in recent years, but catching up with developed countries presumes increased investments in education and scientific and technological research. Numerous studies show that state efficiency in Serbia is low. Public investments typically face delays, the costs of their realization are higher than similar projects in other countries, and the results of students in primary schools on PISA tests are significantly weaker than in Central European countries, with no signs of improvement for over a decade (see Highlights 1). Despite increased investments in healthcare, the overall results of the health system are weak – Serbia was among the top countries in the world in terms of increased mortality during the COVID-19 pandemic relative to its population. Low efficiency is also present in performing other state functions, such as the judiciary, general state services, etc. To achieve a high level of development, in addition to fiscal sustainability, which is ensured by a low fiscal deficit, significantly higher state efficiency is necessary.

We expect that the National Bank of Serbia (NBS) will continue to implement restrictive monetary policy in the coming months to bring inflation within the target range. Maintaining interest rates at the current high level for the next few months is necessary because inflation in Serbia was the highest in Europe in November (see section on Prices and Exchange Rates). An additional reason to maintain restrictive monetary policy is that core inflation, which reflects the impact of systemic factors (fiscal and monetary policies, wage movements, etc.), remains high. Prematurely reducing the restrictiveness of monetary policy could result in slower reduction of inflation, which is macroeconomically undesirable.

Institutions crucially determine the pace of economic growth of countries over a longer period. According to the quality of institutions, Serbia, along with the countries of the Western Balkans, ranks at the bottom of European countries. An additional unfavourable circumstance is that the quality of institutions in Serbia, according to most indicators (rule of law, corruption, etc.), has been deteriorating over the past years. With the existing quality of institutions, Serbia cannot hope to catch up with the countries of Central Europe and Western countries in terms of development level. Therefore, improving the quality of institutions (strengthening the rule of law, combating corruption, enhancing the quality of public administration, etc.) is a necessary condition for Serbia's long-term economic progress.

It is estimated that GDP growth in Serbia in 2023 will be around 2.3-2.4%, which is similar to the previous year's growth rate of 2.5%. However, an important difference is that last year's growth was achieved with a decline in economic activity within the year, while this year's growth has been achieved with an increase in economic activity. The growth of economic activity this year has been significantly aided by one-off factors, such as the recovery of agriculture from last year's drought, strong growth in electricity production due to the resolution of problems in EPS and exceptionally favourable hydrological conditions, and high growth in construction. It is estimated that the cumulative impact of these one-off factors on economic growth this year amounted to about 1 percentage point, meaning that without them, economic growth would have been around 1.5%.

For the next year, we forecast economic activity growth of about 3%, which represents a relatively small increase compared to this year's growth, but this increase is significant considering that in 2024 we cannot rely on the one-off factors that were present this year. The acceleration of GDP growth next year will be influenced by the rise in real incomes due to falling inflation and the expected mild recovery of European economies, while high interest rates will have a slowing effect on economic growth.

Since March of this year, inflation in Serbia has been on a continuous downward trajectory, due to the combined impact of domestic and international factors. Among domestic factors, the crucial impact on reducing inflation came from the restrictive monetary policy, which influenced the decline in credit activity and the alignment of domestic demand with supply. The practically fixed exchange rate of the dinar against the euro and the stagnation of nominal wages in the past part of the year have helped eliminate cost factors of inflation. It is expected that the average inflation rate in Serbia this year will be around 12.4%, which is the third highest in Europe (behind Hungary and Turkey). The above-average inflation in Serbia is a consequence of overly expansionary fiscal policy over the past two to three years, the delay in implementing restrictive monetary policy, and the increase in energy prices this year. For the next year, we expected that inflation will be more than halved and will be less than 5%, with a declining trend throughout the year, so it is expected to enter the target range of the NBS in the second half of the next year. Inflation can be higher than the stated level if new significant increase in the prices of energy and other primary products on the global market occurs, or if monetary and fiscal policies happen to be more expansionary than announced.

In the labour market this year, observed as a whole, there have been no significant changes. The unemployment rate in the first three quarters averaged 9.6%, identical to the same period last year. The unemployment rate within the year varies due to seasonal factors, without showing a clear upward or downward trend. Real wages increased by 1% in the first three quarters, with the year-on-year growth of real wages increasing from quarter to quarter, as a result of relatively stable nominal wages and decreasing inflation. For the next year, a slight improvement in the labour market is expected, which will be realized through a decrease in the unemployment rate and growth in real wages. The unemployment rate is expected to be below 9% next year, with the main drivers of the decrease being an increase in employment and a reduction in the workforce due to negative natural population growth. The significant labour shortage in Germany, despite the uncertain recovery of the German economy, is one of the factors that will contribute to reduced unemployment and increased wages in Serbia next year. We predict that real wage growth next year will be between 3-4%, which is above the expected growth in economic activity and productivity. Wage growth next year will be influenced by a significant increase in the minimum wage as well as a relatively high increase in public sector wages.

During the past part of the year, there has been a significant improvement in the indicators of external economic relations. The current account deficit in the first three quarters of this year was only 1.6% of GDP, compared to 7.8% of GDP in the same period last year. The reduction in the current account deficit is a result of the decrease in the trade deficit in goods and services from 13.5% of GDP in the first three quarters of last year to 4.8% of GDP in the same period this year. The reduction in the trade and current account deficits compared to last year is largely due to the resolution of issues in the energy sector, as well as improvements in the ratio of export to import prices on the global market. In addition to these one-time and cyclical factors, the decrease in external deficits partially reflects the improvement in the competitiveness of the Serbian economy and the gradual increase in domestic savings. It is estimated that the current account deficit in 2023 will amount to between 2 and 2.5% of GDP, which will be the smallest deficit in the last 15 years. For the next year, we expect a moderate increase in the current account deficit to about 3% of GDP, due to the real strengthening of the dinar as well as the rise in unit labour costs. Any deterioration in the terms of trade, due to rising energy prices, would result in a stronger increase in the current account deficit.