Exchange Rate Arrangements and Monetary Policy in Southeastern Europe: An Update (2004–2007)

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This contribution updates a study published in 2004. Four of the ten countries analyzed (Bosnia and Herzegovina, Bulgaria, Croatia and the Republic of Macedonia) continue to feature hard pegs and nominal exchange rate anchors to the euro, while four others (Albania, Romania, Serbia and Turkey) conduct loosely managed floats, and – with the exception of Albania – introduced inflation targeting in 2005 or 2006. One country (Montenegro) and one nonsovereign territory (Kosovo) remain unilaterally euroized. Although all countries have upheld prudent monetary policies supported by strengthened fiscal positions, disinflation has slowed down in recent years. Recent upticks of inflation have been triggered by rising wage pressures, accelerating credit booms, food price spikes caused by extreme weather conditions, and increases in oil prices, utility tariffs and indirect taxes (with some of the latter being one-off factors). While the anti-inflationary effectiveness of pegs continues to be satisfactory overall, the comparatively brief experience with inflation targeting has already delivered good results in some cases. In other cases it may yet be too early to judge. The impact of capital flows on monetary policy has been on the rise, creating new challenges, and triggering repercussions (in both ways) for inflation rates.

1 Introduction

The main purpose of this paper is to summarize, analyze and compare the evolution of exchange rate regimes and monetary policy developments in ten Southeastern European countries[2] – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, the Republic of Macedonia,[3] Montenegro, Romania, Serbia, and Turkey – from 2004 to 2007. The article, an update of a study published in 2004 (Barisitz, 2004), is structured as follows: Section 2 presents a descriptive outline of the monetary policy frameworks in the region over the observation period. Section 3 deals with the individual countries' economic performance as well as their monetary and exchange rate aims, policies, instruments, issues and outcomes. Section 4 summarizes and compares the main results of the preceding sections and draws some overall conclusions.

2 Exchange Rate Regimes and Monetary Policy Frameworks in the Region: A Concise Overview of Developments from 2004 to 2007

De jure and/or de facto, the euro has continued to play an important role for the economies and economic policies of Southeastern European countries. Six of the ten countries under review use the euro as an external anchor for

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[2] *Not all of them are independent countries at present, but they are all separately administered currency areas. Thus, for the sake of simplicity, the author chooses to call Kosovo (Kosova in Albanian) a "country" in this contribution. He is, of course, aware that Kosovo is a UN-administered province of Serbia, and therefore a nonsovereign territory according to international law.*

[3] *The former Yugoslav Republic of Macedonia (FYROM) will be referred to as Republic of Macedonia in this contribution.*

monetary policy (see table 1). Two of these six countries (Bosnia and Herzegovina, Bulgaria) run currency boards; two others (Montenegro, Kosovo) have adopted the euro as their legal tender; one (the Republic of Macedonia) has pegged its currency to the euro; and one (Croatia) conducts a tightly managed float using the euro as reference currency.

The four other countries (Albania, Romania, Serbia, Turkey) have practiced managed or loosely managed floats coupled with money growth targeting; most recently (in 2005 and 2006) all of them except Albania opted for inflation targeting frameworks (see table 1). In early 2005, Romania chose to use the euro as the sole reference currency, replacing a reference basket in which the euro had the largest weight. In August 2005, it opted for inflation targeting and loosened its managed float. Serbia – which had abandoned its tightly managed float and introduced a euro-oriented "real exchange rate anchor" in 2003 – further loosened its float in February 2006 in preparation for implementing informal inflation targeting through "inflation objectives" in September 2006. Turkey also adopted an inflation targeting regime in January 2006. Albania continued to stick to money growth targets coupled with informal inflation goals, but it plans to move to formal inflation targeting soon.

Table 1

Southeastern European Countries' Monetary Characteristics (since 2004)

Country	Currency	Exchange Rate Regime (since); previous	Monetary Policy Framework (since); previous
Albania	Albanian lek (ALL)	Loosely managed float	Informal inflation targeting through money growth targeting
Bosnia and Herzegovina	Konvertibilna marka (BAM)	Currency board, peg to EUR	Nominal exchange rate anchor EUR
Bulgaria	Bulgarian lev (BGN)	Currency board, peg to EUR	Nominal exchange rate anchor EUR
Croatia	Croatian kuna (HRK)	Tightly managed float, reference currency: EUR	Nominal exchange rate anchor
Kosovo (Kosova)	All foreign currencies legalized for transactions, EUR predominant, RSD used regionally		EUR = legal tender
Republic of Macedonia	Macedonian denar (MKD)	De facto peg to EUR	Nominal exchange rate anchor EUR
Montenegro	Unilaterally euroized/EUR		EUR = legal tender
Romania	Romanian leu (RON, redenominated in July 2005)	Loosely managed float (August 2005); managed float. Reference currency EUR (early 2005), previously: reference basket: EUR (75%), USD (25%) (early 2004)	Inflation targeting (August 2005); money growth targeting
Serbia (without Kosovo)	Serbian dinar (RSD); previously called Yugoslav dinar (YUM)	Loosely managed float (February 2006); managed float	Informal inflation targeting through "inflation objectives" (September 2006); real exchange rate anchor (January 2003)
Turkey	Turkish lira (TRY, redenominated in January 2005)	Loosely managed float	Inflation targeting (January 2006); money growth targeting, informal inflation targeting

Source: author's own compilation.

3 Economic Developments from 2004 to 2007 and Current Monetary Policy Issues by Country

3.1 Albania

Macrostructural Background

In the period from 2004 to 2007, economic growth remained robust at 5% to 6% per annum on average. At the same time, the economy remains highly dependent on remittances (which contributed over 15% to GDP in 2006). Despite some progress in reducing administrative barriers to investment and enterprise creation, the business climate continues to be feeble, and governance and the rule of law are still insufficient. The economy is plagued by harmful power cuts and other infrastructure shortcomings, which are pushing up imports and containing growth. While the country's current account deficits remain relatively high, budgetary policies have been tightened somewhat in recent years. Net FDI inflows have lately covered more than one-half of the external disequilibria (see table 2)[4] and promise to be buoyed in 2007 by the sale of Albtelekom.

Table 2

Albania: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	6.2	5.6	5.0	6.0
General government budget balance (incl. grants, % of GDP)	−5.1	−3.6	−3.2	−3.9
Current account balance (incl. official transfers, % of GDP)	−3.9	−6.5	−5.9	−7.4
Net FDI inflows (% of GDP)	4.6	3.3	3.6	4.0
Gross foreign debt (year-end, % of GDP)	20.4	20.5	19.9	19.8
Gross reserves of central bank (incl. gold, year-end, % of GDP)	17.1	18.1	18.7	19.2
Repo rate (end-year, %)	5.3	5.0	5.5	..
Broad money growth (year-end, %)	13.5	13.9	16.3	16.3
Private credit growth (year-end, %)	36.9	73.6	57.2	43.4
CPI inflation (year-end, %)	**2.2**	**2.0**	**2.5**	**2.9**
Exchange rate ALL/EUR (annual average)	127.7	124.2	123.1	..
Exchange rate ALL/USD (annual average)	102.8	99.9	98.1	..

[1] Forecasts or projections.

Source: National statistics, Banka e Shqipërisë, IMF, wiiw, EBRD, European Commission.

Monetary Policy

Banka e Shqipërisë (BS, Bank of Albania) has pursued a cautious monetary policy in recent years, using informal inflation targeting based on money growth targeting. This strategy continued to be remarkably successful (compared with Albania's regional peers) in keeping inflation at low one-digit levels. By controlling M3 money supply (intermediate objective), the BS committed to keeping year-end inflation measured by the CPI within a

[4] *However, not all of foreign direct investment is equity-based, or non-debt-creating. According to expert estimates, on the average about one-quarter of FDI in Southeastern European countries consists of credits and other debt-creating instruments, which therefore add to external liabilities. Yet data clearly separating debt- and non-debt-creating FDI are not always easy to procure. Moreover, FDI – of whichever type – is generally assumed to go to productive uses, which should enhance the future competitiveness of a country's economy and its capacity to earn foreign exchange. Therefore, comparing total FDI inflows with current account deficits, in the author's opinion, still makes sense.*

fluctuation band of ±1% around 3% in 2003. Recently, price increases have tended to be nearer to, or at, the lower end of this band (end-2006: 2.5%, July 2007: 2.1%, see also table 2). Most recently though – in August 2007 – inflation exceeded the upper band limit for the first time with a sharp one-off uptick to 4.2% (year-end). Repo[5] and reverse repo rates remain the main operative policy instrument. In response to the inflationary pressures that emerged in 2006 and have lasted to date (triggered by a gathering credit boom, rising oil and electricity prices, excise tax adjustments and drought-induced food price spikes, which were particularly strong in the summer of 2007), the monetary authorities raised the key interest rate on four occasions by 25 basis points each time (July and November 2006, June and September 2007). In mid-October 2007, the repo rate stood at 6%. Thus, the interest rate differential with the ECB, which had been declining, was restored.

Furthermore, in an effort to keep the credit boom under control, prudential regulations and banking supervision were strengthened in December 2006 and January 2007. In particular, capital requirements were raised for credit institutions with rapidly rising loan volumes. Banka e Shqipërisë has maintained a loosely managed float for the Albanian lek, which appreciated in 2004 and 2005 and has since remained largely stable against the euro in nominal terms. To the extent that the inflation goal is reached, preserving the competitiveness of the country's exports is a secondary goal of the monetary authority. The BS intends to gradually adjust its strategy toward a formal inflation targeting regime with the aim of enhancing the transparency and credibility of its monetary policies.

3.2 Bosnia and Herzegovina

Macrostructural Background

Notwithstanding substantial post-war reconstruction assistance, the country has made only limited progress in building viable and competitive export-oriented capacities. The economy continues to be based largely on raw materials, mining and related manufacturing. Even though external assistance has been reduced gradually, economic growth has remained robust at around 6% in recent years (see table 3). This may be attributable to the strong rise in metal and other resource prices. Foreign direct investment still falls far short of offsetting the huge and persistent current account deficit, but the privatization of Telekom Srpska and more greenfield investment are expected to narrow the financing gap in 2007. Corporate governance is poor, even compared with neighboring countries. The persisting fragility and fragmentation of state authority further complicate structural reform efforts.

Monetary Policy

Fiscal as well as monetary policies have been prudent in recent years; in particular the currency board regime (euro peg) has become a stabilizing anchor for price developments and the economy. Foreign exchange reserves

[5] *A repo (repurchase agreement) is an instrument that central banks use to temporarily reduce banking system liquidity by selling treasury bills or other debt securities of high credibility and repurchasing them shortly thereafter. In a reverse repo, the transaction is carried out in the reverse order with the aim of temporarily increasing liquidity (Bank of Albania 2007, p. 11).*

Table 3

Bosnia and Herzegovina: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	6.0	5.5	6.2	6.2
General government budget balance (% of GDP)	–0.6	2.4	3.0	1.2
Current account balance (% of GDP)	–19.2	–21.3	–11.4	–12.5
Net FDI inflows (% of GDP)	6.5	6.6	6.3	9.0
Gross foreign debt (year-end, % of GDP)	54.8	55.4	54.0	..
Gross reserves of central bank (excl. gold, year-end, % of GDP)	23.5	26.6	30.1	32.4
Broad money growth (year-end, %)	24.3	18.2	24.7	21.0
Domestic credit growth (year-end, %)	18.0	27.6	20.6	22.0
RPI inflation (year-end, %): Federation of BiH	**–0.3**	**4.4**	**6.6**	..
RPI inflation (year-end, %): Republika Srpska	**1.9**	**4.1**	**4.7**	..
Exchange rate: BAM/EUR (annual average)	1.96	1.96	1.96	1.96
Exchange rate: BAM/USD (annual average)	1.58	1.57	1.56	..

[1] *Forecasts or projections.*

Source: National statistics, Centralna banka Bosne i Herzegovine, IMF, wiiw, EBRD, European Commission.

have been on the rise, reaching a value that corresponds to around five months of goods and services imports at end-2006. Managing banks' reserve requirements is the only important monetary policy tool currently at the disposal of Centralna banka Bosne i Hercegovine (CBBH, Central Bank of Bosnia and Herzegovina).

While inflation remained subdued through 2004, continued brisk loan growth as well as the surge in oil and administered prices appear to have made an impact on inflation from 2005 onward. The total credit volume attained a level of 46% of GDP at end-2006, which is second only to Croatia in the entire region. To stem the pace of credit expansion and inflationary pressures, the CBBH raised banks' reserve requirements several times during the observation period, namely in September 2004 from 5% to 7.5%, in December 2004 to 10%, and in December 2005 to 15% of liabilities. At end-2005, RPI inflation came to 4.4% in the Muslim-Croat Federation and to 4.1% in the Republika Srpska. In 2006, the average RPI almost doubled following the introduction of a 17% value-added tax (VAT) at the beginning of the year, with the end-2006 inflation figures climbing to 6.6% in the Federation and to 4.7% in the Republika (table 3). In the first months of 2007, as the VAT effects wore off, the two figures declined sharply, coming to 1.6% (year on year) in August in both entities. This underlines the tendency of price changes to converge across Bosnia and Herzegovina, notwithstanding considerable differences between regional economic structures.

3.3 Bulgaria

Macrostructural Background

The Bulgarian economy has witnessed overall favorable macroeconomic developments in recent years. GDP has expanded on average by around 6%, and may now (mid-October 2007) be showing signs of overheating. The persistently high current account deficit widened sharply in 2005 and 2006 (into double digits). Net FDI inflows have also been substantial and have so far kept up with the current account shortfalls, to which they have largely

Table 4

Bulgaria: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	6.6	6.2	6.1	6.2
General government budget balance (% of GDP)	1.8	3.2	3.7	4.0
Current account balance (% of GDP)	−5.8	−12.0	−15.8	−18.8
Net FDI inflows (% of GDP)	7.9	14.4	15.9	16.9
Gross foreign debt (year-end, % of GDP)	63.8	69.0	78.4	..
Gross reserves of central bank (excl. gold, year-end, % of GDP)	32.5	31.2	33.2	..
Base rate (year-end, %)	2.4	2.1	3.3	..
Broad money growth (year-end, %)	23.3	24.4	26.8	..
Domestic credit growth (year-end, %)	33.3	35.1	17.1	..
CPI inflation (year-end, %)	**4.0**	**6.6**	**6.5**	**7.5**
Exchange rate: BGN/EUR (annual average)	1.96	1.96	1.96	1.96
Exchange rate: BGN/USD (annual average)	1.58	1.57	1.56	..

[1] *Forecasts or projections.*

Source: National statistics, Bălgarska narodna banka, IMF, wiiw, EBRD.

contributed. However, this expansion has reached dimensions that may not be sustainable. After having contracted or stagnated in recent years, foreign debt expanded again markedly in 2006; shrinking public debt has been more than offset by rising private liabilities. Foreign currency reserves cover the equivalent of four to five months of goods and services imports.

Monetary Policy

In the last five years, CPI inflation has remained stubbornly at an average level of about 5% and in 2005 and 2006 exceeded 6% at year-end (see table 4). From June to August 2007, CPI inflation doubled to 12% (year on year), which gives rise to concern, even if it partly reflects an unfortunate temporary supply shock. The speed of overall price rises in recent years is linked to the persistent confluence of a number of factors, giving rise to occasional spikes. These factors include repeated food price increases in the wake of adverse weather conditions, recurrent energy price hikes, excise tax adjustments as well as demand pressures, namely the strong credit expansion, particularly to households. The Bulgarian credit boom of recent years attained some of the highest growth rates among transition economies. The boom has sucked in imports and contributed to the deterioration of the current account. Given that the monetary policy regime (currency board anchored to the euro) largely circumscribes instruments for macroeconomic management, fiscal policy is the main tool for controlling aggregate demand and containing external imbalances. While benefiting from robust growth, fiscal policy has also become very cautious in recent years; since 2003 the general government budget has recorded no more deficits, the 2006 surplus exceeded 3% of GDP, and the 2007 surplus is expected to reach around 4% of GDP.

To help check the credit boom and its repercussions on monetary stability and external balances, the Bulgarian National Bank (BNB) launched a containment strategy in 2003 and implemented a series of monetary, prudential and administrative tightening measures: the BNB repeatedly increased its base interest rate and reserve requirements, strengthened capital adequacy and risk exposure regulations, and has applied credit controls or ceilings for quarterly and annual loan growth (since early 2005). While prudential indicators did not show signs of serious deterioration, bank lending eventually slowed down in late 2005 and in 2006 (see table 4).

This slowdown was, however, partly circumvented by the migration of credit activities abroad and by recourse to nonbank financial intermediation (e.g. leasing companies, retailers), which contributed to the increase of private foreign debt. At the beginning of 2006, the monetary authorities therefore extended supervision to the nonbank financial sector, and in the second half of the year, they started to gradually abolish administrative restrictions while maintaining a stringent supervisory framework. In early 2007, domestic bank loan growth regained momentum, buoyed by the country's EU accession in January of that year. Credit expansion reached 38% in real terms in January–August 2007 (year on year). This reacceleration, the strong wage hike of early 2007 and emerging labor shortages as well as soaring energy prices and exceptionally bad weather (droughts followed by floods) may have been particular causes for the skyrocketing of consumer prices in the summer of 2007. The BNB reacted to the renewed credit boom by hiking the required reserve rate for banks from 8% to 12% on September 1, 2007. The authorities are still planning on ERM II entry at an early date (as far as this is feasible), while retaining the currency board as a unilateral commitment.

3.4 Croatia

Macrostructural Background

The Croatian economy has steadily grown (at 4% to 5% per annum) since the turn of the millennium. While still recording twin deficits (budget and current account), the country has gradually improved its fiscal performance in recent years. Net FDI inflows have been high, but were not always sufficient to cover the substantial current account gaps. Concern remains focused on the country's large gross foreign liabilities, which have been steadily increasing and reached a level of almost 85% of GDP at end-2006 (see table 5). The largest part of the recent debt expansion stems from credit institutions borrowing from parent banks and from corporations directly taking up funds abroad.

Table 5

Croatia: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	4.3	4.3	4.8	5.2
Consolidated general government budget balance (% of GDP)	–4.8	–4.1	–3.0	–2.8
Current account balance (% of GDP)	–4.9	–6.3	–7.6	–7.8
Net FDI inflows (% of GDP)	2.5	3.9	7.8	6.2
Gross foreign debt (year-end, % of GDP)	79.4	81.7	84.7	85.0
Gross reserves of central bank (excl. gold, year-end, % of GDP)	22.5	23.6	25.3	..
Discount rate (year-end, %)	4.5	4.5	4.5	..
Broad money growth (year-end, %)	9.3	10.5	18.0	10.4
Domestic credit growth (year-end, %)	11.8	19.2	18.9	..
CPI inflation (year-end, %)	**2.7**	**3.6**	**2.0**	**2.9**
Exchange rate: HRK/EUR (annual average)	7.50	7.40	7.32	7.38
Exchange rate: HRK/USD (annual average)	6.04	5.95	5.84	5.49

[1] *Estimates or forecasts.*

Source: National statistics, Hrvatska narodna banka, IMF, wiiw, EBRD, European Commission.

Monetary Policy

The Croatian kuna's long-standing tightly managed float has been upheld in recent years. Actually, since 2002, a de facto corridor of about ±4% around a hypothetical central rate of 7.5 to the euro has been observed. Notwithstanding the country's sustained low inflation track record (CPI inflation was 2.6% in August 2007), about two-thirds of loans as well as deposits continue to be denominated in, or indexed to, a foreign currency (persistently high level of euroization). The unfolding of a credit boom has added to macroeconomic tensions (weighing on external imbalances) and inflationary pressures in recent years. At end-2006, Croatia's ratio of credit to GDP reached 76%, the highest of the region and one of the highest of all transition countries.

After implementing some temporary restrictions on credit growth in 2003, Hrvatska narodna banka (HNB, Croatian National Bank) introduced and progressively tightened marginal and special reserve requirements from 2004 to 2006. In addition, prudential regulations were strengthened in 2005 and 2006. These steps could, however, not prevent lending from reaccelerating in 2005 and 2006 (the credit volume grew by about one-fifth each year, see table 5) and from contributing to the further rise of foreign debt. In December 2006, the HNB resorted to a new administrative intervention: It imposed a credit growth limit of 12% on banks for 2007. Moreover, the HNB issued new guidelines to banks on managing household and currency-induced credit risk. While the new measures appear to have helped somewhat rein in bank credit expansion in the first months of 2007, it remains to be seen whether they will keep on being effective for a longer period.

3.5 Kosovo

Macrostructural Background

Kosovo's economy remains almost totally driven by foreign financial aid and by remittances from the Kosovar diaspora. After external donor assistance had declined sharply and the post-conflict reconstruction boom had come to an end, GDP growth ground to a halt in 2002 and all but stagnated until 2006, which saw some revival of economic activity. The current account deficit after grants deteriorated from 3% of GDP in 2001 to 19% in 2006 (see table 6). Some fiscal loosening in 2004 and 2005 could not compensate for the drain of resources triggered by the downsizing of the international community's presence in Kosovo. In 2006 fiscal policy was tightened again and the tighter stance was upheld in 2007. Given a weak business climate, foreign investors have remained largely reticent so far. On a more positive note, significant increases in the number of new firms have been registered. Despite partly still unclear property rights, the privatization of socially-owned enterprises made marked progress in 2005 and 2006, and a rise in capital formation, including FDI inflows, has been recorded.

Table 6

Kosovo (Kosova): Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006[1]
GDP growth (real, %)	2.1	0.6	3.8
Consolidated budget balance (after grants, % of GDP)	–5.8	–2.6	3.4
Remittances (% of GDP)	15.0	17.2	18.7
Current account balance (after grants, % of GDP)	–11.3	–15.0	–19.1
Net FDI inflows (% of GDP)	0.9	2.6	9.8
Interest rate (nonfinancial firms, three to twelve month loans, %)	15.7	15.6	15.5
Growth of credit volume (year-end, %)	60.5	37.5	24.0
CPI inflation (annual average, %)	**–1.1**	**–1.5**	**0.7**
Exchange rate (EUR/USD) (annual average)	1.24	1.24	1.26

[1] *Preliminary data.*

Source: Central Banking Authority of Kosovo, IMF, European Commission.

Monetary Regime and Performance

Kosovo, under unilateral de jure euroization since late 1999, has boasted low single-digit euro CPI inflation since 2002. The Serbian dinar continues to be legal tender in some areas of the province, though. Having contributed to boosting prices in the early years of the United Nations Interim Administration Mission in Kosovo, the international community subsequently scaled down its activities and investments, which was also reflected in modest euro deflation in 2004 and 2005 (see table 6), despite the upward pressure of oil prices and utility tariffs in these years. In the first quarter of 2007, the price level was 1.6% higher than a year earlier. However, repercussions of extreme weather conditions in the summer of 2007 and of international food price developments triggered the strongest increases of consumer prices recorded in the province for half a decade. Accordingly, the CPI rose by 4.7% in July and by 6.6% in August 2007 (year on year). In August 2006, the Banking and Payments Authority of Kosovo (BPK) was redesignated as the Central Banking Authority of Kosovo (CBAK). The CBAK uses liquidity ratios and reserve requirements as the main tools of prudential intervention. Banking and credit activity have been expanding strongly, if from a tiny base. 75% of sector assets have already passed into foreign hands.

3.6 Republic of Macedonia

Macrostructural Background

While the Republic of Macedonia had witnessed only a hesitant recovery in the wake of the economic destabilization triggered by the 2001 ethnic and security crisis, growth seems to have gathered some momentum since 2004, helped by strong external demand for basic metals (the major export staple). Robust growth and increasing fiscal rigor helped bring about a near-balanced budget, which was accompanied by a substantial narrowing of the current account gap in recent years. Apart from occasional spikes, like in 2006, FDI has so far not been impressive, though (see table 7). Continued political risk, weak governance, a feeble judiciary and the modest quality of transport connections have been the main obstacles for strategic foreign investment.

Table 7

Republic of Macedonia: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	4.1	3.8	3.1	5.0
General government budget balance (% of GDP)	0.0	0.3	–0.6	–1.1
Current account balance (% of GDP)	–7.7	–1.4	–0.4	–1.5
Net FDI inflows (% of GDP)	2.9	1.7	5.8	2.5
Gross foreign debt (year-end, % of GDP)	39.2	39.8	40.4	..
Gross reserves of central bank (excl. gold, year-end, % of GDP)	15.3	22.3	26.9	..
Basic rate of NBRM (year-end, %)	6.5	6.5	6.5	..
Broad money growth (year-end, %)	16.1	15.2	24.6	25.1
CPI inflation (year-end, %)	–1.9	1.2	2.9	2.5
Exchange rate: MKD/EUR (annual average)	61.34	61.30	61.19	62.0
Exchange rate: MKD/USD (annual average)	49.41	49.29	48.79	..

[1] *Estimates or forecasts.*

Source: National statistics, Narodna banka na Republika Makedonija (NBRM), IMF, wiiw, EBRD, European Commission.

Monetary Policy

Budgetary consolidation has been flanked by successful perseverance with a tight monetary stance. Narodna banka na Republika Makedonija (NBRM, National Bank of the Republic of Macedonia) has retained its de facto peg of the Macedonian denar to the euro, keeping inflation under control. In 2006, CPI inflation rose to about 3% (see table 7), influenced by a combination of higher energy prices, excise tax adjustments and declining food prices as a result of import liberalization due to the country's WTO accession. With the impact of the excise tax adjustment waning, the overall price level increase declined to 1.3% in July 2007, before a seasonally (drought-)driven surge in food prices lifted inflation to just over 2% in the following month (year on year). Given the mixed performance of external accounts, the exchange rate of the Macedonian denar remained intermittently under pressure. The NBRM countered this pressure by intervening on the foreign currency market and upholding policy rates. Liquidity was also withdrawn through auctions of both central bank and treasury bills.

The improvement in the external accounts since 2005 – largely on the back of staple price rises, expanding remittances and the privatization of a big power distribution company – has reduced macroeconomic tensions. The capital inflows enabled the central bank to replenish its foreign currency reserves, to repay in advance its remaining Paris Club and IMF liabilities and to ease its monetary reins to some degree. From October 2005 to May 2007, interest rates on NBRM bills declined by a total of 5 percentage points. A number of important structural reforms have been adopted recently (among them steps to increase labor market flexibility, improve banking regulation and upgrade infrastructure), which may also attract more FDI in the future and thereby strengthen competitiveness and confidence in the monetary regime. Commercial banks' deposits and loans are expanding steadily (albeit not quite as fast as in neighboring countries), which points to growing reintermediation and confidence in the financial system.

3.7 Montenegro

Macrostructural Background

While Montenegro's recovery following the Kosovo war of 1999 was rather feeble initially, growth picked up in 2004 and almost doubled to around 8% in 2006, when the country became independent. Whereas fiscal reforms (including an overhaul of the tax system and the adoption of a centralized treasury) contributed to reining in deficits and even achieving surpluses, current account disequilibria have remained high. Despite growing tourism revenues and workers' remittances, current account shortfalls have expanded dramatically, reaching 29% of GDP in 2006 and about the same level in the first half of 2007 (see table 8). However, like in some other countries of the region, rising FDI inflows have been the principal drivers of this expansion. These inflows included the privatization sales of the republic's main generator of exports and GDP, the Kombinat Aluminjiuma Podgorica (KAP), as well as the privatization of large parts of the banking sector, entailing significant restructuring efforts. Moreover, investment in real estate and the tourism sector has started to boom. It appears that Montenegro's independence (obtained in June 2006) has reduced uncertainty for investors and other economic actors.

Table 8

Montenegro: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	4.2	4.0	8,3	6.5
General government budget balance (% of GDP)	–2.4	–2.7	1.1	2.0
Current account balance (% of GDP)	–7.6	–8.9	–29.1	–26.0
Net FDI inflows (% of GDP)	3.2	22.0	24.2	22.0
Gross foreign debt (year-end, % of GDP)	38,4	39.3	38.4	..
Gross reserves of monetary authority (excl. gold, year-end, % of GDP)	3.9	10.5	11.1	..
Broad money growth (year-end, %)	16.3	49.6	87.4	..
Domestic credit growth (year-end, %)	42.4	10.6	135.9	..
CPI inflation (year-end, %)	**1.6**	**2.5**	**2.8**	**3.0**
Exchange rate (EUR/USD) (annual average)	1.24	1.24	1.26	..

[1] *Forecasts or projections.*

Source: National statistics, Centralna banka Crne Gore, IMF, wiiw, EBRD, European Commission.

Monetary Regime and Performance

Montenegro's unilateral de jure euroization in 1999–2000 seems to have succeeded in breaking the very high inflation of the past. Annual consumer price increases (euro-based) have declined steadily to about 2% to 3% since 2004 (see table 8) and came to 2.3% in May 2007. However, August 2007 witnessed a spike of 4.6% (year on year) on account of drought-induced food price rises, international food price hikes and utility price increases. Centralna banka Crne Gore (CBCG, Central Bank of Montenegro) uses the regulation of commercial banks' mandatory reserves as its main policy instrument; furthermore, it has the possibility to indirectly influence interest rates by issuing central bank bills.

Starting in 2003, bank loans have been expanding briskly (they more than doubled in 2006 and retained this pace in the first half of 2007), albeit from a modest point of departure. To check the unrelenting speed of the credit expansion, the CBCG tightened reserve requirements as of early October 2007. In the face of swift increases of the money supply (broad money growth accelerated to over 80% in 2006), the overall low level of inflation reflects a strong remonetization process. Notwithstanding the most recent seasonal spike, the danger of euroized Montenegro losing competitiveness through an excessively high inflation differential to the euro area seems to have been contained. This may also be ascribable to the above-mentioned upswing of productivity-enhancing capital inflows. Still, continued structural reforms seem necessary to uphold the momentum and retain competitiveness.

3.8 Romania

Macrostructural Background

Romania has continued to experience robust GDP growth, which accelerated to above 7% in 2006, and may be showing signs of overheating. After the country's fiscal imbalances had descended to low levels in recent years, some loosening occurred in 2006 and seems to have gathered momentum in 2007. The current account gap widened sharply in 2004 and expanded further over the following years, particularly in 2007. This deterioration was driven by an acceleration of domestic demand stemming from rapid wage growth, the above-mentioned fiscal relaxation, and a swift expansion of credit to the private sector. The Romanian leu has also been appreciating since 2004 – until most recently. The strong increase in FDI has played an important role in the widening of the current account gap, although this role appears to be fading in 2007 (see table 9), with large privatizations so far absent in 2007.

Monetary Policy

Until recently, Banca Naţională a României (BNR, National Bank of Romania) conducted a money growth targeting strategy. This was coupled with a

Table 9

Romania: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	8.5	4.1	7.7	5.8
General government budget balance (% of GDP)	–1.0	–0.8	–1.7	–2.8
Current account balance (% of GDP)	–8.4	–8.7	–10.3	–14.5
Net FDI inflows (% of GDP)	8.4	6.6	9.3	6.1
Gross foreign debt (year-end, % of GDP)[2]	30.6	31.1	28.6	26.7
Gross reserves of central bank (excl. gold, year-end, % of GDP)	17.9	21.1	22.0	..
Discount rate (year-end, %)	18.0	7.5	8.8	7.0
Broad money growth (year-end, %)	40.1	33.8	29.4	30.0
CPI inflation (year-end, %)	**9.3**	**8.6**	**4.9**	**4.9**
Exchange rate: RON/EUR (annual average)[3]	4.05	3.62	3.52	3.35
Exchange rate: RON/USD (annual average)[3]	3.26	2.91	2.81	..

[1] *Forecasts or projections.*
[2] *Without short-term liabilities.*
[3] *The lei was redenominated in July 2005. All exchange rates have been converted to the post-July 2005 lei.*
Source: National statistics, Banca Naţională a României, IMF, wiiw, EBRD.

managed float driving a nominal depreciation of the Romanian leu, which, on the whole, resulted in a fairly stable real effective exchange rate. The IMF (2004, p. 767) characterized this regime as an implicit crawling band. From early 2002 to early 2005, a EUR/USD currency basket was the reference unit for the managed float; since early 2005, the euro has been the sole reference currency. Since the early years of the new millennium, the Romanian currency has been under overall appreciation pressure, which was punctuated from time to time by reversals and (short) intervals of weakness. Appreciation pressures have been partially countered by the build-up of foreign exchange reserves and sterilizing interventions. This stance, supported by a coherent policy mix, led inflation to decline from 41% in 2000 to 9% at end-2004 (see table 9). In response to the downward trend of inflation, the central bank lowered its interest rates substantially.

Favored by the improved macroeconomic situation, a credit boom soon emerged. This reflected a long-deferred structural catching-up process in consumption and capital formation. However, this process has worsened external balances and rendered disinflation more difficult. The BNR responded by tightening its reserve requirements, temporarily hiking its reference rate, strengthening banking supervisory procedures and regulations, as well as imposing credit restrictions per borrower in February 2004. But the latter measure only proved effective in temporarily preventing loan growth from accelerating. A further liberalization of the capital account in April 2005 opened the way for larger capital inflows, thus heightening the upward pressure on the Romanian leu.

In August 2005, the BNR shifted to inflation targeting, which it expects to be a more effective monetary policy strategy in an environment of macroeconomic growth tensions and of ubiquitous and volatile capital flows. The introduction of inflation targeting went hand in hand with a loosening of the exchange rate regime. This loosening of the managed float was followed by increased nominal (and real) appreciation of the Romanian leu, which rendered foreign currency loans even more attractive, triggering a tightening of prudential regulations on foreign currency lending in September 2005.[6] With inflation coming to 8.6% at end-2005, the monetary authorities slightly overshot their target for that year (7.5% ±1%).

Therefore, after interest rates had declined again, the reference rate was readjusted upward in the first half of 2006. Moreover, several factors contributed to driving inflation down further to 4.9% in 2006 (table 9), which was in line with that year's target of 5% ±1%: a faster liquidity drain through open market operations, a further nominal appreciation of the Romanian leu (triggered by capital inflows), as well as a pause in the increases of administered prices and the temporary dip in the oil price in the fall of the year. Afterwards, interest rates were allowed to recede again. In June 2007, inflation bottomed out at 3.8%, before it rose again to 5.0% in August. Reasons for the uptick in the summer of 2007 were the reacceleration of credit expansion after removal

[6] *Effective as of the beginning of September 2005, a 30% reserve ratio on all forex-denominated liabilities with maturities longer than two years was implemented (Barisitz et al., 2005, p. 48). In the course of 2006, that requirement was further increased in two steps to 40%.*

of some controls at the beginning of the year, a reversal of the appreciation tendency of the leu under the impact of the international financial turbulences and of concerns about Romania's external vulnerabilities, as well as drought-induced sharp food price increases. The 2007 target is set at 4% ±1%. While the (still) relatively low level of inflation is certainly a major achievement, the possible further acceleration of price increases and continuing depreciation against the backdrop of fiscal relaxation might soon trigger a reversal of the BNR's monetary policy stance.

An EU member since the beginning of 2007, Romania plans to join ERM II around 2012 and to be ready to enter the euro area two years later. The authorities take the view that the country needs some years to entrench macrostability to lower inflation and to carry on with structural reforms to fulfill the Maastricht criteria in a sustainable manner.

3.9 Serbia (without Kosovo)

Macrostructural Background

Following particularly strong GDP growth in 2004, Serbia's economic expansion has since remained robust at annual growth rates of around 6%. This brisk growth, (first) successes of macrostabilization, and fiscal reforms have improved the country's budgetary performance, leading to budget surpluses from 2004 through 2006. However, some fiscal loosening emerged in 2007. Previously weak foreign direct investment gathered momentum in 2003 and strongly expanded in 2006 (see table 10), driven by a few large successful privatizations. Following a period of decisive banking sector restructuring in 2002, foreign strategic investors moved in and acquired the majority of sector assets, and credit activity gathered momentum and turned into a boom. While current account disequilibria have remained high (about 11% of GDP in 2006), about three-quarters of the shortfalls have been covered by FDI on average in recent years, even if these inflows have been quite volatile. FDI and privatization proceeds have allowed the central bank to steadily increase its reserves to a comfortable level (over one-third of GDP) and have permitted the authorities to prepay some of their foreign debt.

Table 10

Serbia: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	8.4	6.2	5.7	6.2
General government budget balance (% of GDP)	0.9	1.9	1.6	0.5
Current account balance (% of GDP)	–11.7	–8.5	–11.4	–13.5
Net FDI inflows (% of GDP)	3.9	5.9	13.7	..
Gross foreign debt (year-end, % of GDP)	52.5	61.9	58.5	..
Gross reserves of central bank (excl. gold, year-end, % of GDP)	15.2	22.6	34.7	..
Two-week repo rate (year-end, %)	17.4	19.2	14.0	..
Broad money growth (year-end, %)	17.1	31.4	47.3	30.2
RPI inflation (year-end, %)	**13.7**	**17.5**	**6.6**	**6.8**
Exchange rate: RSD/EUR (annual average)	72.57	82.91	84.06	82.00
Exchange rate: RSD/USD (annual average)	58.38	66.71	66.82	..

[1] *Forecasts or projections.*

Source: National statistics, Narodna banka Srbije, IMF, wiiw, EBRD, European Commission.

Monetary Policy

In order to better protect the Serbian economy's fragile external accounts and overcome the strong real appreciation tendency that had emerged after the launching of the dinar's tightly managed float in 2000 (anchor currency: DEM/EUR), Narodna banka Srbije (NBS, National Bank of Serbia) chose to loosen somewhat the dinar's float at the beginning of 2003. During the three years until the end of 2005, the Serbian currency nominally depreciated by a cumulative 40% against the euro (and by some percentage points against the U.S. dollar), but the dinar's real effective exchange rate remained broadly unchanged. The NBS thus pursued a "real exchange rate anchor" policy (not unlike the Romanian strategy until 2005). However, after it had fallen to around 8% at end-2003, inflation strongly increased again to 17.5% in 2005 (see table 10). The deterioration of the situation had been triggered by repeated adjustments of administered prices, rising costs of oil and other fuel imports, and the one-off effect of VAT introduction in 2005. Moreover, despite some progress in privatization, Serbia's backlog in still-to-be-tackled restructuring efforts (compared with other countries of the region) implied that strong domestic demand met with still relatively unresponsive supply and weak competition. Furthermore, continuing dinar depreciation and the widespread exchange rate indexation of prices (entrenching high pass-through rates) played a major role.

The NBS reacted to the inflation spike of end-2005 by readjusting its strategy. It further loosened the exchange rate regime by withdrawing from foreign exchange interventions in early 2006. This discontinued the managed nominal depreciation tendency. As a result of persisting large capital inflows, the Serbian currency appreciated by 8% in nominal terms vis-à-vis the euro and by 15% vis-à-vis the U.S. dollar during 2006. In September 2006, Narodna banka Srbije adopted a new monetary policy framework that focused on achieving price stability through numeric inflation objectives, which can be viewed as a kind of informal inflation targeting. These objectives are initially defined in terms of core inflation (excluding i.a. administered prices and food prices, end-2006 target corridor: 8% ±1%) and are to be achieved primarily by adjusting the NBS's key policy rate, the interest rate on its two-week repo operations. With efforts underway to strengthen its research capacity, the central bank envisages adopting a formal inflation targeting regime by 2008.

Disinflation success was impressive in 2006. By December, retail prices had declined to 6.6% (see table 10) and core inflation came in at 5.9%. This overfulfillment of the year's inflation objective was attributable to a combination of several factors: a sharp nominal appreciation of the dinar, the NBS's substantial interest rate hike, its tightening of reserve requirements and the government's (temporary) freezing of controlled prices. As a result of the marked deceleration of inflation and in order to check further dinar appreciation, which threatened to put Serbian export industries under renewed pressure, the NBS cut its policy rate in a number of steps in late 2006 and the first half of 2007 to 9.5%. After continuing to decline in the first months of 2007, inflation rose again somewhat in the second and third quarters and came to 6.3% in August; core inflation, however, remained stable at 3.0% that month. Given renewed inflationary pressures (adjustment of regulated prices, fiscal weakening, strong wage growth, drought-triggered food price spikes), the NBS put an end to its loosening cycle in August 2007 and raised its key rate by 25 basis points. That same month, the government resorted to direct market intervention: It decreed a 90-day grain export ban and one-year price controls on bread and cooking oil. Notwithstanding these surprising and distorting measures, the core target band for end-2007 (6% ±2%) looks well within reach or may be undershot again.

3.10 Turkey

Macrostructural Background

The core of Turkey's 2001 stabilization program was the floating of the Turkish lira and the reintroduction of money growth targeting (pertaining to restrictive base money goals), accompanied by ambitious fiscal, structural and institutional reforms. The ensuing economic recovery has been quite impressive: Growth exceeded 7% per annum on average in the period from 2002 to 2006. The implementation of the fiscal reform component has contributed to spectacular results. After its crisis-driven peak in 2001, the fiscal imbalance steadily receded to 9% of GDP in 2003 and to around 1% of GDP in 2005 and 2006 (table 11). This performance was of course assisted by the unexpectedly strong and sustained economic expansion. At the same time, robust growth has partly been responsible for the sharp widening of the current account shortfall in recent years (8% of GDP in 2006). Having increased strongly in 2005 and 2006, FDI may have been a key factor in driving the widening of the current account gap most recently.

The expansion of foreign direct investment embodies a long awaited and important ingredient of structural adjustment and productivity growth. The change in strategic investors' stance was apparently triggered by the launch of EU accession negotiations in 2005. FDI has also made inroads in the Turkish banking sector, lifting the share of foreign ownership in total sector assets from less than 5% at end-2004 to over 25% in mid-2007. Credit expansion has

Table 11

Turkey: Key Macroeconomic and Monetary Policy Indicators

	2004	2005	2006	2007[1]
GDP growth (real, %)	8.9	7.6	6.1	5.3
Consolidated fiscal balance (% of GDP)[2]	–4.6	–1.3	–0.8	–1.4
Current account balance (% of GDP)	–5.2	–6.3	–8.2	–7.8
Net FDI inflows (% of GDP)	0.7	2.4	4.8	5.0
Gross foreign debt (year-end, % of GDP)	50.1	46.7	50.6	52.8
Gross reserves of central bank (excl. gold, year-end, % of GDP)	11.0	14.8	15.0	..
Discount rate (year-end, %)	22.0	17.5	22.5	..
Broad money growth (year-end, %)	22.1	24.5	24.1	14.9
Credit growth to the private sector (year-end, %)	42.0	41.3	35.6	..
CPI inflation (year-end, %)	9.4	7.7	9.7	6.5
Exchange rate: YTL/EUR (annual average)[3]	1.78	1.68	1.81	1.80
Exchange rate: YTL/USD (annual average)[3]	1.43	1.35	1.44	1.35

[1] Forecasts or projections.
[2] Public sector.
[3] The lira was redenominated in January 2005. All exchange rates are based on the post-January 2005 lira.

Source: National statistics, Türkiye Cumhuriyet Merkez Bankası, IMF, wiiw, European Commission.

gained momentum in recent years; banks and enterprises have been attracted by low foreign currency interest rates and have taken recourse to foreign loans, which can be regarded as the second major driving force behind the recent swelling of the external disequilibrium.

Monetary Policy

The commendable adjustment of inflation and the reestablishment of trust in the Turkish lira were among the salient factors that contributed to the swift stabilization and the restoration of confidence after the crisis of 2001. CPI inflation descended steadily over the years to below 8% at end-2005 (table 11), a level unseen since the early 1970s. After rising sharply in late 2001, interest rates came down again. Given the encouraging inflation environment, Türkiye Cumhuriyet Merkez Bankası (TCMB, Central Bank of the Republic of Turkey) repeatedly cut its intervention rate (overnight deposit rate) in a number of steps down to 13.5% in April 2006. The decline in interest rates and payments helped reduce budgetary pressures and fiscal deficits, which in turn reduced pressure on interest rates (virtuous circle). But inflation might not have come down as much as it did had the Turkish lira not appreciated substantially in nominal-effective terms. This was caused by rising capital inflows and happened despite the monetary authorities' recurrent interventions to stem appreciation pressures and build up foreign currency reserves.

In this situation, the TCMB adopted formal inflation targeting at the beginning of 2006. The end-2006 inflation target was set at 5% ±2%, the 2007 target at 4% ±2% (uncertainty bands). The nominal appreciation of the Turkish lira (on top of a still sizeable inflation differential) started to raise concerns about the country's competitiveness against the above-mentioned backdrop of fragile external accounts. In the spring of 2006, the global financial markets witnessed a widespread decline in risk appetite for emerging market exposures, with tangible but transient consequences for Turkey. Capital flows temporarily reversed. In May and June 2006, the Turkish lira's exchange rate against the euro fell by about 25%, but in the following months recovered again partially. The exchange rate shock pushed inflation up to 11.7% in July, before it declined again to 9.7% in December 2006 (table 11).

The monetary crisis was quickly overcome by the energetic response of the TCMB, which intervened on the foreign exchange market to defend the Turkish currency, withdrew liquidity through open market transactions, reversed its policy of interest rate cuts and ratcheted its key rate back up by 4 percentage points in the summer of 2006. (Thus the interest rate level reverted back to where it had been in early 2005 and stayed there until early September 2007.) Inflation was brought back under control, even if the 2006 target was missed by a considerable margin. The monetary tightening may have contributed to the weakening of economic growth in 2006, though. By July 2007, inflation had receded to 6.9% (year on year), a new record low. Like practically all other countries of Southeastern Europe, Turkey experienced an uptick of inflation in the late summer of 2007, triggered by drought-induced food price rises. In August, the overall price level increase came to 7.4%. The U.S. subprime crisis also had repercussions in Turkey, but these largely pertained to heightened volatility – not weakness – of the exchange rate, revealing nervousness on the part of financial markets. Notwithstanding the inflationary uptick, which was apparently judged to be a one-off event, the TCMB decided to cut its key rate by 25 basis points in early September, in order to support economic activity.

4 Comparative Overview and Conclusions

Having typically faced many similar economic challenges and having produced comparable economic performances, the Southeastern European countries all appear to be on more or less robust catching-up routes. Yet they continue to employ a wide array of monetary and exchange rate regimes and instruments. This may suggest that various paths can lead to success or progress. The majority of countries in the region (including the smallest ones, though) have opted for the euro as an external anchor: Croatia (with its tightly managed float), the Republic of Macedonia (de facto peg), Bosnia and Herzegovina as well as Bulgaria (currency boards) and Kosovo and Montenegro (euro as legal tender). The four other countries (among them the largest in the region) have introduced or retained loosely managed floats, while conceding primary weight to the euro as reference currency, and they have moved toward inflation targeting: Romania made the transition in August 2005, Turkey in January 2006, Serbia in two steps in the course of 2006, while Albania is planning to move to formal inflation targeting soon.

Taking a closer comparative look at the evolution of macrostructural environments of monetary policies and regimes, and at policymakers' reactions and their endeavors to shape developments and achieve monetary stability, we may note that economic expansion has remained strong and even accelerated in the period from 2004 to 2007, resulting in average GDP growth of 6% per annum in most countries under review. GDP growth has been less dynamic, but accelerated as well, to 4% per annum in the Republic of Macedonia and to 2% per annum in Kosovo.

Given generally buoyant and accelerating private domestic demand, practically the entire region (with the notable exception of the Republic of Macedonia) remains saddled with high or very high current account shortfalls, which have even been on the rise most recently. Kosovo has been particularly dependent on foreign grants and financial assistance to help cover exorbitantly high external gaps. But this support is dwindling, which is one reason why international attention still focuses on whether the Kosovar economy will be viable in the long run. Foreign financial assistance to Bosnia and Herzegovina as well as to Albania has already declined to low levels. Bosnia and Herzegovina's growth has meanwhile benefited from high staple prices, masking continued serious structural weaknesses. In contrast to external disequilibria, fiscal deficits have narrowed substantially or vanished altogether across the region in recent years. This development is ascribable to the strengthening of economic growth, to tax and budget reforms and to fiscal tightening measures. Fiscal policies have generally become cautious (even producing surpluses in 2005 and/or 2006 in Bosnia and Herzegovina, Bulgaria, Kosovo, Macedonia, Montenegro and Serbia), which has considerably reduced the burden on monetary policy. More recently, however, some weakening and slippage occurred in a number of countries.

FDI used to be weak across the region, but has expanded dynamically in recent years (in some cases multiplying from a basis of almost zero), and has obviously been pushing external imbalances to some degree. In 2005 and 2006, net FDI inflows covered current account deficits almost or fully in Bulgaria, the Republic of Macedonia (although both indicators remain modest in this country), Montenegro and Romania. Important progress has also been achieved in Croatia, Serbia and Turkey, whereas FDI is still remarkably feeble in Albania, Bosnia and Herzegovina, and Kosovo. In 2007, Romania seems to have witnessed a weakening of FDI inflows, which consequently covered a lower amount of the external deficit. Gross foreign indebtedness is not generally high in Southeastern Europe and seems to be stagnating or slowly declining (as a percentage of GDP) in most countries. This is being driven by prudent fiscal policies and contracting public liabilities, while corporate and bank debt have been rising. The two striking exceptions to the overall trend are Croatia and Bulgaria, where the increase in private foreign debt has been more than offsetting the decline of public debt and where national liabilities have attained very high levels, although this does not appear to have perturbed markets so far. In the two countries – as in the entire region – foreign exchange reserves have been on the rise.

During the observation period (from 2004 to 2007), average annual (year-end) CPI inflation rates were low (below 3%) in Albania, Croatia, Kosovo, the Republic of Macedonia and Montenegro; they were at a medium level (between 3% and 6%) in Bosnia and Herzegovina; and they were relatively high (above 6%) in Bulgaria, Romania, Serbia and Turkey. In this context, it appears striking that the three countries that have recently reverted to explicit inflation targeting with loosely managed floats (the latter three) have witnessed relatively high price increases – yet the two countries with long-standing currency boards anchored to the euro (Bosnia and Herzegovina, Bulgaria) cannot boast of low inflation, either. In any case, the two very small countries that are unilaterally euroized (Kosovo and Montenegro) feature among the best performers on the inflation front.

In 2005–2006, and then again in the summer of 2007, inflationary upticks could be observed in many countries. There are various reasons for these upticks: the ubiquitous credit booms, oil price rises, wage hikes, utility tariff increases, excise tax adjustments, bad weather conditions impacting on food prices, sharp depreciation triggered by financial turbulences (Turkey). In early 2007, inflation tended to ease somewhat. This easing pertained to several factors: monetary policy reactions including key interest rate hikes (following trend declines in previous years), the raising of minimum reserve requirements, tightening of prudential regulations and the supervision of credit institutions, controlled currency appreciation in some countries, and a temporary freezing of administered prices in others. However, inflation reaccelerated again in the summer of 2007, driven by near-pervasive drought-induced food price spikes coupled with world market agricultural and energy price rises, and, in some countries, a further acceleration of credit expansion.

Despite the apparent entrenchment of inflation in recent years (including the seasonal or one-off uptick in the summer of 2007) after a long period of decline since the late 1990s, there can be little doubt that persistent monetary policy stringency has served the Southeastern European countries well in improving their inflation track records. Such was the stabilizing influence of the exchange rate as an external nominal anchor that all countries with hard pegs – except Bulgaria – have registered low single-digits lately. Bulgaria was hit by a confluence of factors fueling inflation in recent years, the most important of which may have been the unrelenting credit boom, which the authorities so far do not seem to have gotten under full control.

Countries with loosely managed floats – except for Albania – are for various reasons still struggling with somewhat higher inflation levels, which, however, continue to be on a long-term downward trend. In Serbia, the transformation of the nominal exchange rate anchor into a "real exchange rate anchor" in 2003 contributed to interrupting the tendency of declining price increases in 2004 and 2005. The loosening of the exchange rate regime in early 2006 in the context of the transition to inflation targeting triggered a swift appreciation in an environment of rising FDI, portfolio capital and credit inflows. Disinflation resumed. In Romania, a comparable environment and a similar transitional strategy had corresponding effects in 2005 through the first half of 2007. The latter two inflation performances may represent a particular degree of dependence on – partly volatile – capital flows. Repercussions of such dependence have also recently affected by Turkey, which introduced inflation targeting in early 2006. However, Turkey can point to a (so far) very successful path of breaking decades of inertia and bringing down stubbornly high price increases. Finally, Albania, a country which has conducted a loosely managed float for around 15 years now, has boasted an extended performance of commendably low inflation.

Notwithstanding prioritizations inherent in monetary policy choices, most of the inflation targeters have had to live up to recurrent conflicts of aims: cutting inflation (monetary stability objective) versus limiting currency appreciation or depreciation (external equilibrium objective). Policy rates have therefore repeatedly zigzagged, reflecting switching priorities, and finding themselves increasingly at the mercy of capital flows. Perhaps the most illustrative examples of such developments is what has been going on in Serbia's and Turkey's monetary policies in the period between 2005 and today.

Summing up, the confidence and stability-enhancing effect of hard pegs appears to have borne out success in most of the countries analyzed; but this does not preclude other monetary strategies – notably inflation targeting and a loose float – from being effective as well. Overall monetary and economic policy soundness, credibility and perseverance remain the key to success here. In particular, prudent fiscal policies and general policy discipline, possibly favored by peer pressure within the Southeastern European region, IMF surveillance and EU membership aspirations (now already fulfilled in the cases of Bulgaria and Romania), have assisted the central banks in pursuing their goals.

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