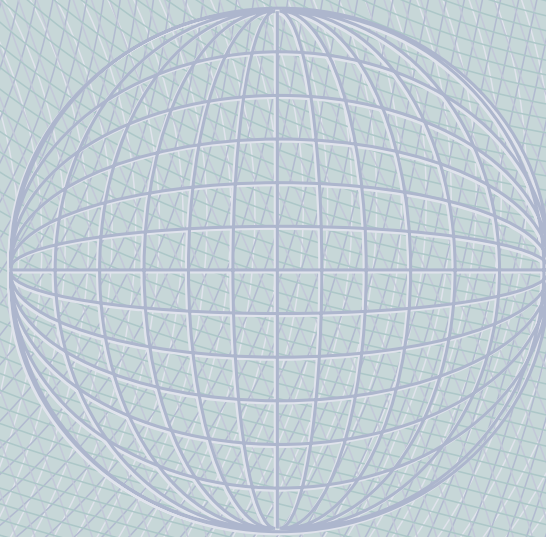




OESTERREICHISCHE NATIONALBANK

F O C U S   O N   T R A N S I T I O N  
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*This study tries to give an account of the manifold and varied economic developments in recent years in the Southeast European nonassociated countries, called “SEENACs” here. The countries covered are Croatia, Bosnia and Herzegovina, the Federal Republic of Yugoslavia, the Former Yugoslav Republic of Macedonia and Albania. The EU terms this group the “Western Balkan” region. Plagued by ethnic tensions, political instability and partly even military warfare, they have so far not been able to join the European integration process. The latest war, the Kosovo conflict, has had a strong impact on all SEENACs and may prove to be a turning point in relations between these countries and the EU if the Union follows up on its intention to become more actively involved in the region. Given the strong diversity of economic and political developments, the analysis is carried out country by country, outlining the political background, GDP and output, the fiscal and monetary policies, banking systems, foreign trade and current accounts, indebtedness, privatization and restructuring, FDI, unemployment and economic prospects. On the basis of these data, the author attempts to derive the key economic and political characteristics of the SEENACs. Finally, the evolution and prospects of relations with the EU are described.*

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## *Editorial*

The semiannual periodical of the Oesterreichische Nationalbank "Focus on Transition," first published in 1996, is addressed to all readers with an interest in the analysis of economic developments in Central and Eastern Europe.

Like the previous issues of the Focus on Transition, this volume is divided into four parts: The first section is an update of recent economic developments in the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The second section contains two studies from the Bank's Foreign Research Division. A third section follows with a summary of the latest activities of the Oesterreichische Nationalbank on transition topics (lectures, discussions, technical cooperation) and a statistical annex concludes this edition.

The first study examines the timely issue of the suitability of direct inflation targeting as an alternative monetary policy strategy for Central European Countries, as the Czech Republic and Poland have recently introduced this monetary regime. After outlining the theory of direct inflation targeting and the practical problems of designing such a strategy, the paper gives a brief summary of the experience of four Western economies with this monetary framework. Against this background the paper analyzes the new monetary strategies applied in the two transition countries, their weaknesses and potentials as well as similarities and differences between the Czech and the Polish frameworks. Both economies seem to meet the general conditions for a successful implementation of direct inflation targeting. However, empirical evidence has been very scarce up to now, and it is too early to conclude what contribution the shift of the monetary regime has made to achieving further disinflation. The other transition economies are following the experience of these two countries with keen interest, as some of them are considering modifications in their monetary and exchange rate strategies.

The second study reviews the recent developments and prospects in the European region that can be considered as standing by the wayside of the recently speeded-up integration process. This group of countries termed the Southeast European Nonassociated Countries – Croatia, Bosnia and Herzegovina, the Federal Republic of Yugoslavia, the former Yugoslav Republic of Macedonia and Albania – have undergone divergent economic and political developments, but all of them have been very negatively affected by the Kosovo conflict. However, the latest war may prove to be a turning point in their relations with the EU, if the Union follows through on its intention to become more actively involved in the region. The thorough analysis of the economic developments in each of the countries covered helps to identify some common characteristics of these transition countries. The analysis does not cover all aspects, selecting issues which are of particular interest from a central-bank point of view.

I would like to draw your attention to the fact that the proceedings of the OeNB's international conference of November 1997 have been published under the title "Current Account Imbalances in East and West:

Do They Matter?” and are also available under the address below. We invite you to address any comments or suggestions you may have about this publication or the studies in it to:

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Klaus Liebscher

Governor

# RECENT ECONOMIC DEVELOPMENTS



Peter Backé

## I Introduction

The growth performance in the five countries covered in this report – the Czech Republic, Hungary, Poland, Slovakia and Slovenia – was mixed during 1998 and the first months of 1999. While the Czech Republic was in recession, the other four economies recorded positive real growth rates. Generally, growth diminished, but the slowdown started at different times in different countries and is more pronounced in some than in others. Unfavorable external developments, in particular the lower import demand of the EU, the five countries' main trading partner, played an important role in this deceleration. Poland, which has had somewhat stronger trade links with Russia than the four other countries, besides experienced tangible negative direct trade effects in the aftermath of the Russian crisis. For some of the five countries, internal factors also contributed to the deceleration of growth.

The Czech Republic, Hungary, Poland and Slovenia succeeded in lowering inflation significantly; in Slovakia, the relatively low inflation rate remained basically unaltered. In general, low energy, raw material and food prices contributed to this performance, while prices for services typically rose faster than the general price level. Sustained disinflation has also helped weaken inflation inertia, which, in turn, facilitated further advances towards price stability.

Current account developments were not uniform among the five countries. While the Czech Republic reduced its deficit substantially in 1998, the Slovenian current account remained basically in balance, as in the years before. The Polish and Hungarian current account deficits widened, but remained within manageable limits (slightly below 5% of GDP), and the Slovak deficit increased somewhat from its already high level of 1997. During the first months of 1999, Hungary and Poland recorded a further worsening (as compared to the first months of 1998), while Slovakia's deficit narrowed. The Slovenian and the Czech current account balances changed only marginally.

Fiscal performance has been mixed. All five countries posted general government deficits in 1998, ranging from 0.6% of GDP in the case of Slovenia to 5.5% for Slovakia. While the Czech and the Slovak fiscal stances loosened last year, the fiscal positions of the three other countries did not change significantly. Slovakia intends to reduce its deficit-to-GDP ratio significantly in 1999, while Poland and Hungary aim at more moderate reductions. Slovenia and the Czech Republic, in turn, envisage broadly unchanged fiscal stances. However, budgetary developments during the first months of 1999 have been worse than expected in most of the countries under review and several, though not all five countries have undertaken adjustment measures or are contemplating such steps.

The accession process has made progress. The acquis screening with the first-wave countries (the Czech Republic, Estonia, Hungary, Poland, Slovenia and Cyprus) is already in its ultimate stage and should be finished by July 1999. From a central-bank viewpoint, the most interesting of the 31 chapters are Economic and Monetary Union, Free Movement of Capital and Free Movement of Services, in particular Financial Services, which were

screened in December 1998 and February 1999 respectively. After the completion of the multilateral *acquis* screening with the second-wave countries (Bulgaria, Latvia, Lithuania, Romania and Slovakia), the bilateral screening started in March 1999 and is to be finalized in fall. The European Council in Vienna in December 1998 followed the Commission's proposal not to open accession negotiations with any additional candidate countries yet, but indicated the prospect of opening accession negotiations with Latvia, Lithuania and Slovakia. Substantive accession negotiations were opened with the first-wave countries on the first seven of 31 chapters of the *acquis communautaire* in November 1998. In the meantime talks on eight additional chapters have begun, and negotiations have made progress: seven to eight chapters could already be provisionally closed with the Czech Republic, Estonia, Hungary, Poland and Slovenia. The negotiations on the central-bank-related chapters will be opened in the fall of 1999.

Slovenia's EU Association Agreement, which had been signed in June 1996, went into force on February 1, 1999, after a lengthy ratification procedure.

The introduction of the euro had immediate effects on Poland and Hungary, which have pegged their currencies to baskets that contained EU currencies superseded by the euro.<sup>1)</sup> Poland streamlined its basket, which had contained five currencies until the end of last year (45% USD, 35% DEM, 10% GBP, 5% FRF, 5% CHF). The new basket, in effect since January 1, 1999, consists of 55% EUR and 45% USD. Hungary, in turn, substituted the DEM in the 70% DEM and 30% USD basket by the euro. The new basket has thus consisted of 70% EUR and 30% USD since the beginning of this year. As of January 1, 2000, Hungary will move to a 100% EUR peg.<sup>2)</sup> The other three countries, the Czech Republic, Slovakia and Slovenia, which have managed floating regimes, adopted the euro as their reference currency (instead of the DEM), effective January 1, 1999, and, for Slovenia, February 1, 1999. In general, the euro has become the most important anchor currency for Central and Eastern Europe already today and, in all likelihood, its role will be strengthened further in the years to come.

## 2 Country Reports

### 2.1 Czech Republic

Real GDP decreased by 2.7% in 1998.<sup>3)</sup> The economic decline – which resulted primarily from a fall in domestic demand – accelerated throughout the year; output contraction in the fourth quarter amounted to 4.1%. Apart from the factors common to all five countries, in the Czech case, the down-

1 Both countries operate crawling peg regimes.

2 Estonia had a DEM peg under a currency board arrangement before the inception of Stage Three of Economic and Monetary Union. It intends to change the peg of the kroon to the DEM (EEK 8 / DEM 1) into a EUR peg. When exactly this technical modification will be effected is still open. At the latest, it will have to be done when the DEM loses its status as legal tender (in early 2002). On December 31, 1998, the central bank announced that one EUR would equal 15.6466 kroon and stated that "in currency deals between the central bank and commercial banks, the Estonian central bank equates the role of the euro and the role the German mark had."

3 If not indicated otherwise, percentage changes refer to the change against the year before or the same period of the year before.

turn in economic activity was mainly triggered by macroeconomic stabilization measures taken in 1997 and deepened by structural weaknesses in the enterprise and banking sectors. Final consumption was down 1.4% in 1998, with private consumption falling 2.4% and public consumption rising by 1%. Gross capital formation declined by 6.6% last year, fixed capital formation by 3.7%. While exports grew faster than imports, this could alleviate but by no means offset the fall in the other components of aggregate demand. Industrial production grew by 1.6% in 1998 as a whole, with industrial output beginning to contract in September 1998. Construction declined by 7% and agricultural output by 2%. Unemployment rose quickly during the course of 1998, from 5.2% to 7.5%, while real wages fell by 1.3% last year.

The latest figures indicate that the contraction of domestic demand may have begun to ease somewhat. Retail sales began to grow again in March and may be spurred further by an upturn in real wages (+5.4% in the first quarter). Industrial sales are still shrinking (-5.9% in the first quarter), but not as fast as industrial output (-9.1%). Construction, however, is still declining markedly (-16% in the first quarter). Unemployment increased further to 8.4% in March before falling to 8.1% in May 1999. This is close to 3 percentage points higher than in May 1998.

Against the backdrop of recession and a strong domestic currency, inflation, which had been in the low double-digits from September 1997 to July 1998, has come down substantially in the second half of 1998 and in the first months of this year. In May 1999, it amounted to a mere 2.4% year on year.

The current account deficit was significantly reduced in 1998, and came in at USD 1 billion (1.9% of GDP), after having amounted to USD 3.2 billion (6% of GDP) a year earlier. The improvement was attributable mainly to the narrowing of the trade deficit from USD 4.5 billion to USD 2.6 billion,<sup>1)</sup> which resulted from the recession and the preceding real depreciation of the koruna. The services balance strengthened somewhat from a surplus of USD 1.7 billion to USD 1.9 billion. Net FDI inflows doubled to USD 2.5 billion in 1998, while portfolio investment inflows were almost unchanged at USD 1 billion. Other investment recorded an outflow of USD 0.9 billion (down from USD 1.3 billion a year earlier). Official foreign currency reserves increased from USD 9.7 billion at the end of 1997 to USD 12.5 billion a year later. Gross foreign debt increased from USD 21.6 billion at the end of 1997 to USD 24.3 billion a year later.

Balance-of-payments figures for the first quarter of 1999 do not show significant changes in the external position of the Czech Republic. The current account deficit stood at USD 315 million (compared to USD 349 million in the first quarter of 1998), the trade deficit at USD 557 million (USD 512 million). The upturn in net FDI continued (USD 583 million, as compared to USD 222 million) and portfolio investment was negligible, as in the first quarter of 1998. Other investment saw an outflow of USD 195 million (versus an inflow of USD 487 million a year earlier). Official foreign

<sup>1)</sup> Exports grew by USD 3.6 billion, imports by USD 1.5 billion.

exchange reserves at the end of May 1999 amounted to USD 11.7 billion.<sup>1)</sup> These reserves cover five months of imports.

Monetary policy was gradually relaxed from July 1998 following the release of unfavorable data on economic activity and the easing of inflation. Interest rates were reduced in several steps. Currently, the two-week repo rate is 6.9% (which is 810 basis points lower than in July 1998), the discount rate comes to 6% (down by 700 basis points), and the lombard rate is 10% (900 basis points lower). However, due to simultaneous disinflation, real interest rates have not fallen. Moreover, with the banking sector characterized by financial fragility (see below), monetary relaxation did not translate into an expansion of credit volumes. A cut in the minimum reserve requirement from 5% to 2%, announced in May and effective from October 7, 1999, will further ease the monetary stance. In 1998, the improved current account, rising FDI inflows and the relatively high interest rate differential with the EU led to a nominal appreciation of the koruna against the euro by approximately 10%. In the course of January 1999, the Czech currency fell back to the level of early 1998 and subsequently stabilized around CZK 38 per euro, before appreciating slightly to just above CZK 37 per EUR at the end of May and in early June.

The Czech National Bank, which has followed a direct inflation targeting strategy since the beginning of last year, significantly undershot its 1998 inflation target. While the range for year-on-year net inflation<sup>2)</sup> in December 1998 was set at 5.5% to 6.5%, it actually came in at 1.7%. For end-1999, a range of 4% to 5% was set. Currently, net inflation is again significantly below this range. In May 1999, it was in fact negative (-0.5%). The Czech central bank, however, expects inflation to augment in the second half of the year, due to a weakening of the currency and rising wages and raw material prices. The target for end-2000, already announced in 1998, is 3.5% to 5.5%. On April 8, 1999, the central bank adopted a long-term monetary strategy proposing a long-term net inflation target of 1% to 3% for the year 2005.<sup>3)</sup> This target is still to be agreed with the government. In the central bank's view, a joint commitment by the government and the bank on the long-term inflation target will minimize the costs of disinflation by increasing the credibility of the target and thus favorably affecting inflation expectations.

In 1998, the state budget posted a deficit of 1.7% of GDP (versus a planned balanced budget), which means that the fiscal stance softened in comparison to 1997, when the deficit had run to 1% of GDP. The 1998 general government deficit is estimated at 3% of GDP. The budget plan for 1999, adopted in mid-January 1999, includes a deficit target of CZK 31 billion (1.6% of GDP); it is based on a GDP growth rate of 1.5%. As the actual growth performance will be worse – the authorities have lowered their forecast to -0.8% – the original deficit target will presumably not be met, even

1 No figures on gross foreign debt developments are available for the first months of 1999 yet.

2 The net inflation index excludes regulated prices and the impact of tax changes. The excluded items represent about 18% of the CPI. For details see Krzak/Ettl in this issue.

3 The central bank expects CPI and net inflation to converge by 2005.

though the deficit recorded in the first four months of 1999 (CZK 2.4 billion) was modest, mainly for seasonal reasons. The Czech Finance Ministry has acknowledged this and intends to impose expenditure cuts in most budget areas (on the order of close to 0.4% of GDP) to contain the state budget deficit to approximately 2% of GDP. Moreover, the 1999 budget will benefit from a recently adopted increase in excise taxes, which is effective from July 1, 1999. However, these hikes are part of a broader tax package scheduled to reduce personal income taxes from 39% to 32%, corporate taxes from 35% to 31% and the capital gains tax from 25% to 15%. These cuts will come into force from the beginning of next year and most likely result in lower revenues.

On May 18, 1999, the government adopted a medium-term economic strategy for the entry of the Czech Republic into the EU. Its macroeconomic part contains a medium-term budget outlook until 2002 and is linked to the long-term monetary strategy of the central bank. The document's main focus is on microeconomic restructuring and on improving the business environment in order to embark on a catching-up process with the EU. Within ten years, the Czech Republic intends to raise its GDP per capita to two thirds of Germany's level.

Structural reforms have recently speeded up; they have concentrated on the banking sector, which is burdened with substantial substandard and non-performing loans (with shares of close to 30% of total loans at the end of March 1999), as well as on large, highly-indebted industrial conglomerates, typically the banks' main debtors.

The privatization of banks has made progress. In late May 1999, it was announced that the 66% state stake in Československá Obchodní Banka (ČSOB), the third-largest bank, will be sold to the Belgian KBC Bank for CZK 40 billion (USD 1.1 billion). The contract is to be signed soon. The two other big banks in which the state holds significant stakes, Komerční Banka (49% state owned) and Česká Sporitelna (48% state owned), are currently being recapitalized in order to prepare them for privatization. Both banks recorded significant losses in 1998 and in the first quarter of this year.<sup>1</sup>) In early 1999, the government decided to increase Česká Sporitelna's equity by up to CZK 7.6 billion. This capital injection will come on top of a bailout at the end of last year, when Konsolidacni Banka bought CZK 10.5 billion of bad loans from Česká Sporitelna and the National Property Fund granted Česká Sporitelna a subordinated loan of CZK 5.5 billion. The privatization of the bank has started with the invitation of bids in April 1999 (reportedly six foreign banks and the Czech insurance company Česká Pojistovna have expressed their interest in Česká Sporitelna) and is planned to be completed by early next year. In May 1999, the government decided to raise Komerční Banka's capital by between CZK 7.5 billion and CZK 9.5 billion, starting in July 1999. According to the government's timetable, bids for

<sup>1</sup> These high losses are very much associated with a substantive tightening of disclosure requirements and provisioning requirements for nonperforming assets, enacted in 1998 (see Focus on Transition 2/1998) and, in the case of Česká Sporitelna, also with losses due to a high exposure towards Russia.

Komerční Banka will be invited before year-end and the bank's sale will be finalized by summer or fall 2000.

In April 1999, the government adopted a revitalization program for large loss-making conglomerates. A revitalization agency, a subsidiary of Konsolidacni Banka, will temporarily take control of large problem companies,<sup>1)</sup> restructure and eventually, at the latest by January 1, 2003, privatize them. Companies to be included in the program have to fulfill three out of four criteria, namely they have to have a workforce of more than 2,000 employees, annual purchases of domestic inputs have to come to at least CZK 1 billion, outstanding debt at Komerční Banka, Česká Sporitelna or Konsolidacni Banka has to exceed CZK 3 billion, and they have to have earnings (rather than losses) before interest and tax payments. The revitalization program is supposed to be managed by an international investment bank. The respective tender announcement is envisaged for mid-1999. The authorities have not yet agreed on a list of companies to be revitalized under this program. It is therefore too early to assess what scope the program will have, how it will affect the budget and to what extent it will remedy existing microeconomic weaknesses. Along with the restructuring of the conglomerates, enterprise privatization, in particular the sale of public utilities, is to be speeded up.

In the legal field, a recently adopted amendment to the public auction law has somewhat simplified procedures for creditors to seize collateral; unfortunately, the revised rules are applicable only to newly granted loans.

On January 1, 1999, a government decree on capital transactions approved in May 1998 took force. It removes the remaining restrictions on the following types of capital movements: financial credits and guarantees extended by residents to nonresidents, the issue and introduction of foreign securities on Czech markets, derivatives operations, and the purchase abroad of foreign currency by residents (except for the purpose of circumventing restrictions on capital movements).

## 2.2 Hungary

Economic growth accelerated to 5.1% in 1998 from 4.4% in the year before, with growth continuing unabated at 5.2% in the fourth quarter of 1998. Besides investment (fixed capital formation rose by 11.4%), growth was increasingly driven by private consumption, which recovered markedly (+3.8%), and also by public consumption (+4%). Export growth (16%) lost a good deal of its momentum during the course of the year and was outpaced by import growth (22.2%), which fell much more slowly. Industrial production and construction grew by 13% in 1998, while agriculture stagnated.

The most recent data show that growth, continuously driven by domestic demand, slowed somewhat in early 1999: Industrial production growth decelerated to 7.1% in the first four months of the year (which is still markedly stronger than in the other four countries under review), while construction advanced by 5.7% in the first quarter. Retail sales expanded sluggishly in

*1 Under the program, the revitalization agency will buy problem loans of the companies from the large state-owned banks and other creditors and take control of the enterprises by performing debt-equity swaps.*

the first two months, but soared in March, yielding an overall growth of 6.5% in the first quarter of 1999. In the same period, fixed capital formation increased by 7.1%.

Dynamic growth in 1998 reduced the unemployment rate from 10.4% at the end of 1997 to 9.6% a year later; this is the lowest yearend figure since 1992. In early 1999, the unemployment rate moved back to levels slightly above 10% before falling to 9.6% in May 1999, essentially the same level as 12 months earlier. Real wages increased by 3.7% in 1998 and by 3.1% during the first quarter of 1999, while labor productivity continued to grow, although at somewhat less dynamic rates recently.

Inflation went down significantly in 1998 (annual average: 14.3% after 18.3% in 1997) and in early 1999. Since January 1999, annual inflation has fallen to a single-digit level for the first time since 1987. The authorities expect consumer prices to rise by 9% in 1999 (annual average); the twelve-month inflation rate for December 1999 is forecast at 8%.

The deficit in the current account increased from USD 1 billion in 1997 to USD 2.3 billion in 1998 (4.8% of GDP). There are three reasons for this deterioration, namely a higher trade deficit (USD 2.1 billion after USD 1.7 billion in the year before<sup>1</sup>), a falling surplus in the services balance, and a significant rise in net income payments abroad. FDI inflows amounted to USD 1.9 billion, while FDI outflows came to USD 0.5 billion. Portfolio investments were highly volatile in 1998; over the whole year, Hungary recorded an inflow of USD 2 billion.<sup>2</sup> In 1998, gross foreign debt rose from USD 23.7 billion to USD 26.7 billion. Official currency reserves mounted from USD 8.4 billion at the end of 1997 to levels of around USD 10 billion in mid-1998. After the outbreak of the Russian crisis, reserves declined to USD 8.3 billion, but recovered again later (USD 9.3 billion at the end of 1998).

In the first four months of 1999, the current account deficit increased further to USD 763 million (compared to USD 445 million), mainly because the shortfall on trade burgeoned from USD 374 million to USD 654 million. Net FDI inflows rose to USD 563 million (against USD 427 million). In early April, Hungary was the first transition country to issue a global bond.<sup>3</sup> Hungary's official borrowing program for 1999 was almost completed in early June 1999.<sup>4</sup> Gross foreign debt at the end of March 1999 amounted to 26.4 billion, slightly less than at the end of 1998. By the end of April 1999, official reserves had declined somewhat to USD 8.7 billion.

<sup>1</sup> In 1998, exports grew by USD 1.1 billion, while imports increased by USD 1.5 billion.

<sup>2</sup> After inflows had been very high during the first four months of 1998 (USD 1.8 billion), they dried up in the May to July period. Between August and October, the country experienced outflows on the order of USD 1.4 billion due to the impact of the Russian crisis; during the last two months of the year, there was another sharp turnaround and inflows amounted to USD 1.6 billion.

<sup>3</sup> Due to the Kosovo crisis, the issue was initially put off from end-March to the second week of April, and the volume was reduced from USD 750 million to 500 million. In early May 1999, market conditions became more favorable again, and the bond was brought back to the originally planned sum.

<sup>4</sup> At this time, the country placed a five-year EUR 500 million bond priced 71 basis points over comparable French bonds.

After a short break in the wake of the Russian crisis,<sup>1)</sup> in November 1998 the central bank returned to the policy of fairly frequent and small interest rate reductions it had followed since mid-1995. From November 1998, the repo rate was lowered by 375 basis points, and the two deposit rates by 175 and 275 basis points respectively. Currently, the repo rate for active overnight transactions is at 17.75%, the overnight deposit rate at 12.75% and the two-week deposit rate at 15.25%. The base rate, which had been cut in five steps from 20.5% to 17% in 1998, was further reduced to 16% effective February 1, 1999, and to 15.5% as of June 1, 1999. The forint, which had been at the weaker end of the fluctuation band ( $\pm 2.25\%$ ) in September and early October 1998 as a consequence of financial contagion from Russia,<sup>2)</sup> recovered to a level around parity in November 1998 and appreciated further close to the stronger edge of the band at the turn of 1998/1999. In late February 1999, it moved back to levels around parity and remained in this range until mid-April. Subsequently, it again appreciated close to the stronger end of the band, where it has been trading since early May.

The gradual lowering of the automatic monthly devaluation rate within the crawling peg system was continued: As of January 1, 1999, the rate was reduced from 0.7% to 0.6%, in April 1999 further cuts to 0.5% as of July 1, 1999, and to 0.4% as of October 1, 1999, were announced. These preannouncements of the exchange rate path by the central bank cover a comparatively long period of more than half a year, probably with the intention to further dampen inflation expectations and wage growth as well as to discipline fiscal policy, which, if successful, would contribute to containing the current account deficit. In April 1999, the discussion on a potential widening of the band regained momentum. The finance ministry appears to be in favor of a fast widening of the band, while the central bank takes a more cautious view. Hungary plans to phase out the crawling peg by around 2001 and to peg its currency to the euro; at this stage, at the latest, Hungary will move to a wide fluctuation band.

The general government budget recorded a deficit of 4.6% of GDP, slightly better than the target of 4.9%. As compared to 1997, when a general government deficit of 4.4% of GDP had been recorded, the fiscal stance remained basically unchanged. As in the years before, the 1998 central budget deficit (3.3% of GDP) was lower, the social security deficit higher than planned. The budget for 1999 adopted at the end of 1998 includes a general government deficit target of 4% of GDP. It is based on a 5% GDP growth assumption, but contains a special reserve which was built into the budget in the wake of the Russian crisis in order to accommodate a growth slowdown of up to 1 percentage point. Fiscal developments in early 1999 raised doubts about whether the budget target would be achievable. Within the first four months of the year, the deficit reached 70% of the target for all of 1999. As a first reaction to this trend, the government decided to freeze the special reserve in the second half of February. More recently, the authorities have hinted that further corrective measures in the order of half a per-

1 See *Focus on Transition 2/1998*.

2 See *Focus on Transition 2/1998*.



centage point of GDP may be needed to meet the original fiscal target, but that no measures would be taken before August. In mid-January 1999, Hungary was the first transition country to issue a ten-year bond on the domestic market denominated in a national currency.

In mid-December 1998, the rating agency Standard & Poor's raised Hungary's long-term sovereign debt rating from BBB- to BBB with a stable outlook.

Structural reforms have been continued. The recapitalization of the Postabank and the Hungarian Development Bank was effected at the end of 1998, as planned.<sup>1)</sup> Realbank, a small bank which had become insolvent, was closed in January 1999, after a rehabilitation attempt led by the Deposit Insurance Fund had failed. The next bank failure occurred in spring 1999: The Vienna-based CW Bank, a subsidiary of the Hungarian central bank, which had accumulated substantial amounts of bad loans in recent years, will either be sold by mid-year or silently taken off the market. Its nonperforming assets will be taken over by the Hungarian Development Bank. The Land Mortgage Bank is ailing as well and is to be recapitalized by the Hungarian State Privatization and Holding Company and the Hungarian Development Bank; it is to be put up for sale later this year. In the enterprise sector, the government is about to reduce the list of strategic companies and thus to lift some of the remaining restrictions on privatizing these firms (blocking minority stakes and golden shares); furthermore, it is working out a strategy for the management of those enterprise stakes which are to remain permanently in state hand.

In conjunction with the 1999 budget, several reform steps were taken, in particular the introduction of joint tax and social security contribution collection, furthermore an adjustment of the pension indexation formula. A more ambivalent step concerned the three-pillar-based new pension system which had come into force at the beginning of 1998: It was to some extent diluted by the repeal of the increase in the contribution rate to the second (obligatory, fully-funded) pillar envisaged for 1999.<sup>2)</sup> Currently, the pension system is being reviewed by a government commission, which is to present proposals for further adaptations by the end of July. A further weakening of the second (and possibly of the third) pillar would call into question one of the most important economic reform steps Hungary has taken in recent years.

Currently, a tax reform is being worked out. It is scheduled to go into effect at the beginning of next year. The main aim of the reform is not a fundamental change, but rather a simplification of the tax system. VAT rates are to be brought somewhat more in line with EU levels, however it will be difficult to offset revenue shortfalls resulting from a lowering of the higher rate of 25%. The number of income tax brackets will probably be reduced to two (25% and 40%) and a modest capital gains tax will be introduced. The gov-

<sup>1</sup> For more details see *Focus on Transition 2/1998*.

<sup>2</sup> The system proved to be more expensive than expected, as more Hungarians switched to the new system during 1998 than envisaged. The reform measure intends to contain the budgetary effects this has.

ernment also intends to further lower the nonlabor wage costs, which have already been reduced as of January 1999.

A social security and health care reform is planned to come into effect as of January 2001. Preparatory work on this reform is still in an early conceptual phase.

### 2.3 Poland

Real GDP grew by 4.8% in 1998, with decelerating growth rates from the second quarter of 1998 onwards. In the last quarter of 1998, growth was at 2.9% year on year; estimates for the first quarter of 1999 range from 1.5% to 2.5%, pointing to a further deceleration. In 1998, growth was driven mainly by domestic demand, both in consumption and investment. Gross fixed capital formation was up 14.5% in real terms in 1998; during the first quarter of 1999, the enterprise sector's investment outlays augmented by 15%. Individual consumption rose by 4.9%.<sup>1)</sup> Industrial production was up 4.8% in 1998. After a slump in January and stagnation in February 1999, there was some recovery in March and April, which mitigated the overall fall in industrial sales during the first four months to 2.3% year on year. Construction, which had grown by 11.6% in 1998, remained flat during the first four months of 1999. Agricultural production accelerated by 6.6% in 1998. The unemployment rate crept up from 9.5% of the labor force in August 1998 to 10.4% in December and climbed further to 12.1% in March 1999 before falling to 11.8% in April 1999. This is close to 2 percentage points higher than in April 1998.

Disinflation continued in 1998 and early 1999. In October 1998, the year-on-year CPI inflation rate dropped to single digits for the first time since 1981. On average, consumer prices increased by 11.8% in 1998, 3.1 percentage points less than in the year before. The first two months of 1999 witnessed a further slowdown (despite some hikes in administered prices in January), while year-on-year inflation accelerated slightly after that (May 1999: 6.5%).

Poland's current account deficit reached USD 6.8 billion in 1998 (compared to USD 4.3 billion in 1997). This corresponds to 4.5% of GDP. The increase was mainly due to the trade deficit, which widened from USD 11.3 billion in 1997 to USD 13.7 billion in 1998.<sup>2)</sup> Moreover, the services balance shifted from a USD 0.5 billion surplus to a USD 0.3 billion deficit, while the surplus in the current transfers balance improved by USD 0.8 billion to USD 1.9 billion. While the current account deficit was lower in the first eight months of 1998 than in the same period of 1997, it worsened rapidly from September onwards, reflecting a fast-rising trade deficit due to the effects of the Russian crisis, slower growth in the EU and possibly to the earlier real appreciation of the zloty. The 1998 current account deficit was largely financed by FDI inflows, which increased by USD 2 billion to USD 5 billion on balance. Net portfolio inflows came in at USD 1.3 billion, other investment at USD 4.4 billion net. In the course of 1998, Poland's already high

1 No figures on other aggregate demand components were available yet during writing.

2 Imports grew by USD 5.4 billion, exports by USD 3 billion.

official reserves increased by another USD 6 billion to USD 26.4 billion (import coverage: more than seven months).

During the first four months of 1999, the current account deficit widened further, reaching USD 3.2 billion (as compared to USD 2.5 billion), despite a narrowing of the trade deficit by more than USD 0.4 billion to USD 3.8 billion. This, however, was overcompensated by a worsening of the services and the unclassified flows balances. Net FDI inflows increased slightly to USD 1.5 billion, while net portfolio investment recorded an outflow of some USD 0.5 billion; other investment inflows were at USD 0.5 billion. Official reserves declined slightly during the first four months of 1999 (April 1999: USD 25.4 billion, import cover: six months).

The consolidated budget deficit<sup>1)</sup> reached 2.4% of GDP in 1998, the general government deficit was somewhat higher. It is difficult to assess to what extent the fiscal stance changed from 1997 to 1998, as the calculation and classification methods for fiscal accounts were modified at the beginning of last year. According to our own calculations, the 1997 consolidated budget deficit, determined according to the new methodology, was in the order of 2.7% of GDP. Moreover, the definitions of broader fiscal balances are not fully transparent. According to the European Commission and the OECD, the general government budget deficit barely changed from 1997 to 1998 while the Polish Finance Ministry reported a tangible improvement of the public sector deficit from 1997 to 1998.<sup>2)</sup>

The consolidated budget deficit for 1999 is forecast to come in at 2.15% of GDP based on a GDP growth projection of 5.1%.<sup>3)</sup> During the first four months of 1999, the deficit reached 73% of the target for the entire year, with high deficits in the first two months, mainly due to prepaid reforms of provincial and local administration as well as the health care system, but also due to a high social security deficit as well as lower VAT and corporate income tax revenues. According to the Polish Finance Ministry, revenues will be close to plan in 1999; as most of the shortfall to date will be recovered during the remainder of the year, expenditures will be contained and no fiscal adjustment will be needed to meet the deficit target.<sup>4)</sup> In May 1999, Poland was the second transition country (after Hungary) to issue a ten-year bond on the domestic market, denominated in a national currency.

1) The consolidated government balance includes the central government, social security funds and the local governments. Changes in public-sector commitments are excluded. Privatization revenues are counted as a financing item.

2) The European Commission holds that the general government deficit decreased from 3.1% of GDP in 1997 to 3% in 1998. According to the OECD, the general government shortfall shrank from 3.8% of GDP in 1997 to 3.7% in 1998. The Polish Finance Ministry has stated, however, that the deficit of the public sector (which should closely correspond to the general government deficit) went down from 4.5% in GDP in 1997 to 3.1% in 1998.

3) Due to the direct and indirect impact of the Russian crisis on Poland, the growth assumption was reduced from an original 6.1% in the budgetary process.

4) Several observers expect the Polish deficit to come in 0.5 percentage point of GDP higher than originally envisaged due to lower GDP growth and the higher-than-expected costs of implementing reforms (especially in health care). Furthermore, revenues may be lower than targeted, as inflation may remain below the budget assumptions (8.5% year on year in December 1999).

The zloty, which had been hit temporarily during the Russian financial turmoil but recovered a good deal of its losses within a few weeks,<sup>1)</sup> appreciated until early 1999 to 9 percentage points above parity, before weakening again against the background of the Brazilian crisis and domestic worries. Between the end of February and the end of April it practically fluctuated in a range between -1 and +1 percentage points from parity, subsequently it recovered somewhat to a range of between +2 and +3 percentage points above parity.

In January 1999, the National Bank of Poland adopted a new monetary policy strategy by switching to direct inflation targeting while retaining, for the time being, the crawling band regime. The Polish central bank targets consumer price inflation; the target for end-1999 was originally set at 8% to 8.5% year on year, but was lowered to 6.6% to 7.8% in March 1999 because of unexpected disinflation. The bank's intention is to reduce inflation to 4% by 2003.

In March 1999, the National Bank of Poland decided to lower the monthly crawling peg rate from 0.5% to 0.3%. At the same time, the fluctuation band was widened from 12.5% to 15% on either side of the central parity rate. Both measures follow up on earlier steps to reduce the crawl rate and extend the band implemented in recent years. Poland intends to float the zloty in the not-too-distant future in order to determine the equilibrium exchange rate and, subsequently, to peg it to the euro within a fluctuation band of  $\pm 15\%$ .<sup>2)</sup>

On June 10, 1999, the rating agency Standard & Poor's raised the Polish long-term sovereign debt rating to BBB with a positive outlook (from BBB- with a positive outlook).

Structural reforms have recently concentrated on health care, the pension system and the state administration. At the beginning of 1999, a first package of measures for the reform of the health system went into force. However, central elements of the reform were badly designed and thus proved difficult to implement. This has led to a very tense situation in the health sector, which more recently has gradually eased.

During the second half of 1998, the legal basis for the pension reform was completed. The reform, which replaces the pay-as-you-go with a three pillar system (pay-as-you-go, obligatory fully-funded and voluntary fully-funded), went into force on January 1, 1999, but became fully effective only in April when the eighteen pension funds of the second pillar began to operate. All Poles born in 1969 and later have to join the new system while people born before 1949 remain in the old system. The age group in between can opt for either the old or the new system until the end of 1999.

A third reform, which took effect at the beginning of 1999, revamped administration at the district and local level. Changes include a reshuffling

1 See *Focus on Transition 2/1998*.

2 On June 7, 1999, the National Bank of Poland discontinued trading in currencies as part of the fixing mechanism at the end of the day and began to announce official daily zloty rates based on the quotations of the banks most active in the market.

of responsibilities and the introduction of a new system for allocating financial funds among the different territorial authorities.

In the banking sphere, privatization is continuing. The search for a strategic investor to take over up to 52% in the Grupa Pekao SA, the second-largest bank by assets, is nearing completion: The successful bidder will presumably be announced by the end of June 1999. The privatization of up to 80% of Bank Zachodni, Poland's twelfth-largest bank in terms of assets, is also well advanced, with only one bidder still in the race; it is to be finalized in the third quarter of 1999. With the completion of these two transactions, two banks remain for privatization, Bank PKO BP, the largest retail bank, and BGZ SA, which primarily serves the agricultural sector. The sale of these two banks is tentatively planned for 2000 and 2001, but will probably have to be preceded by a restructuring of the loan portfolios of both institutes.

During the first months of 1999, no large-scale privatizations were carried out, but a number of projects are in the pipeline. Most prominently, the second phase of the privatization of Telekomunikacja Polska (TP SA) is to be launched soon; after an initial sale of 15% in 1998, the government will seek a strategic investor for a 25% to 35% stake in the company. A substantial stake in the country's largest insurance company PZU SA, which was recapitalized in early 1999, will be offered for sale later this year.

The implementation of revised plans to restructure and downsize the coal mining sector begun in 1998 is continuing, but has recently been accompanied by miners' protests. Plans to restructure the oil and steel sectors were approved in 1998, but implementation has begun only for the oil sector, where mergers have taken place and the privatization of refineries is being prepared. In the steel sector, the government is currently undertaking a new attempt to restart privatization: It intends to sell Poland's largest steel mill in Katowice later this year.

In January 1999, a new foreign exchange law took effect. It restates the full liberalization of current transactions in force since 1995. The new law abolishes all limitations on medium- and long-term capital movements within the OECD area. All balance-of-payments transactions can now be effected in zloty. The law incorporates safeguard clauses, which can be invoked for monetary policy reasons and if the stability of the financial system is at risk.

For 2000, an overhaul of the tax system is planned: The corporate income tax is to be lowered from 34% to 28% (and gradually reduced further to 22% by 2003), a number of exemptions and tax credits are to be abolished, but new subsidies will be introduced for families with three or more children. For individuals, the effective tax burden will rise on average. A reform of the personal income tax will follow in 2001: The government intends to lower tax rates and reduce the number of brackets from three to two (18% and 28% instead of 19%, 30% and 40%).

## 2.4 Slovakia

Real GDP growth in 1998 was 4.4%. After dynamic growth in the first three quarters, a considerable slowdown (to a mere 0.5%) was recorded in the fourth quarter. In 1998 as a whole, private consumption advanced by 4.9%, public consumption by 0.2% and investment by 11%, while export growth outpaced import growth. Industrial production expanded by 5%, construction (driven by large state-financed projects) by 15%, while agriculture stagnated. The economy appears to have deteriorated further in early 1999, mainly as a consequence of austerity measures (see below). Industrial production in the first four months of 1999 declined by approximately 5% as compared to the average 1998 level,<sup>1)</sup> while construction plummeted by 27.4% against the January to April 1998 period. Real wages, which had increased by 2.7% in 1998, stagnated during the first four months of 1999, while retail sales went up by 6.2%.

The unemployment rate shot up from 12.5% to 15.6%<sup>2)</sup> in 1998 and increased further to 16.7% during the first quarter of 1999. In April, it came to 16.4%.

Average CPI inflation was at 6.7% in 1998, slightly up from 6.1% a year earlier, while monthly year-on-year inflation fell somewhat in the course of 1998. A strict monetary policy and the delayed adjustment of administered prices contributed to this performance. The flotation of the koruna last October<sup>3)</sup> had no immediate impact on consumer price developments. In early 1999, consumer price inflation crept up a bit to around 7%, mainly due to the increase of regulated prices.

The current account deficit reached USD 2.1 billion in 1998 (10% of GDP), up from an upward-revised USD 2.0 billion a year earlier. The current account deficit was attributable mainly to a trade gap of close to USD 2.3 billion (compared to USD 2.1 billion in 1997).<sup>4)</sup> The rise in the trade deficit coincided with the gradual phasing out of an import surcharge introduced in mid-1997. In 1998, Slovakia attracted more FDI than in previous years (USD 374 million), but compared to other transition economies inflows still remained low. Portfolio investments recorded an outflow of USD 175 million, while other investment inflows (chiefly loans from abroad) on the order of USD 1.5 billion were the main source from which the current account shortfall was covered. In the first two months of 1999, the current account deficit halved to USD 147 million and the trade gap contracted to USD 187 million.<sup>5)</sup> On June 9, 1999, Slovakia returned to international capital markets for the first time after having lost its investment grade rating last September<sup>6)</sup> to issue its first euro-denominated bond.<sup>7)</sup>

1 Since the beginning of 1999, changes in industrial output data published by the Slovak statistical office have related to the average of the previous year (and no longer to the same period of the preceding year).

2 The actual increase was even higher, as the calculation method was changed at the beginning of 1998; *ceteris paribus*, this lowered the unemployment rate by approximately 1 percentage point.

3 See Focus on Transition 2/1998.

4 Exports grew by USD 2.4 billion, imports by USD 2.6 billion.

5 Converted at a rate of SKK 37.5 per USD.

6 See Focus on Transition 2/1998.

7 The bond has a five-year maturity; its volume was increased from an original EUR 300 million to EUR 350 million, its spread over comparable German bunds was 420 basis points.

Official foreign exchange reserves, which had fallen significantly in the weeks before the flotation of the koruna, remained stable at around USD 2.9 billion between October 1998 and March 1999. More recently, official reserves decreased further (as the central bank intervened to defend the exchange rate) to USD 2.5 billion in early June 1999. This corresponds to approximately ten weeks of imports. High debt-creating inflows were reflected by the ongoing fast enlargement of gross external debt, which climbed to USD 11.8 billion in December 1998 from USD 10.7 billion in December 1997. In January 1999, total debt increased slightly before falling significantly – to USD 9.9 billion – in February 1999. The decrease in commercial banks' debt was primarily due to a reduction of their short-term debt in the wake of a decision by the central bank to abolish the required foreign exchange position limit.<sup>1)</sup> Moreover, corporate foreign debt declined.

The 1998 state budget deficit amounted to 2.7% of GDP, significantly higher than both the original and the revised forecasts of 0.7% and 1.1% of GDP respectively. The general government deficit was estimated at some 5.5% of GDP, which meant a further deterioration from the already high deficit ratio of 1997. Large-scale state investments in infrastructure and housing were among the driving forces behind widening fiscal deficits; the situation was compounded by increasing tax collection problems. The 1999 budget passed in March envisages a substantial rectification of the fiscal stance. The central government deficit is to be lowered to 1.8% of GDP, while the general government deficit is to be slashed to 2% of GDP; the budget is based on a GDP growth assumption of 3%. This fiscal turnaround is at the heart of the macroeconomic policy steps taken after the change in government last fall.<sup>2)</sup> According to the original budget plan, it was to be achieved mainly by measures on the expenditure side (especially a reduction of public investment and a freeze on the wage total in the public sector). Moreover, the budget plan provides for a significant upward adjustment of administered prices and measures to contain tax evasion. A first wave of price increases, mainly for private households, was enacted in January and February 1999, and a number of tax law amendments designed to improve tax collection came into force in April. The new authorities perceive fiscal austerity to be instrumental in reducing aggregate domestic demand and the current account disequilibrium to 5% to 6% of GDP.

Against the backdrop of worse-than-expected budget developments<sup>3)</sup> and an increasingly blurred growth outlook, which put pressure on the koruna (see below), the government in late May 1999 adopted additional fiscal measures equivalent to some 2.5% of GDP in order to achieve the original target. Unlike in the original budget plan, the stress is mainly on revenue-enhancing measures: A 7% import surcharge applicable to 75% of imports was introduced as of June 1, 1999,<sup>4)</sup> and the lower VAT rate will

<sup>1)</sup> Concomitantly, the foreign exchange reserves of the banking system fell significantly.

<sup>2)</sup> See *Focus on Transition 2/1998*.

<sup>3)</sup> The budget deficit reached 58% of the whole-year target in the period January to May 1999.

<sup>4)</sup> The import surcharge is to be lowered to 5% as of January 2000, to 3% as of July 2000 and is to be abolished as of end-2000. The (re)introduction of the surcharge was criticized by the European Commission and by some Member States.

be raised from 6% to 10% as of July 1999 (and to 12% as of January 2000), while the higher VAT rate will be lowered from 23% to 22%. In addition, some excise taxes were raised.<sup>1)</sup> On the expenditure side, social transfers (unemployment and health benefits) will be lowered as of July 1, 1999. Simultaneously, further significant rises in administered prices will come into effect, especially for households. Due to these increases, the authorities expect this year's average CPI inflation to come in at 11.4% (instead of the previously forecast 10%). These measures are complemented by two steps of a more medium-term nature, namely a substantial reduction in the number of civil servants over the next two years and a gradual reduction of the corporate tax to be implemented from 2000 onwards and completed in 2005.

Overall, monetary policy has remained strict after the flotation of the koruna last October. Recently, the lowering of the minimum reserve rate from 9% to 8% in April 1999 marked a slight relaxation. The intermediate monetary target is M2; simultaneously, the central bank intends to focus more on the inflation target. During the last two months of 1998, the koruna weakened slightly against the DEM. In early 1999, it traded fairly stably against the EUR at rates of about SKK 43 per euro; by mid-March, it had depreciated to levels of SKK 45/EUR, and in May to SKK 47/EUR. Most recently, after the announcement of additional fiscal stabilization measures, the koruna recovered to levels below SKK 46/EUR.

Before the change in government, the pace of structural reforms was very slow. Privatization was nontransparent. An enterprise revitalization program weakened the financial discipline of companies without furthering reform. In fact, due to a lack of financial means, it was barely implemented. The profitability of the enterprise sector worsened while intercompany arrears grew. The banking sector has become more fragile in recent years. Competition in the sector remained relatively low, and there was no genuine privatization of state-owned banks. The share of classified loans in the books of the three large, state-owned banks is between 30% and 40%, while provisions are substantial as well but do not fully cover prospective losses.

The new government put structural reforms on the agenda again, with the main aim of strengthening competitiveness, especially of industry. The financial discipline of enterprises is to be improved, inter alia by a functioning and flexible insolvency law which is currently being worked out. The enterprise revitalization program, which softened enterprises' budget constraints, was cancelled in November 1998. Stepping up the fight against asset stripping in the enterprise sector is another priority.

Privatization is to be put on a transparent basis and is to be accelerated. Ambiguous privatization deals undertaken before the fall of 1998 are being reviewed, but will be repealed only in case of blatant irregularities; the review process is to be concluded soon. The privatization of a 34% to 49% stake of the Slovak telecom company is about to be launched, the respective tender announcement is envisaged for July 1999. Until fall 1999, a 36% share of Slovakia's mobile telephone operator will be offered

*1 These tax measures still have to be approved by Parliament.*



for sale. Furthermore, privatization restrictions on strategic enterprises were loosened in May 1999, and the government is preparing to abrogate the act on strategic enterprises.

The banking sector is to be restructured, and the state-owned banks are to be privatized, preferably by sale to foreign strategic investors. Alongside with the recent fiscal stabilization measures, the government announced a timetable for bank privatization in late May. The 51% state stake in VUB, the largest commercial bank, is to be privatized by the end of 2000. The other big state-owned bank, Slovenska Sporitelna, which is fully publicly owned, is to be partially privatized until summer 2000. The state will probably retain a 51% stake in the institute. The privatization of IRB, the third-largest bank, which had been put under central bank administration in late 1997, has already begun and is to be completed by October 1999. A more detailed bank restructuring plan is to be presented in mid-1999. The Finance Ministry estimates that the cost of bank rehabilitation will run to up to 10% of one year's GDP. Moreover, the authorities confirmed their commitment to a thorough overhaul of the banking law and capital market regulations. In early June, Parliament passed an amendment to the deposit insurance law, which strengthens the protection of bank deposits of natural persons and introduces an accelerated mechanism of payoffs of deposits to citizens from a defaulted bank.

In April 1999, substantial tax incentives were introduced for medium-sized and large foreign direct investments, in particular for export-oriented production and tourism.

## 2.5 Slovenia

Real GDP grew by 3.9% in 1998. After a strong first quarter (+6.4%), growth ran to between 3% and 4% in the subsequent three quarters. Growth was driven by domestic demand. Within the latter, gross fixed investment rose somewhat more dynamically than consumption. Net exports, in turn, deteriorated slightly. Industrial production was up 3.7% in 1998, after a shallow 1% rise in both 1996 and 1997. Construction increased by 3.9% last year, agricultural output by 2.2%. In early 1999, growth appears to have slowed. Industrial output in the period January to April 1999 fell by 5.4%, but these data will probably be revised. The unemployment rate (national definition) has been very stable in recent years, hovering between 14% and 15%; in March 1999, it was at 14.1%. Measured by the ILO methodology, the jobless rate has continued to be much lower (7.7% in the first quarter of 1999).

Between late 1995 and spring 1998, the pace of disinflation was very slow. Since then, CPI inflation has decelerated considerably, from high single-digits to 4.3% year on year in May 1999. Apart from favorable price developments on world markets, moderate wage developments contributed to this performance: Real wage growth was at a mere 1.6% in 1998 and 2.2% in the first quarter of 1999, following a two-year wage agreement among social partners passed in mid-1997. In spring 1999, this agreement was renewed for another two years, which bodes well for future wage developments and their impact on prices. Furthermore, the agreement will also

limit the impact the introduction of a value-added tax system in mid-1999 (see below) will have on the price level.<sup>1)</sup>

As in the period 1995 to 1997, Slovenia recorded an essentially balanced current account in 1998. The trade deficit also remained virtually unchanged (USD 775 million).<sup>2)</sup> The trend in the first quarter of 1999 does not indicate any substantive change in this pattern. Net FDI inflows reached USD 154 million in 1998, only half the amount recorded in the year before. Legal obstacles (e.g. in the company law), the dispersed ownership structure of privatized enterprises and a certain ambivalence toward foreign direct investment in general may have contributed to this fairly disappointing performance. Other capital flows remained rather small, too. Official reserves increased from USD 3.3 billion to USD 3.6 billion in the course of 1998, while gross foreign debt increased from USD 4.2 billion to USD 4.9 billion in the same period.

Slovenia's monetary policy, which is based on monetary targeting (but also places a strong weight on exchange rate developments), remained basically unaltered in 1998 and in early 1999. In line with falling inflation, the discount and the lombard rates were lowered from 10% to 8% and from 11% to 9% respectively, as of January 1, 1999. The monetary target for 1999 envisages M3 growth of 16% to 24%. During the first five months of 1999, the tolar depreciated against the euro by 2.5% in nominal terms, after 2.4% against the ECU during the whole of 1998.

The fiscal stance tightened slightly in 1998, as the general government deficit ran to 0.6% of GDP, following a deficit of 1.1% in 1997. Expenditure cuts in the last quarter of 1998 were instrumental in containing the deficit. The 1999 budget, which was passed by Parliament in December 1998, envisages a general government deficit of 0.7% of GDP. It is based on a 3.5% to 4% real GDP growth assumption. During the first four months of 1999, the central budget recorded a fairly small deficit.<sup>3)</sup>

In recent months, Slovenia has speeded up structural reforms in some areas, partly against the backdrop of the Association Agreement with the EU entering into force.

In February 1999, a new banking law became effective which grants freedom of establishment to foreign banks. Moreover, the special approval procedure for foreign direct investments in Slovenian banks of up to 10% of base capital was abolished. Furthermore, the law reforms the deposit insurance system and strengthens the central bank's powers in the event of a banking crisis. Overall, competition in the Slovenian banking sector is still weak. The long-standing interbank cartel agreement on deposit interest rates was replaced by a somewhat looser recommendation by the Banking Association in early 1999, which may spur competition in this market segment. The two big banks Nova Ljubljanska Banka and Nova Kreditna Banka Maribor, which play a prominent role in the sector, still await privatization.

1 According to the new wage agreement, VAT-related price increases will not be fully compensated.

2 Exports and imports grew by USD 0.7 billion each.

3 Figures for the general government balance in the first months of 1999 are not available.

Also in February 1999, the Bank of Slovenia eased some of the capital controls which had been introduced between 1995 and 1997. While in general, foreign portfolio investments must still be effected through custodian accounts with local banks, investors who hold their investments for at least four years (or sell them to other nonresidents during this period) have been exempted. Moreover, only investments of up to 10% of a company's capital are to be counted as portfolio investment (before: 50%). Furthermore, foreign financial loans are no longer subject to non-interest-bearing deposits (before: 40% of the loan volume for all loans of up to seven years). However, the central bank retains the legal right to reinstate such deposits temporarily in emergency situations. In April 1999, a new foreign exchange law took effect. It brought regulations in this field in line with the EU Association Agreement. In contrast to the earlier law, it is based on the principle that balance-of-payments transactions are considered free, unless explicitly restricted. The new law uses the same terms and typology of capital movements as the EU, thus harmonizing national with European standards. Inter alia, it widens investment possibilities for foreigners, who now can own up to 100% of the equity in rail, air transport and publishing companies (previously restricted), while restrictions on foreign ownership remain in place for five sectors: the military industry, insurance companies, investment fund management companies, brokerages and the mass media. Furthermore, the new law removes restrictions on outward foreign direct investment.

In December 1998, Parliament decided to replace the existing sales tax system by a VAT as of July 1, 1999. The standard VAT rate will be 19%; a reduced rate of 8% will apply to food, school books, hotel services and a few other items. A reform of the corporate and income tax regimes originally scheduled to be passed together with the introduction of the VAT was delayed and is one of the major reform tasks for the near future.

In April 1999, the government reached agreement with the trade unions on a reform of the pension system. The package which is now pending discussion in Parliament will modify the current pay-as-you-go system and supplement it with a voluntary fully-funded pillar. The retirement age will gradually be raised from 58 to 63 years for men and from 53 to 61 years for women while leaving the possibility of early retirement at 58 in case the insured person has worked for 40 years (men) or 38 years (women) respectively. Furthermore, the pension indexation formula will be modified.

In the enterprise sector, Slovenia faces two main challenges. First, it has to restructure (or close) problem companies owned by the Slovene Development Corporation and to privatize state-owned enterprises. Second, it has to facilitate ownership concentration in the formerly self-managed (socially owned) enterprises, whose privatization was completed at the end of last year, to improve their competitiveness.

Editorial close: June 10, 1999

S T U D I E S

# *Is Direct Inflation Targeting an Alternative for Central Europe? The Case of the Czech Republic and Poland*

Maciej Krzak  
and Helmut Ettl<sup>1</sup>)

## **I Introduction**

In the 1990s, following pioneering New Zealand (1989), a number of industrial economies (Canada, 1991; the United Kingdom, 1992; Finland, 1993; Sweden, 1993; Australia, 1994; Israel, 1994; Spain, 1994) adopted what was termed “direct inflation targeting” (DIT) as their monetary policy strategy.<sup>2</sup>) A distinctive feature of DIT is that it does not use an intermediate target. In most cases the adoption of this framework was a response to difficulties with either exchange rate targeting (pegging), e.g. in the UK, Finland and Sweden, or some monetary aggregate as an intermediate target, e.g. in New Zealand and Canada (Leiderman and Svensson, 1995). A common feature of the DIT countries is their relatively poor inflation record over recent decades compared to other industrial countries such as Germany, Switzerland, Japan and even the U.S.A.; the latter have never adopted inflation targeting. As the former group’s monetary policy credibility was poor, these countries wanted to provide a new nominal anchor for the economy. At the same time, monetary theory was stressing price stability as a desirable goal of monetary policy, deemphasizing its anticyclical role. Since the use of intermediate targets like the exchange rate or monetary aggregates did not succeed in bringing inflation down to targeted levels, which cast doubt on their applicability and the predictability of their influence on inflation in the given countries, policymakers considered passing them by and targeting inflation directly. The alternatives – either pure discretion, which has a number of caveats, in particular so-called time inconsistency, or other intermediate targets such as nominal GDP – were rather unappealing.<sup>3</sup>)

Small wonder then, that the adoption of a new monetary policy framework stimulated research and a lively economic debate on its merits and on practical issues such as the choice of a price index, point targets versus ranges, a time horizon, the accountability of the central bank etc. The experience of inflation-targeting economies has been closely watched. Furthermore, a flurry of papers on the subject in 1995 to 1997 preceded and later coincided with the time during which the European Monetary Institute (EMI) debated what kind of a monetary strategy the future ECB should adopt. As it seems that almost everything has been said on the subject, an additional paper on the topic needs a justification. This justification lies in the fact that, as the first of the transition economies, the Czech Republic and Poland have recently switched to DIT. The usual questions arise: Why did they choose this strategy, are these economies and transition economies in general institutionally fit to use this framework successfully, and under which conditions can they benefit from its use? These two transition economies follow disinflation targeting, as their inflation rates are still relatively

*1* Foreign Research Division, OeNB. Helmut Ettl wrote Section 2.4. We would like to acknowledge Olga Radzyner’s valuable remarks on the draft. The standard disclaimer applies.

*2* In the case of Australia and Israel it is hard to pinpoint the exact dates (see Bernanke et al., 1999). Finland and Spain abandoned the framework when they joined EMU in January 1999.

*3* Furthermore, a direct inflation target is highly visible to the general public, as inflation indices are frequently published while announcements about monetary aggregates are not transparent to the public at large. In turn, despite their visibility, fixed exchange rates entail the risk of collapsing before they succeed in transferring the low inflation of a country (countries) to whose currency the country pegs.

high: They target the path of *disinflation* to low levels. Disinflation becomes even more important in the light of these countries' aspiration to join the EU and subsequently EMU in a few years.

The paper is organized as follows. Section Two discusses the theoretical background of inflation targeting based on the recent findings of mainstream monetary theory. Then it focuses on the mechanics of this monetary policy strategy and on a short comparison of inflation targeting with other monetary frameworks. Several practical issues are discussed subsequently. This part is completed by a concise analysis of four Western economies' experience with inflation targeting. Section Three of the paper describes the framework of inflation targeting in the Czech Republic and Poland pointing out the similarities and differences. Their first experiences are also discussed. Conclusions wrap up the paper.

## 2 Inflation Targeting in Theory and Practice

### 2.1 Underpinnings of Inflation Targeting

The recent conclusions of monetary theory formulate the underpinnings of inflation targeting. They state that price stability is a prime candidate for the ultimate target of monetary policy and deemphasize the countercyclical role of monetary policy. Mainstream economic theory these days establishes and explains the links between money and inflation in the following manner, depending on the time framework (see e.g. Mishkin, 1997):

First, in the long run, there is a systematic relationship between money and inflation, which is a purely monetary phenomenon. The quantity theory of money is valid, which implies that money is neutral in the long run, i.e. it does not influence real variables. Thus, in equilibrium (dynamic steady state), monetary policy can, at best, achieve price stability or, second best, a desired rate of inflation. Therefore price stability or a specific inflation rate are logical choices for final goals of monetary policy. However, in the long run, higher inflation has higher costs in real terms and no benefits in terms of lower unemployment, therefore a low target for the inflation rate is better than a high target. Price stability encourages an efficient allocation of resources because inflation is detrimental to long-term economic growth (see e.g. papers by Barro, 1995; Sarel, 1996; Bruno and Easterly, 1996). Furthermore, price stability also promotes financial stability (Mishkin, 1997).

Second, in the short run, money can influence prices and real variables such as output and unemployment, but in an unsystematic way, i.e. with long and variable lags and with varying effects that are not perfectly understood. Furthermore, activist and discretionary monetary policy with an aim to reduce unemployment in the short run results in the so-called inflationary bias of this policy, which means it mostly leads to higher inflation, but barely affects output (unemployment) if the central bank has incentives to renege on its pledges to deliver low inflation. Policy decisions are made assuming that expectations are given. With expectations fixed, the central bank can stimulate output by pursuing a more expansionary monetary policy than economic agents expect. However, the public also holds expectations of monetary policy and simply becomes aware that monetary authorities, if not constrained by rules, have an incentive to produce more inflation. Therefore the

public keys this possibility into inflation expectations, which implies that the stimulus affects only inflation but not the level of output. This is a result of the now classical time-inconsistency problem of monetary policy (Kydland and Prescott, 1977; Barro and Gordon, 1983).<sup>1)</sup> Since the theoretical analysis concludes that attempts to use monetary policy for anticyclical purposes are likely to be counterproductive, a central bank should pursue a goal of price stability (papers in Leiderman and Svensson, 1995; Mishkin, 1997).

The proposition that price stability be the final goal of central banks explains why countries with inflation targets are said to pursue direct targets as opposed to countries with intermediate-target strategies, which aim at a specific inflation range by adhering to a specified rule about the intermediate target, be it a monetary aggregate, an interest rate or an exchange rate, and by relying on the functional relationship between this intermediate target and the final goal.

## 2.1 Framework and Implications

In short, the inflation targeting strategy involves fixing an explicit quantitative inflation target for a chosen index of inflation. There is a tolerance interval around the target; the time frame during which the target is to be reached is specified and possibly the situations under which the target can be modified or even disregarded.<sup>2)</sup> Inflation targeting breaks with the traditional division into ultimate and intermediate targets: The absence of an intermediate target is a distinctive feature, which explains the stress on the word “direct” inflation targeting, but there is nothing wrong with using an indirect monetary target as long as it does not conflict with the ultimate goal (Leiderman and Svensson, 1995). The difference between intermediate and final-target approaches in practice may be more a matter of appearance than an actual fact (Haldane, 1995; EMI 1997a and b), as intermediate targets are used to promote the final target of price stability. In fact, projected inflation serves as an intermediate target. In a useful simplification, inflation targeting is a monetary framework under which monetary policy decisions are guided by expected future inflation relative to an announced target. Thus, DIT is a forward-looking approach. Furthermore, a country pursuing a pure intermediate monetary target theoretically places a 100% weight on money growth relative to its target, but in the practice of monetary targeting additional financial and economic variables, such as domestic credit developments, exchange rates, underlying rates of inflation and real economic developments, are also monitored. Hence the reality of a monetary targeting country is quite close to that of a country pursuing direct inflationary targeting that uses several leading indicators of inflation, among them monetary aggregates or the exchange rate.

The role of inflation forecasts determines how DIT fits in the debate on rules versus discretion. Bernanke and Mishkin (1997) argue that DIT cannot be treated as a rule in the traditional sense, since it does not specify simple operating instructions to the central bank. It is indeed a look-at-everything

<sup>1</sup> See also Mishkin (1997) or Scarth (1988).

<sup>2</sup> The next section discusses these issues extensively.

approach, i.e. it attempts to use all the information the central bank deems relevant for formulating an appropriate monetary policy to achieve the assigned inflation target. This information may be based on formal models, but may be based on judgmental analysis as well. DIT, if placed in a proper time framework, leaves enough room for response to adverse developments in the short run, e.g. a rise in unemployment, excessive exchange rate fluctuations etc. Bernanke and Mishkin coined the term “constrained discretion” to describe the framework. Their interpretation squares with findings by Green (1997), who used a simple model of inflation to show that the ambitious expectation that inflation targeting eliminates the inflation bias is unwarranted (rules are supposed to do this). He pointed out that “... in view of the uncertainty with which policy instruments affect future inflation, establishing the policy rule might be difficult, thus leaving the authority with discretion over how to set policy instruments” (p. 782). Bernanke’s and Mishkin’s notion of constrained discretion is also close to the distinction between strict and flexible DIT introduced by Svensson (1996). Svensson demonstrated in a formal model that convergence to a target can either proceed optimally within the inflation forecast horizon or be more gradual if the weight on the deviations of output from its natural level is placed on the typical loss function of the central bank, if there is model uncertainty, or if instrument (e.g. interest rate) smoothing is involved.

However, inflation targeting becomes a rules-based strategy when it is transformed into inflation forecast targeting (Bowen, 1995; Svensson, 1996 and 1997). The central bank produces a forecast of the future path of inflation, the forecast is compared to the target inflation rate (a forward-looking procedure), and the difference determines the necessary adjustment of the policy. Thus, the inflation forecast plays the role of an intermediate target. The forecast should be made for a time horizon consistent with the lags of monetary policy (a so-called control lag), because for shorter periods inflation is predetermined. In this way a feedback rule transparent to the public is constructed (provided that forecasts are regularly published): If the rate of forecast inflation is higher than the target, the central bank will raise interest rates (or reduce money supply) and vice versa; in general, an instrument of monetary policy must be used to bring the inflation forecast in line with the inflation target. The tacit assumption is that the central bank possesses the technical and institutional capacity to model and forecast domestic inflation and has some knowledge or an estimate of the time it takes for inflation determinants to have a full effect on the inflation rate.

According to the general features of a “good target” as outlined by theorists (see e.g. Cukierman, 1995 a; or Haldane, 1995), a target should be controllable, highly visible and transparent to the public, display a strong and predictable link with the final target as its leading indicator and be observable at short time intervals. In this respect, the inflation forecast is a suitable target. An inflation forecast is fully controllable and correlated with the target (Svensson, 1996), and is transparent if explanations about the methodology of the forecast are attached. At this point it is useful to compare DIT and strategies based on intermediate targets which it replaces, i.e. monetary targeting and exchange rate targeting. The rationale for intermediate



targets rests on lags in the transmission of monetary impulses to final demand and to prices. The relationship between the intermediate and the final target should be predictable, and the intermediate target should be a leading indicator of future nominal variables, i.e. the price level (Haldane, 1995). In theory, inflation forecast targeting uses all relevant information to predict future inflation while theoretical monetary targeting involves information on monetary aggregates and their possible deviations from targets only. A special case of DIT would boil down to monetary targeting, i.e. when money supply is a sufficient indicator for future inflation, or to exchange rate targeting if future inflation is fully correlated with exchange rate movements.

Problems with regard to the implementation of DIT and its monitoring by the public are serious (Svensson, 1996 and 1998). Inflation targeting may be hard to implement because central banks have little control over the inflation process, as current inflation is predetermined by previous contracts and decisions. Thus, central banks' efforts may influence only future inflationary outcomes. However, "long and variable lags" in the effects of monetary policy on future inflation compound the choice of a central bank's reaction. Future inflation is also affected by shocks which occur within the "control lag," i.e. the shortest time span in which inflation can be affected by a policy reaction. The imperfect control of inflation makes the monitoring and evaluation of monetary policy by the public inherently difficult, since observed inflation is the result of several other factors besides monetary policy. A central bank may argue that a deviation of inflation from the targeted level is caused by factors beyond its control, therefore it cannot be held accountable for this deviation.

A further issue is which authority assigns the inflation target. Central bank independence does not necessarily have to mean that the central bank has the freedom to establish its own final goals. On the one hand, central bank independence is enhanced when it has the right to determine these goals. On the other hand, the central bank is an agent acting on behalf of society (a principal), which is represented by the democratically elected government.

### 2.3 Practical Issues

A description of more down-to-earth details related to the DIT framework follows. These issues are: what measures of inflation to choose, what target value should be adopted and by whom, should it be a point target or a range, what time horizon should targeting cover and how accountable can a central bank be for inflation performance (see Bernanke and Mishkin, 1997; Debelle, 1997; EMI, 1997b; Haldane, 1995).

The authorities have to decide on inflation versus price level targeting. Price level targeting – for the sake of convenience, let us suppose the price level is stable – would imply that shocks to the price level have to be reverted over time. This could introduce instability into instruments, and via their changes more instability into the real economy in the short run, as periods of surprise inflation should be compensated by periods of deflation. In the economics jargon, price level targeting reduces low-frequency, long-run uncertainty about the price level; a so-called "base drift" is eliminated, as

all shocks are reversed. However, this comes at a cost: Price level targeting leads to high-frequency short-run inflation variability, so it may raise output variability, e.g. suppose a supply shock, which tends to raise the general price level and which will call for the tightening of monetary policy. This, in turn, will reinforce the adverse impact on domestic output. On the other hand, inflation targeting implies that results of shocks are never offset (bygones are bygones), so the variability of the price level is higher. Inflation targets accommodate one-off price shocks, introducing a trend into the price level, so uncertainty about the price level builds up over time. This involves costs, because price level uncertainty will be harmful to those entering nonindexed long-term contracts, inducing front-end loading of debt repayments and eroding the role of money as a unit of account.

The next step is to decide on the price index which will be targeted. There is a consensus in the literature on the subject that it should be the broadest measure possible, such as the GDP deflator or the CPI, which reflects inflationary developments best. Central banks have very imperfect control of inflation, and their response to temporary price shocks may not always be desirable, e.g. in the case of seasonal food and energy price fluctuations. This issue boils down to choosing a headline inflation measure or an index of underlying inflation (also called base or core inflation). A headline inflation index such as the CPI is most transparent to the public. However, the index should exclude at least first-round effects of changes in regulated prices or taxes (one-off increases in the price level), trade shocks and the like. The purpose of focusing on underlying inflation is to exclude the non-monetary determinants of inflation from the inflation rate. Focusing on underlying inflation may be problematic if wage decisions are made on the basis of headline (published) inflation. Allowing for exemptions involves some credibility risk. The choice of an index should be clearly explained to the public in order to prevent the public from thinking that the index was selected in a biased way.

There are pros and cons to adopting a point target as opposed to a target range. According to the prevailing view, this choice involves a tradeoff between credibility and flexibility. A range diminishes the risk of deviations which could cause a loss of face, but the wider the range is, the less commitment to a specific inflation rate on the part of the central bank is communicated to the public. An important consideration in determining the bandwidth of the target is that adopting a narrow band may induce instability in monetary policy instruments. For example, if the band is too narrow, necessary oscillations of interest rates may be destabilizing for financial markets. Furthermore, the narrower the band is, the more difficult it is not to exceed, as shocks beyond the control of the central bank are likely to drive inflation outside the targeted narrow range. On the other hand, the damage to credibility caused by missing a wider range is greater than the damage of missing a point or a narrow target. Cukierman (1995b) argued that people with rational expectations would expect a point target to be missed more often than not, because of the obvious difficulties in hitting the point target, so the cost to credibility would be negligible provided that the deviation is small.

The choice of a numerical value for the target is equally controversial. The implicit aim of DIT is to ensure “price stability,” which was inscribed as a final goal of central banks in numerous countries, in particular the EU economies.<sup>1)</sup> A strict definition of price stability would suggest inflation rates close to zero. However, there are statistical and economic reasons why adopting a low positive rate of inflation would be more appropriate. A number of recent studies have shown that the broadly used fixed-weight CPIs are biased upward (see, e.g. Boskin Report, 1996; Hoffmann, 1998).<sup>2)</sup> They do not take into account the substitution effect. Moreover, these indices usually fail to account for quality changes as well, whereas price rises due to improved quality should not be considered inflation.

Economic factors are at least as important as the statistical aspects listed above. Summers (1991) argued that negative real interest rates may be required to boost an economy, but if inflation is zero, there can be no negative real interest rates, as nominal rates cannot be set negative. Akerlof et al. (1996) point out that a possible downward rigidity of nominal wages allows for wage reduction only by means of inflation (money illusion). If inflation is nonexistent, a decline for labor demand in certain industries or regions will not lead to a fall in real wages, so it will not induce a reallocation of labor to expanding sectors or regions and will raise unemployment instead. According to Bernanke et al. (1999), a more decisive argument against targeting zero inflation is the danger of tipping the economy into unanticipated deflation, in particular into debt deflation. Persistent deflation could create liquidity and solvency problems in the financial sector which could evolve into a full-blown financial crisis.

The selection of a time horizon also merits serious attention, as it determines the speed of convergence to the target if the inflation rate is outside the targeted range even if this range is de facto a point. The rule is that the horizon should be long enough to make the reaction of the central bank to inflationary developments meaningful, i.e. the horizon should coincide with lags of monetary policy. Due to lags in monetary policy, targets for periods shorter than one year do not make much sense. However, despite the fact that the longer the targeting horizon is, the more flexibility in its policy the central bank will enjoy, distant targets will have little credibility, because the public will treat them like fig leaves of discretionary policy. Therefore long-term targets should be supplemented with shorter-term targets if a central bank engages in a disinflation process, above all if it wants to keep the process gradual in order to avoid excessive costs of disinflation (Yates, 1995).

Another practical issue is how accountable the central bank should be for achieving the target (Bernanke et al., 1999). One role of inflation targeting is to anchor inflationary expectations and to make disinflation less costly in terms of output, another is to provide a yardstick against which the actions of the central bank can be evaluated. Since the controllability of inflation tar-

<sup>1</sup> See Article 105 (1) of the Maastricht Treaty and Article 2 of the ECB Statute.

<sup>2</sup> Studies in various countries have generally found a possible CPI upward bias of up to one percentage point, for example in Germany 0.5 to 1, the UK 0.35 to 0.8, Canada 0.5 to 0.7, and around 1.1 percentage points in the U.S.A.

gets is low, it is hard to determine whether a breach is caused by policy errors or by exogenous shocks. This provides an argument in favor of escape clauses, which, however, must be formulated clearly enough to enable the public to objectively evaluate the central bank's performance. The central bank has to grapple with such questions as when, if ever, it is legitimate to miss a target on purpose and when, if ever, the target should be reset prior to the end of the announced time horizon. A temporary supply shock will generally justify missing or revising the target if no contingencies are included in the targeting framework.<sup>1)</sup> It is important for the public not to see a divergence of the actual outcome from the targeted value as the abandonment of the whole strategy, otherwise the central bank's credibility would be undermined. This brings us to the issue of communicating the central bank's strategy and policy to the public.

To reiterate, the DIT framework is supposed to enhance the transparency of monetary policy in order to influence the public's expectations in the right direction. This requires an open and active information policy, since the evaluation by the public of whether a breach of a target is a result of errors or whether it is due to shocks outside the control of the central bank will often prove difficult because of the imperfect link between instruments and the inflation rate. To facilitate this unwieldy task, comprehensive information is necessary. The publication of inflation reports serves this purpose. There is a broad consensus about what such a generic report should contain (Debelle, 1997; Bernanke et al., 1999). It should explain principles by which monetary policy will be conducted, provide a description of the central bank's inflation forecasts and the methodology used, describe measures that will be used if the interim inflation rate does not meet the forecasts, explain past action (and inaction) of the bank and how it might affect the central bank's future policy and the probability of meeting the inflation target; finally, it should describe perceived risks. An important element of the central bank's communication policy is a timely announcement of policy changes and the explanation of reasons for these changes to the public. The publication of minutes of the monetary policy decision-making body's meetings on a nonattributed basis to allow for a free discussion can serve such a purpose. These minutes would provide coverage of all arguments put forward for and against the decisions actually taken. The disclosure of the record of any vote is found to encourage the quality of the individual decision for or against an action, because members of the body face prospects of defending their stance in public.<sup>2)</sup>

1 A large permanent shock may also lead to a temporary deviation due to the real cost of staying on target.

2 This is the practice of the Bank of England, for example.

## 2.4 The Experience of Inflation-Targeting Countries

The main factor which the countries choosing to use explicit inflation targets have in common is a history of a higher-than-average inflation. In some cases, they had previously used monetary aggregates and/or a fixed exchange rate regime without or with only limited success. And, unlike countries with a history of relatively low inflation, the history and consequent problems of policy credibility in inflation-targeting countries meant that they were unable to rely upon a general qualitative commitment to low inflation (Ettl, 1996).

Between 1990 and 1993 several OECD countries adopted official inflation targets. The countries we deal with in this paper are Canada, New Zealand, Sweden and the United Kingdom, as they have the longest experience with this specific monetary strategy.<sup>1)</sup> As these countries instituted their inflation targets with substantially different legislative provisions and targeting procedures, their experiences should eventually provide useful information on the design of effective central bank arrangements.

### 2.4.1 New Zealand

By far the most ambitious of the four arrangements is that of New Zealand, which features a degree of formal institutionalization that goes well beyond the extent found elsewhere. The Reserve Bank of New Zealand Act 1989, enacted by Parliament, specifies that “stability of the general level of prices” shall be the overriding objective of monetary policy – indeed, it is the only objective mentioned. This Act requires the Bank’s Governor and the Minister of Finance to make periodic Policy Target Agreements (PTAs) regarding the price index to be targeted and the target range.

The switch of the monetary regime came after a period of considerable disinflation. Since 1990 six PTAs have been in force. The first PTA was signed in March 1990 and defined a 0% to 2% inflation band as the target to be achieved in December 1992 but specified a less ambitious range for a transition period, since the inflation rate at the time was above 6%. Thus, New Zealand followed disinflation targeting in the beginning. Up to 1996 the basic requirement was to keep the twelve-month inflation rate in the 0% to 2% range. In 1996 this range was broadened to 0% to 3% due to problems controlling inflation. The pros and cons of widening the range were hotly debated. In a skeptical statement about the wider target range Donald T. Brash, Governor of the Reserve Bank of New Zealand (RBNZ), found two reasons for the new target: First, a wider target range requires less policy activism to meet the target and, second, the number of occasions on which the target is missed can be reduced (and, as a result, central bank credibility enhanced).<sup>2)</sup>

Since 1990, the target variable has also changed. Originally, the consumer price index (CPI) was targeted. The December 1997 PTA defined a new index, the CPIX, which excludes credit services, as the target variable. Whereas the basic requirement is to keep twelve-month increases in the

<sup>1</sup> Australia also has a direct inflation target. Finland and Spain had pursued inflation targets before they both joined EMU.

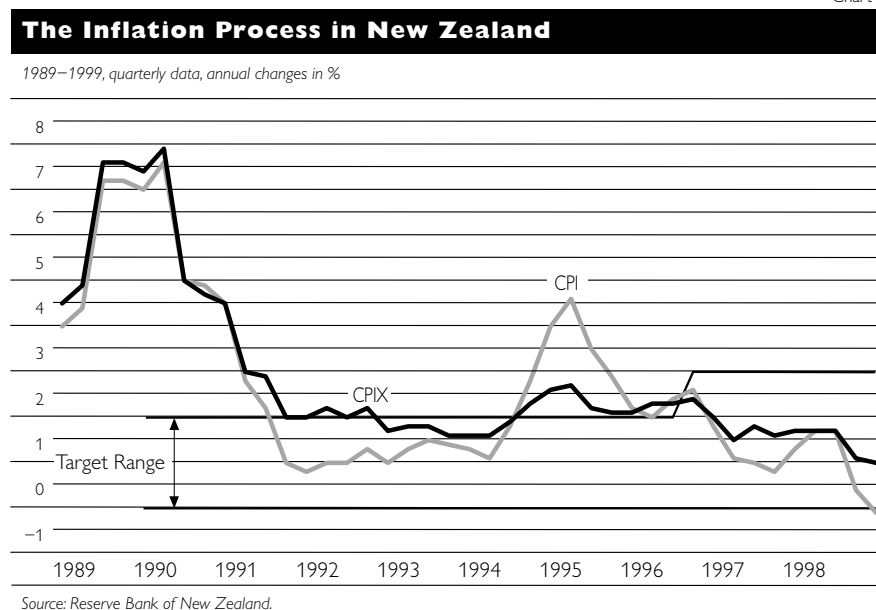
<sup>2</sup> See Brash (1997).

CPIX in the 0% to 3% range, there are some important exceptions or caveats. Specifically, the 1997 PTA recognizes that “there is a range of events that can have a significant temporary impact on inflation as measured by the CPIX, and mask the underlying trend in prices which is the proper focus of monetary policy. These events may even lead to inflation outcomes outside the target range. (...) When disturbances (...) arise, the Bank shall react in a manner which prevents general inflationary pressures emerging.” Each PTA was explicit in listing the shocks to inflation to which the central bank should respond in order not to allow the transitory changes to prices to impact on the trend inflation.

Inflation forecasts play an important role within the DIT framework. In terms of its policy feedback procedure for achieving the inflation rate targets, the RBNZ adjusts monetary conditions in response to discrepancies between expected future inflation rates and the target midpoint. If the inflation rate forecast for a period of two to six quarters in the future is above 1.5%, for example, the bank will tighten monetary conditions. Following the Bank of Canada, the central bank of New Zealand constructed a monetary conditions index (MCI) and has used it since late 1996 as a means to assess the overall stance of monetary policy. The main indicator variable used in gauging monetary conditions is the trade-weighted exchange rate, which has a weight of two, while the 90-day interest rate has a weight of one. Among the quickly responding variables, the exchange rate is believed to have the greatest predictive and explanatory power for the inflation rate. One should recall that New Zealand is a small, open economy that exports commodities.

The DIT framework puts a strong emphasis on the accountability of the central bank. Whenever inflation outcomes are outside the target range, the Bank must explain in Policy Statements why such outcomes have occurred and what measures it has taken to ensure that inflation is brought back within the range. A notable feature of the framework is the provision whereby the

Chart 1



Governor, who must report on inflation performance to Parliament twice a year, may be dismissed prior to the end of his five-year term if the inflation rate moves outside its specified target band. While this target has been over-shot, this clause has been invoked to date.

The extent of information provided to the public by the RBNZ is quite impressive. In addition to quarterly Monetary Policy Statements, the Bank publishes quarterly forecasts and expository articles on monetary policy in its quarterly Bulletin.

Chart 1 shows New Zealand's inflation process measured both in terms of the CPI and the new target variable, the CPIX. Since 1991, the behavior of the CPI has been much more volatile than that of the CPIX. In terms of the CPI, inflation remained consistently within the then 0% to 2% target from 1991 until December 1994, despite economic growth in 1993 to 1995 which, by New Zealand standards, was exceptionally high. Between March 1995 and September 1996 the inflation target was strongly exceeded, in part because of a very sharp hike in the prices of fruit and vegetables. In the year to March 1999 CPI inflation excluding interest rates was slightly below the middle of the target range (at 1.0%). Since the broadening of the target range to 0% to 3% and the redefinition of the target variable, the RBNZ has been able to meet the target without any problem.

#### **2.4.2 Canada**

Canada's formal and explicit inflation target scheme began in February 1991, when the Bank of Canada and the Minister of Finance jointly announced a series of targets.

Participation by the latter was significant because it signaled "that the government was supportive of the price stability goal" (Freedman, 1995). As in the case of New Zealand, the shift to DIT was preceded by a period of substantial disinflation.

The specific price index utilized in the Bank of Canada's target scheme is the CPIX, the Consumer Price Index (CPI) excluding food, energy, and the contribution from changes in indirect taxes. The rationale for these exclusions is that the components in question are frequently subject to sharp temporary movements that, because of their transitory nature, should not be responded to by monetary policy.

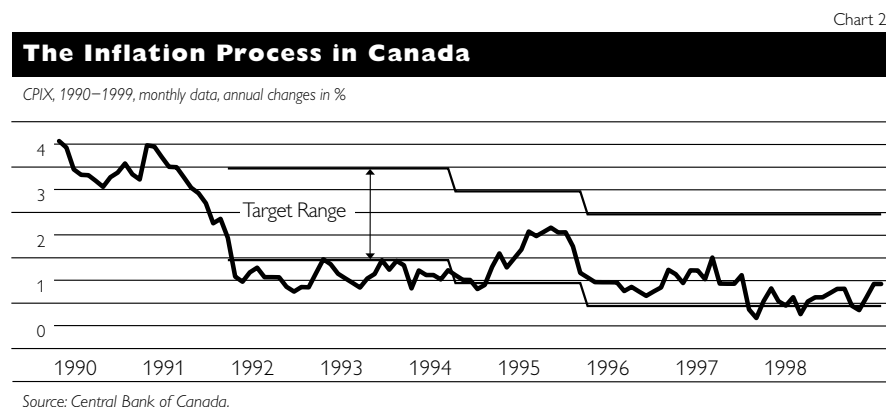
The series of targets announced in February 1991 were target bands, with a width of two percentage points. Unlike in New Zealand, the midpoint of the range plays the role of a focal point. As in the case of New Zealand, DIT was initially used to achieve further disinflation. The band's midpoint was specified to fall to 3% at the end of 1992 (this was consistent with the central bank's own assessment of monetary policy lags extending from six to eight quarters), then to 2.5% as of mid-1994, and finally to 2.0% at the end of 1995. Subsequently, in December 1993, the government and the Bank agreed to maintain the latter target unchanged to the end of 1998. In February 1998 the existing inflation targets were extended to the end of 2001.

An important component of any monetary policy targeting arrangement is the feedback procedure that is used in selecting instrument settings, based

on inflation rate forecasts. The Bank of Canada's procedure is basically to use an econometric model to calculate, given experts' assessments regarding future values of exogenous variables, the time path of a "monetary conditions index" (MCI) that will be required to achieve an inflation path near the midpoint of the target range. The MCI, introduced in 1995, is defined so that its changes reflect the changes in exchange rates and interest rates, both in nominal terms, with three times as much weight given to the changes in interest rates as to the changes in exchange rates. When the MCI needs to be increased in value, the Bank of Canada takes action to adjust the level of liquidity in the system, thereby producing an appropriate rise in interest rates.

There is no legal procedure like in the case of New Zealand by which the central bank is held accountable for its inflation performance. There are no explicit sanctions if it misses the target. The Minister of Finance, who acts as the "principal," cannot dismiss the Governor, but can issue a "policy directive," e.g. an order to raise interest rates, with which the central bank has to comply. No such action has ever been taken, however. Biannually, the Bank publishes a Monetary Policy Report, which offers a detailed assessment of the economic outlook. After each issue is released, senior Bank officials appear before the Finance Committee of the House of Commons to discuss the Report. Since 1996, press releases providing an explanation of the Bank's actions have accompanied each change in the official interest rate.

The possibility of enhancing commitment to the inflation targeting arrangement arose in early 1992, after the government proposed amendments to the Bank of Canada Act that would have changed the Bank's mandate to focus exclusively on price stability. But although the proposal was supported by the Governor of the Bank, it was rejected by a parliamentary committee. In their testimony to this committee, academic economists were almost unanimously opposed to the proposed changes, as they preferred a broader range of central bank objectives.



Following the initial announcement of targets in February 1991, inflation fell rapidly. Indeed, for much of 1992 it was below the bottom of the target range. Since then, with the exception of a brief period in 1995, the trend of inflation has been in the lower half of the target range. The speed of the decline in inflation during 1991 was surprising. It reflected a much more



severe economic slowdown than the Bank of Canada and most other forecasters had expected. In part, the depth of the 1990 to 1991 recession was due to international factors, such as lower-than-expected growth in the United States and an unexpectedly sharp decline in raw material prices. But in Canada, it also reflected the unwinding of distortions in asset prices and debt accumulation associated with the preceding period of inflationary pressures.

In the first half of the 1990s, unprecedented corrective actions were required to put public finances onto a sounder path after two decades of continuous fiscal deficits and public-sector debt accumulation in Canada. These resulted in sluggish domestic demand and a weaker-than-expected recovery in the economy. Monetary conditions were easing through much of this period. However, for quite a long time the Bank of Canada was unable to provide as much monetary stimulus as it would have liked because of fiscal, political, and international developments that, at times, caused financial markets to be nervous and volatile. It was only after 1995, with improved credibility on the fiscal front and subsequent to the Quebec referendum campaign, that the Bank was able to achieve a durable reduction in short-term interest rates. As the credibility of both monetary and fiscal policy improved, Canadian interest rates across the maturity spectrum moved to levels below comparable interest rates in the United States. In response to easier monetary conditions, domestic demand in Canada recovered, with a strong expansion beginning in mid-1996 and continuing through 1998.

#### **2.4.3 United Kingdom**

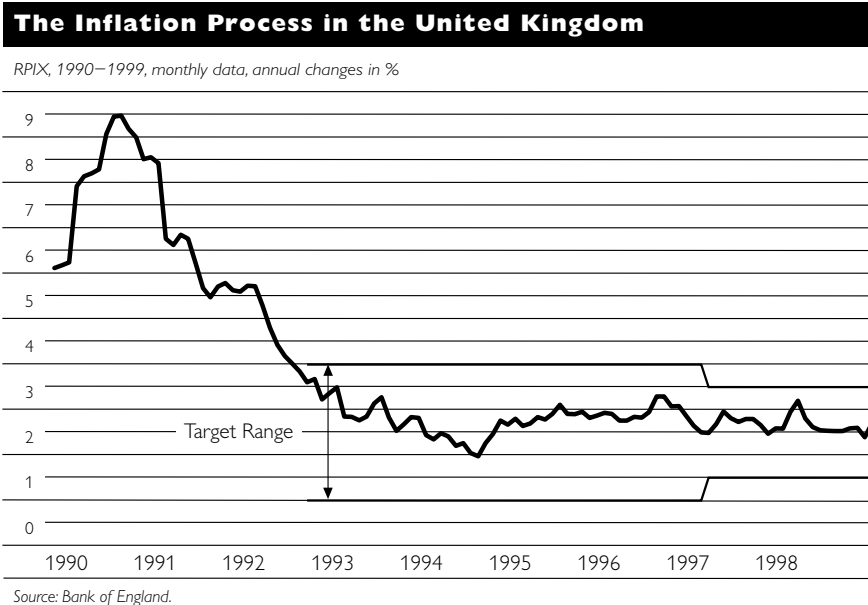
The United Kingdom, like Sweden, turned to inflation targeting after exiting the European exchange rate mechanism in September 1992. There was more governmental involvement, however, since the Bank of England (BoE) had very little independence from the Treasury at this time; the Treasury controlled the instruments of monetary policy, specifically the interest rates. Thus, the initial announcement of inflation targets in October 1992 was made by the Chancellor of the Exchequer, acting in a sense as a “principal.” The target bands specified for the retail price index excluding its mortgage interest component (RPIX) were 1% to 4%, with the target rate to be below 2.5% by “the end of the present Parliament,” i.e. by spring 1997 at the latest. Since September 1992 significant institutional changes have taken place, which have led to the current working framework. In May 1997, the new Chancellor announced that he was handing over the operational responsibility for setting interest rates to the Bank of England. The current framework for monetary policy is provided by the 1998 Bank of England Act. The Bank’s final goal is to deliver price stability. Without prejudice to the objective of price stability, the Bank has to support the Government’s economic policy, including its objectives for growth and employment. A newly established Monetary Policy Committee, which comprises representatives of the Bank as well as independent experts in monetary policy, works as a decision-making body for interest rate setting. In this new setup, the government holds responsibility for setting the objectives of economic policy and therefore it sets the inflation target. In June 1997, the Chancellor announced a

new inflation target for the RPIX of 2.5%, which was later confirmed. In this way the UK formally switched from a range target to a point target. However, the BoE must report why the target is breached only if the deviation is more than  $\pm 1$  percentage point from this target, so de facto it still follows a range.

Increased accountability of the Bank is achieved through various arrangements. If inflation is more than 1 percentage point above or below the target, the Bank is required to publish an open letter explaining why inflation has deviated from the target and what actions it intends to take to get prices back on target. Under certain circumstances the Treasury is allowed to give instructions to the Bank for a limited period of time. These powers can, however, only be used if the Treasury is convinced that they are required in the public interest because of “extreme economic circumstances.” The publication of the nonattributed minutes of the Monetary Committee Meetings and of the quarterly Inflation Report enhances the accountability to the broad public. Initially, the minutes were published six weeks after the meeting, in October 1998 this time period was reduced to two weeks. The Inflation Reports contain forecasts of inflation.

Inflation forecasts play a crucial role in the DIT framework, and the BoE seems closer to a theoretical concept of inflation forecast targeting than any other inflation targeter. The Bank evaluates inflationary performance by comparing a two-year inflation forecast which assumes unchanged monetary policy with the intended range. If the forecast does not fall in the targeted range, changes to monetary policy are considered and their impact on future inflation is estimated. There is no strict feedback rule, but the course of monetary policy is much more predictable. Much work has been invested to improve the techniques of inflation forecasting. The Bank has stopped publishing a point forecast, but publishes the probability distribution of future inflation outcomes in order to account for the uncertainty of economic forecasts.

Chart 3



In this way the BoE wants to stress the scope of upward and downward risks of the inflation process.

Since the inflation target was formulated, the Bank of England has held the inflation rate within the band. But there was one major complication. From around the autumn of 1996 the sterling's exchange rate appreciated very sharply against the core European currencies. This apparently had little to do with relative monetary conditions. The effect was to introduce a pronounced imbalance into the British economy. The strong exchange rate threatened to dampen demand for UK exports and had a direct restraining effect on cost and price inflation, but domestic demand was unsustainably strong and, in terms of aggregate demand, the economy was approaching full capacity utilization.

This situation confronted policymakers with an uncomfortable choice. Tightening policy to prevent the entire economy from overheating would have pushed the exchange rate up even further, aggravating the pressures on the international sectors of the economy. On the other hand, not tightening at that stage and thus heading off an acceleration of inflation would have put the whole economy at risk. This episode rather vividly illustrated the point that in targeting the inflation rate, the central bank can only target the economy as a whole, and other economic variables like the exchange rate can react very strongly.

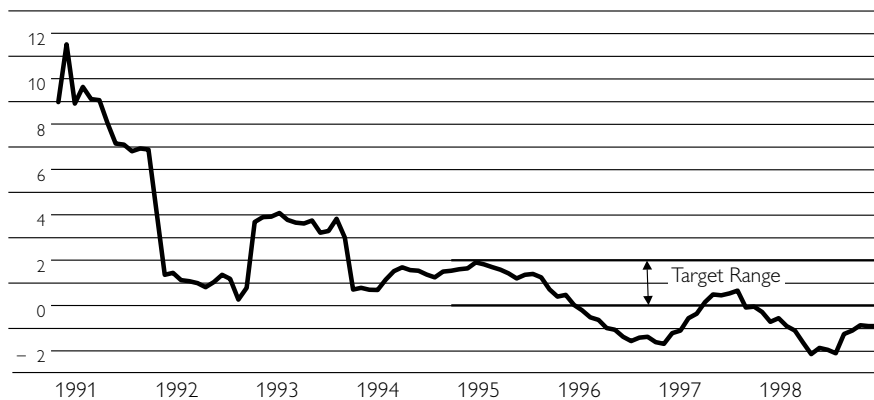
#### **2.4.4 Sweden**

Sweden's adoption of inflation targets, unlike in the UK, New Zealand and Canada, was announced solely by the central bank, the Riksbank, in January 1993. It followed the breakdown in November 1992 of the krona's exchange rate peg to the ECU. Sweden chose to target the all-item CPI. The target rate was set at 2%, with a tolerance band from 1% to 3%. This target was scheduled to apply to the twelve-month inflation rate of the CPI starting in 1995, as inflation outcomes in 1993 and 1994 were seen to be predetermined to a large extent. Compared to that of Canada, New Zealand and the United Kingdom, the inflation targeting scheme in Sweden is not as highly institutionalized. In particular, the Riksbank's 1993 announcement was made by its Governing Board without any accompanying statement from the government. However, in the recent past, some additional elements of inflation targeting arrangements in other countries have been implemented in Sweden. The latest reform steps specifically aimed at improving transparency and accountability. The Riksbank publishes a quarterly Inflation Report in which it analyzes all relevant economic variables and releases an inflation forecast. The role of the inflation forecast within the whole strategy framework is gaining more and more importance. The inflation forecast shows the Bank's numerical assessment of future inflation. Against this statement, the public can evaluate the Bank's policy steps and judge its credibility. In 1998 the Swedish parliament passed legislative amendments with the aim of strengthening the independence of the Riksbank. This new legislation defines maintaining price stability as the main objective of monetary policy. Since the beginning of 1999, the Riksbank has published the minutes of the Executive Board's monetary policy meetings with a time lag of six to eight weeks.

Chart 4

### The Inflation Process in Sweden

CPI, 1991–1999, monthly data, annual changes in %



Source: Sveriges Riksbank.

In the period from 1996 to 1998 the annual rates of inflation, measured by the CPI, were 0.8%, 0.9% and 0.4%, respectively. This means that in each of these years the change in the CPI was below the lower tolerance limit of 1%. Since 1996 there have been two sharp downward deviations. For several months the headline inflation rate fell below zero. The central bank did not react to these developments, pointing out that – excluding more transitory price effects (altered indirect taxes and falling commodity prices) that monetary policy neither can nor should try to fully counter – the inflation rate has been inside the stipulated tolerance interval. Thus, although core inflation is not considered an official measure, the central bank used this index in the explanation of its inaction. However, these developments motivated the Riksbank to clarify the inflation target formulation in January 1999: “Monetary policy is normally conducted so as to be on the target, defined in terms of the CPI, one to two years ahead. Departures from this general rule may be warranted for two reasons. One is that the CPI can be pushed upwards or downwards in the relevant time perspective by one or more factors that are not considered to affect inflation more permanently. Changes in interest expenditure, indirect taxes and subsidies are examples of such factors. The other reason for departing from the rule can be that a quick return to the target in the event of a sizeable deviation can sometimes be costly for the real economy. In the event of either of these situations occurring, the magnitude of the deviation from the inflation target, defined in terms of the CPI, that may be motivated 1 to 2 years ahead will be clarified by the Riksbank in advance” (Sveriges Riksbank, 1999).

#### 2.4.5 Comparative Analysis of Experiences

All four inflation targeting countries have four strategy elements in common:

- the public announcement of medium-term numerical targets for inflation;
- an institutional commitment to price stability as the primary, long-run goal of monetary policy, which is operationally defined by the inflation target;

- increased transparency of the monetary policy strategy through communication with the public and the markets about the plans and objectives of monetary policy;
- increased accountability of the central bank for attaining its inflation objectives.

All four countries introduced inflation targeting after the former monetary policy strategy failed and the countries experienced a time of high inflation rates. This aspect of timing is well known in other fields of economics. In times of crisis, it is easier to convince the public to adopt a broad package of economic reforms. In all countries reviewed, the new strategy was implemented with some fanfare, in a way that made clear to the public that a distinctly new approach was being adopted. In order to gain credibility for the new strategy, the central bank and the government made a joint announcement (the Swedish case is the exception). In order to be credible, all countries analyzed here tried to meet their initial inflation targets with the help of medium-term targets announced together with short-term transitory targets.

Since the implementation of the initial frameworks in the early 1990s, some gradual reform steps have been taken and we can observe some kind of convergence among the countries. As monetary policy measures have a long time lag, inflation rate forecasting techniques have been gaining increasing importance. Meanwhile, all four central banks publish their forecasts to give the public an orientation about the future direction of monetary policy. As the public has the opportunity to compare the central banks' assessments and actions, monetary policy can build up reputation and credibility in a continuous manner.

The general principle of transparency is, indeed, one of the cornerstones of all inflation-targeting countries. In all four countries, the central banks have intensified their information policy. The monetary policy officials explain the reasoning for their policy in numerous public statements and articles. Additionally, two countries – the United Kingdom and Sweden – publish the minutes of the discussions in the decision-making bodies soon after the sessions. The rationale behind enhanced transparency is on the one hand to facilitate private-sector planning by reducing uncertainty about monetary policy, interest rates and inflation. On the other hand, transparency has an educational purpose. The central banks explain to the public what they can and cannot achieve using monetary policy measures. Transparency in tandem with active communication enhances central banks' accountability.

So far, no country has chosen the level of prices as a target variable, but have rather opted for the rate at which prices change over time. The reason is that policymakers in all four countries are concerned about the effect a price-level target might have on short-run economic stability (see Section 2.3). The fear of deflation is the main reason why all four countries have chosen inflation targets above zero. In addition, Sweden, Canada and the United Kingdom have explicit or implicit lower interval limits above zero. In the view of the monetary authorities of all four countries, the inflation rate compatible with price level stability is not zero, but rather marginally above

zero.<sup>1)</sup> With the somewhat unclear exception of Sweden, the central banks in the examined countries target a “CPIX” (the CPI excluding food, energy, and the effect of changes in indirect taxes). The operational focus on the core rate of inflation makes it clear that the focus of monetary policy is on the trend of inflation and not on temporary fluctuations. It also means an attempt to make the target more controllable by the central bank and enhances its accountability. On the other hand, the general public feels the impact of transitory changes on the headline CPI, requiring a great effort on the part of the monetary authorities to explain their target and motives.

The legal frameworks under which the four central banks are working are quite different, ranging from the original formulation of the new strategy in the United Kingdom in 1992, when the Bank of England was merely an operational unit of the Treasury, to the highly independent approach of the Riksbank, which announced the new strategy alone. Meanwhile, the consensus that operational and instrumental central bank independence is a precondition for inflation targeting seems to be emerging. The target may be set by the government. In such a formulation of the framework, inflation targeting can solve the traditional conflict between democracy and central bank independence.

Taking into account the economic record of the four countries since the adoption of direct inflation targeting, the new framework of monetary policy seems to have been a success. The inflation rates in all four countries have come down to historically low levels. Since the mid-1990s, economic growth performance has been quite favorable as well. A final conclusion, however, is not possible. The 1990s have been a period of declining inflation rates in all industrialized countries. Other countries with bad inflationary experiences in the past have also reduced their inflation rates substantially without adopting direct inflation targets. Recent empirical work (Bernanke et al., 1999) finds evidence that in the case of Canada, New Zealand, Sweden and the United Kingdom, inflation levels and inflation expectations have fallen below, and remain below, “what would have been expected based on extrapolations of the past.” Two qualifications, however, are added. First, nobody can “know precisely what would have happened had they not adopted inflation targeting”; the economic performance of nontargeters is not appreciably different from that of inflation targeters. Second, the proposition “that the costs of disinflation would decline as a result of inflation targeting was not fulfilled during the first post-adoption disinflations.” The adoption of DIT does not in itself establish immediate credibility for monetary policy, nor is the announcement of the shift to DIT enough to ensure success. Inflationary expectations are slow to fall to the targeted range.

1 Several arguments which are given in favor of a low inflation rate rather than a zero inflation rate were discussed in Section 2.3.

### 3 DIT and Economies in Transition

So far inflation targeting has proved successful in the Western economies which have adopted it. The countries in transition are still searching for appropriate frameworks for their monetary policies,<sup>1)</sup> and DIT is one of the options considered, especially as most of the countries still face further disinflation. On comparing the merits of DIT with the actual conduct of monetary policy, Orłowski (1998) suggested that advanced transition economies could find monetary strategies based on DIT to be superior to other strategies, as they would discipline their efforts to reach rates of inflation compatible with those of EU member countries.

Inflation targeting calls for a number of institutional prerequisites. The two general prerequisites of IT as perceived by economists are rather self-explanatory: the absence of so-called fiscal dominance, and no commitment to maintaining another nominal anchor (Debelle, 1997; Masson et al., 1997). Lack of fiscal dominance means that the central bank is capable of conducting its monetary policy with a free choice of instruments to attain some nominal objective without being constrained by developments of a fiscal nature. Translated into a blunt statement, this means the absence of fiscal sources of inflation. For example, an excessively large stock of public debt may create expectations of higher inflation in the future, which may prevent the central bank from reaching its target in the short run. The central bank may then be forced to react with higher nominal interest rates, which in turn will tend to raise debt service costs for the government and induce further borrowing (a case for “unpleasant monetarist arithmetic”). To eliminate fiscal dominance, public-sector borrowing from the central bank should be prohibited. Moreover, the government should count on a broad revenue base to avoid excessive reliance on seigniorage, while financial markets should be developed enough to have the capacity to absorb placements of public debt.

As concerns the second requirement, any other goal can be pursued to the extent that it does not conflict with the inflation target (Svensson, 1995; Debelle, 1997; Masson et al., 1997). In general, inflationary targeting is inconsistent with fixed exchange rates, since it is not possible to target an inflation rate that differs strongly from that of the country to which the domestic currency is pegged. Variants of crawling bands may relax these strictures to some extent, but preference should be given to the inflation target if a conflict arises. A goal of full employment does not have to be incompatible with DIT provided that a proper time framework is considered, i.e. when flexible DIT is used (Svensson, 1996). The goal of financial stability of the banking sector does not have to be in conflict with DIT either, though if the banking sector is fragile, instrument (interest rate) flexibility may be hampered, leading to what is referred to as the smoothing of interest rates. Such a situation again calls for flexible inflation targeting.

Transition economies share some institutional features and characteristics of the inflation process which distinguish them from advanced economies that

<sup>1</sup> Poland is a ready example, as it started with exchange rate targeting. Subsequently, it switched back and forth from interest rate targeting to monetary targeting while maintaining a crawling peg system, not to mention targeting domestic credit expansion at times.

have switched to inflation targeting. At the beginning of transition, fiscal dominance was rather the rule than the exception: Direct government borrowing from central banks was prevalent, as financial markets were practically nonexistent. The inflation process in these countries is dotted with one-off increases in price levels caused by the liberalization of prices, large increases in administered prices or the introduction of indirect taxes such as VAT and excise taxes, which tend to generate large swings of relative prices. These factors complicate the inflation process, so looking at measures of underlying inflation makes even more sense than in the case of stable market economies (Christoffersen and Wescott, 1999) in order to identify trends in inflation by eliminating one-off increases of the price level or other temporary influences. However, these measures are poorly developed.<sup>1)</sup> Thus, the predictability of the inflation process is impaired as compared to stable Western economies.

At the outset, the economies in transition experienced high inflation after they had liberalized prices, so stabilization became a priority. Only recently has the CPI inflation come down to single digits in a number of these economies. Disinflation is usually costly in terms of output foregone. Therefore the adoption of the DIT framework implicitly assumes further disinflation in these economies. This requires the time horizon to be set long enough to avoid excessive output costs. Medium-term frameworks that assume low inflation or short-term frameworks that assume a gradual reduction of inflation are appropriate from this angle. Inflation targeting becomes de facto disinflation targeting, and it falls under flexible inflation targeting.

Furthermore, the DIT strategy assumes that the central bank uses all information relevant to price formation. Among other things, the central bank uses a model (or models) of the economy. Due to the (rather) rapid structural changes, model uncertainty in transition countries is higher than in advanced economies. Short time series often do not allow for valid statistical inference, as data from before the start of transition cannot be used or do not exist in the first place. Issues such as how shifts in the monetary policy instruments, i.e. interest rates, exchange rates or monetary aggregates influence inflation, what lags monetary policy has, how inflation responds to changes in other economic variables such as wages, the unemployment rate or capacity utilization, are mostly weakly identified. For example, Christoffersen and Wescott (1999) conclude their work on Poland as follows: "... the statistical power of inflation forecasting models in Poland still appears to be modest, especially when the forecast horizon extends for periods of one year or longer." In short, a quantitative framework linking policy instruments to inflation is largely missing, e.g. the authors quoted above did not find a clear (negative) statistical link between changes in the short-term interest rate and inflation in Poland, as both variables have been trending downward for years due to successful disinflation. All this impairs

<sup>1</sup> The work of Christoffersen and Wescott (1999) is an attempt to develop various measures of underlying inflation and show relationships among them and the headline inflation in Poland. The authors provide a short introduction into the literature of measuring underlying inflation. The discussion of these problems is beyond the scope of this paper.



the capacity to model and forecast domestic inflation, which usually requires an adequately long and extensive historical database. Model uncertainty provides another argument for flexible inflation targeting, to round off the discussion of the prerequisites of DIT.

Finally, inflation targeting calls for a high degree of framework and policy transparency to influence the general public's inflation expectations and to make the central bank accountable. However, transparency has never been a strong suit of continental European central banks, which have had a strong penchant for secrecy. It is not the strongest suit of central banks in transition economies, either. A DIT framework calling for comprehensive information requirements may help improve information and communication policies.

So far two countries belonging to the leading group of transforming economies have made the decision to switch to monetary strategies based on inflation targeting. Inflation targeting in the Czech Republic and Poland could be labeled disinflation targeting, in order to distinguish them from countries which have already achieved low inflation and which mostly make efforts to maintain inflation rates within a generally accepted range. Leading transition economies still have to disinflate in order to reduce their inflation rates to levels compatible with those of the EU economies, a prerequisite for joining EMU in the future. This task requires good coordination of macro-economic policies and determines which body should be responsible for setting an inflation target: the central bank, the government or both. The preference in the literature (Orlowski, 1998) is given to an equally shared responsibility for achieving the target, as this diminishes the risk of fiscal dominance.

### 3.1 The Czech Case

Let us start with the two prerequisites for successful DIT: the absence of fiscal dominance and the lack of other monetary anchors. The risk of fiscal dominance in the Czech Republic is rather low. The Czech National Bank (CNB) has been granted a high degree of independence, many aspects of which are comparable with those in other countries which have adopted the DIT framework.<sup>1)</sup> The CNB is legally endowed with monetary policy independence by the Central Bank Act (Article 9). In fact, the CNB enjoys target independence, as it autonomously fixes the inflation targets. The ultimate goal is the "stability of the Czech national currency," as defined by Article 2, but the choice of monetary strategy rests with the central bank. The financing of government deficits by the CNB is not altogether prohibited, but the law contains safeguards that limit this kind of operation to a specified amount, form and maturity: The CNB may purchase Treasury bills with a three month maturity for up to 5% of the previous year's state budget revenues at most (Article 30 of the Central Bank Act). The Czech government has not taken recourse to direct borrowing from the central bank despite a considerable worsening of its fiscal position in 1997 and 1998 when a recession ensued, so the risks appear to be limited.

1 See Radzyner and Riesinger (1997) for a detailed coverage of central bank independence issues in selected transition economies.

Furthermore, the CNB has no other nominal anchor: a managed floating system has been operational since May 1997. On occasion, the monetary authorities attempt to influence the market, but primarily to smooth exchange rate fluctuations. One reads that “the CNB intervened on the foreign exchange market not to maintain the exchange rate at a certain level or to influence the trend, but to moderate exogenous effects and, through foreign exchange interventions, to ensure relatively smooth shifts in foreign exchange trading between different exchange rate levels.”<sup>1</sup>) The introduction of DIT came at a time when the current account deficit had already started improving from a ratio to GDP which was hardly sustainable.

The main motivation for introducing DIT in the Czech Republic was the May 1997 collapse of the fixed exchange rate regime. The search for new monetary policy anchors led to the adoption of an inflation target. The CNB explained the choice of its new monetary strategy by pointing to the evidence that money is neutral in the long run, i.e. affects only prices, and that stable prices also support long-term economic growth. According to the CNB, the inflation target is transparent; it has an impact on inflationary expectations and will make “convergence of domestic inflation with EU inflation smoother” (CNB, 1998 a).

The framework of DIT in the Czech Republic is the following. The central bank in the Czech Republic targets a “net inflation” index (NII), defined as a rate of increase in consumer prices excluding administered and regulated prices as well as the impact of indirect tax increases. The NII is not seasonally adjusted. Administered prices represented around 18% of the CPI basket in 1998 (i.e. the NII basket is about 82% of the CPI) and they include water and heating (directly set by the authorities), electricity and gas and telephone costs, rents (maximum prices), taxi and parking rates (set by local authorities), as well as insurance fees and charges (including health insurance and vehicle insurance). Seen from another angle, 85% of the net inflation basket consists of tradables (of which food is 42%) and nontradables are 15% (but some 60% of all nontradables are included). As a result, the net inflation index is more sensitive to exchange rate movements than the CPI, in which tradables account for around 67%. Thus, the NII is a complex formula which does not seem transparent enough to the public at large. The credibility of target calculations is enhanced by the fact that since February 1998 the net inflation estimates have been produced by the Central Statistical Office. The goods and services excluded from the CPI are listed annually in the Ministry of Finance’s Price Bulletin. The choice of the NII as a targeted measure of inflation illustrates the problems of an economy in transition in which changes in the relative price structure have not been completed yet. This choice enhances the accountability of the central bank for inflation performance on the one hand, as the NII is more controllable than the CPI, but on the other hand, the NII is newly constructed and consequently its targeting tends to reduce the transparency of the monetary strategy. Furthermore, Orłowski (1998) rightly points out that regulated prices strongly affect the costs of

1 CNB (1998 b) p. 32.

production, so they have an indirect impact on unregulated prices anyway. Hence, a higher controllability of NII inflation is more apparent than real.

The NII target is formulated as a range. The CNB constructed a three-year medium-term target, i.e. a fall of the NII inflation rate to between 3.5% and 5.5% in 2000. This target was supplemented by a short-term, one-year target: The central bank fixed NII growth at 6% year on year in December 1998, with a  $\pm 0.5$  percentage point margin. At the time the target was set, the NII was up by 6.8% year on year in December 1997, so the target did not look overly ambitious. The CNB did not explain why it chose this specific pace of disinflation and this particular width of the band for 1998 or for 2000. No escape clauses were announced to the public in 1998. This target was actually undershot (more later), which prompted the CNB to include contingencies while fixing the 1999 target for the NII at 4.5%  $\pm 0.5$  percentage point year on year in December 1999. If monetary policy has a lag of up to two years, as the CNB asserts (CNB, 1998a), then establishing a target for one year is much less meaningful, because at this time horizon inflation is predetermined. Determining a target with a one-year horizon to a certain extent puts the credibility of the strategy at risk, as inflation may deviate from the targeted range for reasons beyond the control of the central bank. However, the public will hold the CNB accountable for this. The achievement of the lower edge of the medium-term range does not mean that the process of disinflation will be over, since price stability is defined by the ECB as a CPI rise of below 2%. The CNB has recently formulated a draft of its five-to-seven-year monetary strategy, which will clarify how it intends to proceed with further disinflation.<sup>1)</sup>

Along with the 1999 target, due to uncertainties with regard to raw material and commodity prices and the exchange rate of the koruna, the central bank announced an inflation forecast with a much wider range of possible outcomes of 2.5% to 5.5% year on year in December 1999. This forecast will be updated in the course of the year. The Bank did not elaborate on the role of this forecast, pointing out only that it will serve as the main guide for monetary policy. Nothing was said about the potential role of inflation forecasts as intermediate targets, and no feedback rule was formulated, leaving a potential reaction to the discretion of the central bank. From the start of DIT, the CNB has been vague on the methodology of how it produces inflation forecasts. It is unclear whether, how and how fast the CNB will respond to deviations of inflation forecasts from its inflation target. Nor is there an announced timetable for preparing and publishing inflation forecasts. Hence, the CNB framework would fit the description of inflation targeting as “constrained discretion” (see Section 2).

The short record of DIT in the Czech Republic showed that the CNB encountered a few problems with the new strategy, and this experience prompted some ramifications of the monetary policy framework.<sup>2)</sup>

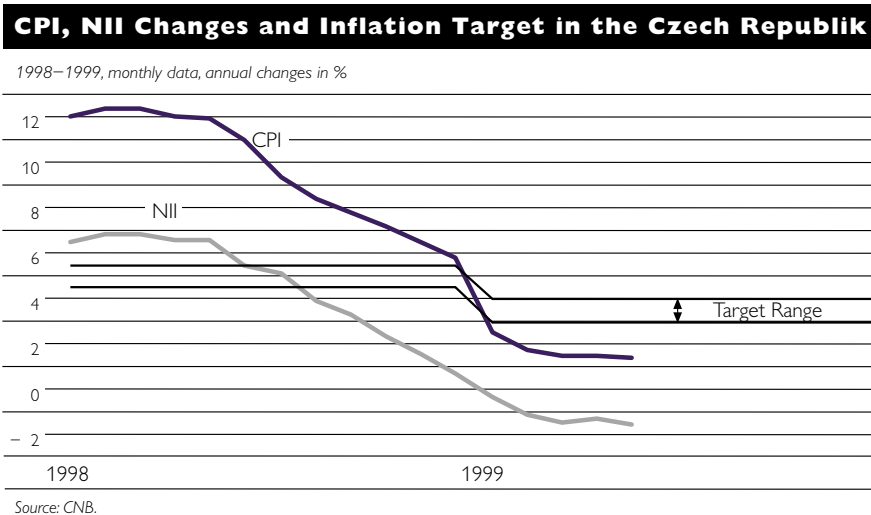
1 It has not been released to the public as of writing. The press release of the CNB on this matter reads: “...the document which deals with the manner of setting inflation targets and monetary policy principles in the horizon of the next five to seven years, will be published after it has been submitted to the Government” (CNB homepage: [www.cnb.cz](http://www.cnb.cz)).

2 For a relatively detailed description of inflationary developments see Jonas (1999).

First, the need to raise regulated prices led to large discrepancies between the NII and the CPI year on year in each month of 1998, which amounted to 5.7 percentage points on average in 1998. This exemplifies one of the problems of inflation targeting in transition economies. Large gaps between the targeted index, in this case the NII and the CPI, may give rise to questions about the credibility of the target despite the well-known causes. This is so because the general public usually builds inflationary expectations on the basis of the CPI, as this is the index which most accurately approximates the “true” cost of living and is most widely published. Under such circumstances announcements that inflation is on target would sound hollow to the general public, especially if the two indices exhibited divergent trends. This shows that striving for greater controllability of the target has its effective limits, because the public may not be convinced that one-time hikes in the CPI do not necessarily imply renewed inflationary pressure, and that such pressure is more accurately indicated by the price index used as a target by the central bank than by the CPI. Therefore inflation targeting can be difficult to implement when the process of relative price adjustments is still incomplete, which was the case in the Czech Republic in 1998 and could be the case in other, less advanced transition economies if they considered switching to a monetary strategy based on DIT.

Second, as mentioned before, the actual NII undershot the targeted inflation rate in 1998; the NII came to 1.7% year on year in December 1998 (the CPI was up 6.8% year on year at the end of 1998). The central bank had not foreseen such a course of events when it initially embraced the framework of DIT. Inflationary expectations were biased upward at that time, as headline inflation was accelerating due to increases in administrative prices. The situations in which the target is missed raise questions about the extent to which the central bank is to be held accountable for such an outcome. The central bank was subject to criticism in 1998 that disinflation had come about too fast, claiming too high a price in terms of output. In 1999, indirectly responding to such criticism and accounting for such cir-

Chart 5



cumstances, the CNB defined “escape clauses” under which it cannot be held responsible for inflation outcomes that diverge from the specified target. These contingencies include significant differences between projected and actual world prices of commodities, significant differences between projected and actual exchange rates that do not reflect developments of domestic economic fundamentals and monetary policy, considerable changes in conditions in agriculture which affect agricultural producer prices and natural disasters and similar extraordinary events that produce demand-led and cost-push price shocks.<sup>1)</sup>

Communications policy is an important part of a generic DIT strategy. The introduction of DIT was announced rather laconically by the CNB. For example, the CNB did not explain why it opted for a two-percentage-point range of its three-year target. The CNB started publishing quarterly Inflation Reports in April 1998. It also publishes the minutes of its board meetings. The CNB’s information policy has improved, though crucial information on the methodology of forecasts and the transmission mechanism of monetary policy is still rather scant. In 1999, the CNB delivered more information about why it chose a one-percentage-point interval for deviations from its short-term target. According to the CNB, the interval bandwidth reflects the volatility of economic and monetary variables, the inaccuracy of inflation forecasts and the imperfect knowledge of the transmission mechanism, including the relevant and varying lags.<sup>2)</sup>

### 3.2 Poland

In January 1999, Poland joined the group of countries targeting inflation. Again, it is a good starting point to remark on the two general prerequisites of inflation targeting. Fiscal dominance does not seem to be a problem in Poland. The central bank is independent with regard to the instruments and strategy with which to achieve the final goal, which is derived from the Maastricht Treaty (price level stability). The 1997 Central Bank Act eliminated the possibility of direct lending by the National Bank of Poland (NBP) to the government. The capacity of financial markets to finance government expenditure recently passed its first serious test: At the beginning of 1999, the Polish government suffered from liquidity problems when, following the introduction of administrative, health care and pension reforms, the budget deficit reached over 72% of the 1999 plan in the first quarter. This shortage of funds was financed on the domestic market without a significant increase in government paper yields.

The condition of noncommitment to another monetary anchor is less well satisfied, as Poland still maintains the crawling band system. However, the band of feasible fluctuations is wide:  $\pm 15\%$  from the center parity rate against the basket consisting of the euro (55%) and the U.S. dollar (45%). To comply with the requirements of the DIT strategy, the NBP widened the band to  $\pm 15\%$  from  $\pm 12.5\%$  in March 1999. The central bank intends to replace this system with the managed floating regime, though no date has

1 CNB (1999) p. 46.

2 CNB (1999) p. 46.

been announced (NBP, 1998 b).<sup>1)</sup> The central bank has not intervened on the foreign exchange market since July 1998, so as to allow the market to determine the value of the domestic currency. The Russian crisis put this policy to a positive test, as the exchange rate depreciated rapidly against the then currency basket of five currencies, which gained about 9% in one week in August 1998, but the depreciation stopped when the exchange rate fell to the center of the band. One of the preparatory steps for the switch to managed floating is the planned elimination of the daily exchange rate fixing sessions in June 1999; the aim is to boost the development of the foreign exchange market and to eliminate speculation at these sessions.

The history of monetary strategies based on intermediate targeting is rather varied in Poland despite the fact that transition started only ten years ago. The 1990 stabilization program used a fixed nominal exchange rate to the U.S. dollar as the main monetary anchor. Later, the central bank alternately targeted interest rates and money. Right before switching to the DIT framework, the central bank targeted a monetary aggregate (M2) within the framework of the crawling band system. The NBP missed the money supply target most of the time, but inflation fell consistently. These frequent changes of the monetary policy framework did not feature prominently in the central bank's explanations about why it decided to switch to inflation targeting (NBP, 1998 b). The argumentation why it rejects the two most frequently used alternatives – exchange rate strategy and monetary targeting – is standard, but includes elements typical of transition or developing economies. The NBP argued against disinflation based on a fixed exchange rate, because it has no knowledge of the equilibrium exchange rate, especially amid conditions of strong external shocks, the continued liberalization of capital flows and structural changes in the economy. Furthermore, monetary policy cannot react to internal shocks, the domestic economy is subject to the transmission of disturbances from the anchor country, and finally the fixed regime is inappropriate in the case of liberalized capital movements because it runs the risk of collapsing under a speculative attack. The alternative of monetary targeting requires other preconditions, which, according to the document the Polish economy hardly satisfies, however. Monetary targeting is not appropriate, because the relationship between monetary aggregates and inflation is not stable for three reasons: the excess liquidity of the banking sector, unstable capital inflows and the ever-changing degree of the monetization of the Polish economy due to the ongoing development of financial markets.

Thus, like in the Czech case and elsewhere, inflation targeting can be considered a default solution, but the central bank pointed to its merits as well (NBP, 1998 b). They include universally cited positive properties, such as the transparency of the inflation target for the public, so the performance is easy to verify by the public, and the clear visibility of the costs of short-term fixes in the real economy. The central bank emphasized the flexibility of instruments under DIT, which allows the central bank to find the proper

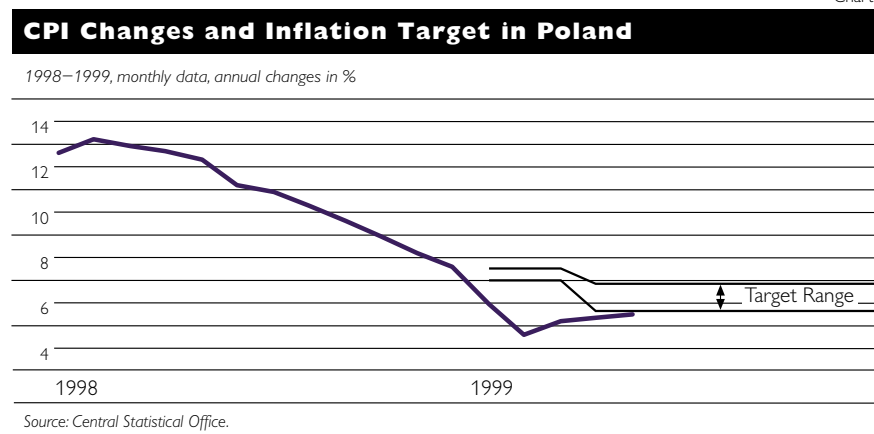
*1 The date of introducing the managed floating system of the exchange rate will hinge on the development of the foreign exchange market and the extent of the liberalization of foreign exchange.*

mix for reacting to various shocks. It is interesting to note that both the CNB and the NBP hope that DIT will dampen inflationary expectations relative to other monetary strategies.

In contrast to the CNB, which targets an index of core inflation, the NBP targets headline CPI. The NBP explained that this measure of inflation is most transparent to the broad public. The central bank gave precedence to transparency over a better controllability of the target. However, it signaled that a measure of core inflation (the term “base inflation” index is used) excluding the impact of administered prices, seasonal influences and supply shock effects will be elaborated by the Central Statistical Office to enhance the controllability of the targeted index. The CPI is calculated by the CSO. To make CPI targeting credible, the government should provide the central bank with a firm schedule for increases in regulated prices and taxes. This was the case in Poland, where the government had drafted the 1999 budget before the NBP decided about inflationary targets.

The NBP, like the CNB, assumes a gradual reduction in inflation and has specified a multi-year inflationary target (five years), which it supplemented with a one-year target. The choice of the one-year period for a short-term target is designed to take account of lags in the effects of monetary policy and to give the policymakers leeway to react to various potential shocks. The NBP’s formulation of the medium-term target’s value differs from the CNB’s. It assumes a reduction of the CPI inflation rate “below 4% by 2003”<sup>1</sup>) and the range is open-ended at the lower edge, so the central bank could not be charged for missing the target on the downside. In 1999, the central bank initially targeted CPI growth of between 8% and 8.5% year on year in December. This target was in line with the assumptions underlying the state budget, so the central bank de facto acted as an agent for the democratically elected government. This was a coincidence, as there are no regulations specifying an agent-principal relationship like in New Zealand. In March 1999, the target range was revised downward to a range between

Chart 6



<sup>1</sup> The formulation of the respective statement (NBP, 1998b, p. 12) is unclear and may refer to the year-on-year inflation in December 2002 or 2003.

6.6% and 7.8% year on year, as unexpected disinflation took place; in February 1999, the downtrending CPI inflation rate year on year was 5.6%.

Despite the stance that too narrow a target range could lack credibility because the central bank may easily miss it, the NBP initially adopted a very narrow band of only 0.5 percentage point for its 1999 target. Later, it somewhat made up for this by widening the range to 1.2 percentage points when it revised its inflationary target downward, but the range is still narrow. Inflation performance in the fourth quarter of 1998 (the CPI rose by 8.6% year on year in December 1998) and in the first two months of 1999 signaled that the target for 1999, which had first been proposed in the assumptions for the 1999 state budget in early fall 1998, might be undershot.<sup>1)</sup> The Monetary Policy Council of the NBP was confronted with three choices at that time: to relax monetary policy in an attempt to meet the target, to lock in unexpected disinflationary gains or to undershoot the target. It chose to target a lower inflation rate by revising the target downward, which actually implies faster disinflation. The exchange rate policy was also subordinated to this task, as the MPC of the central bank reduced the rate of the crawling devaluation of the zloty's central parity rate against the basket to 0.3% from 0.5% monthly at the same meeting. This illustrates a potential contradiction between inflation targeting and a crawling peg mechanism. The NBP's move was consistent with the logic of DIT, under which it should give precedence to inflation. However, cutting the crawling peg rate involves certain risks for current account developments, as the deficit was a relatively large 4.5% of GDP in 1998 and is projected to widen in 1999.

Concerning its information policy, Poland, in contrast to the Czech Republic announced the introduction of the DIT framework in a separate document entitled "Middle-Term Monetary Strategy" (NBP, 1998b), which broadly explained the reasons for the change, the merits of the new framework and the reasons for adopting the particular value of the middle-term target. The NBP promised to publish an inflation report, which would appear semiannually and later quarterly without specifying when the publication would be launched. In consistency with the Central Bank Act, information on MPC members' voting behavior is published in the legal journal *Monitor*. Like the CNB, the NBP has provided little information on the methodology of inflation forecasts and their role as well as on the bank's reaction to the forecast of inflation in excess of targeted inflation (feedback rules). Hence, DIT will remain a framework of constrained discretion for the time being.

*1* Later the inflation rate started creeping upward. In May 1999, the CPI was up 6.4% year on year.



#### 4 Conclusions

This paper started by outlining the theoretical underpinnings and technical issues of direct inflation targeting to proceed to a summary of the experience of four Western, pioneering economies. The aim was to present DIT frameworks and the first experiences of the two transition economies, the Czech Republic's and Poland's, in a broader perspective. Empirical evidence is still scarce, as the Czech Republic switched to DIT in January 1998, while Poland adopted the strategy in January 1999. Both countries meet the general prerequisites for DIT, i.e. inflation targeting is not jeopardized by fiscal dominance, and there are no interfering other nominal anchors. Poland maintains a crawling band system, but the band is wide and will be dismantled in the near future, as the central bank intends to introduce a managed float.

There are similarities and differences between Poland's and the Czech Republic's monetary policy frameworks. The targets are announced and adopted by the central banks which consequently assume the sole responsibility for lowering inflation; this is the second best solution next to a joint announcement by the government and the central bank. An important common feature of the two DIT frameworks is disinflation targeting, which is compatible with Svensson's concept of flexible DIT, i.e. gradual disinflation allowing for less output variability than under strict inflation targeting and for accommodating model uncertainty or instrument smoothing. While both central banks have decided on medium-term targets of lower inflation, their achievement will not mark the end of disinflation in these countries, because these targets do not correspond to a notion of price stability. The ultimate inflation targets should lie below 2%, assuming this range remains the ECB definition for price stability, since both countries intend to join EMU in the future.<sup>1)</sup> The CNB target horizon is three years ending in 2000, and the lower end of the net inflation rate range is 3.5%. If the central bank decides to stick to inflation targeting after that period, it will most likely opt for a more ambitious target value to bring inflation down to levels more compatible with a prospective EMU entry. The Polish strategy is longer, covering a time horizon of five years and putting a 4% ceiling on the CPI rate for 2003, but does not specify any lower limit to disinflation. This formulation leaves room for further disinflation, if the target value achieved lies within a 2% to 4% range.

Table 1

<b>Main Components of the DIT Frameworks</b>				
<b>in the Czech Republic and Poland</b>				
Country	Target index definition	Target level (inflation in percent)	Time horizon	Escape clauses
Czech Republic (1998)	CPI excluding administered and regulated prices, indirect taxes	3.5 to 5.5 4.5 ± 0.5	3 years (2000) one year (1999)	Yes (1999)
Poland (1999)	CPI	below 4 6.6 to 7.8	end 2003 end 1999	None

1 Assuming that the actual inflationary performance of the EU-11 will be compatible with this aim.

Both countries announced one-year targets as focal points of their strategies. In the short run, they target ranges, and these ranges are narrow even judging by the standards of the advanced economies which pioneered inflation targeting. Both countries share the optimism that DIT will be well suited to influence inflationary expectations, but as the experience of Western economies has shown, this comes rather later and only once the central banks have built a reputation for meeting their targets (Bernanke et al., 1999).

The CNB published an inflation forecast for 1999 while the NBP has yet to do so as of the writing of this text. In both banks' strategies the role of inflationary forecasts is rather vague. No feedback rules linking inflation forecasts and actual inflation outcomes were specified, but this is common practice in Western economies, too. Such an approach increases the degree of discretion inherent in the DIT framework if inflation forecast targeting is not used. Therefore it is safe to describe the CNB's and NBP's strategies as "constrained discretion" following Bernanke and Mishkin.

The Czech and Polish central banks have chosen to target different types of inflation indices: The NBP targets headline CPI inflation, while the CNB targets core inflation, i.e. the "CPIX." This important distinction between two frameworks points to the major difficulty of inflation targeting, that inflation is imperfectly controllable, i.e. CPI inflation is less a monetary phenomenon than core inflation. The degree of imperfect control rises in the case of transition economies, as their relative price adjustment is still incomplete. Assuming that the central bank knows the regulated price hikes and tax change schedules before it determines its inflation target and can evaluate the impact of these changes on the headline inflation index, under the still incomplete adjustment of relative prices the issue of whether a DIT strategy based on headline inflation is more effective than a DIT strategy based on core inflation remains open. A serious drawback of core inflation targeting during the phase of disinflation is that wide discrepancies between headline inflation (usually observed by the general public) and core inflation may arise. This was the case in the Czech Republic as of writing. Under such circumstances core inflation will not gain the role of an anchor for the public's inflationary expectations, because it has no relevance to measuring the cost of living; besides, the public may claim that the central bank chose the core inflation index to make its life easy. Low inflation controllability is a compelling case for the inclusion of escape clauses allowing the central bank to deviate from the target because of various temporary shocks or hikes in regulated prices and taxes. Contrary to that logic, Poland has not included any escape clauses, but the CNB, which undershot its target in 1998, did so after its first year of experience. These comparisons suggest that both countries still have scope to refine their DIT strategies, in particular with regard to accountability and transparency. The UK's and New Zealand's frameworks are ready examples of how these problems are solved in practice.

A number of crucial questions will have to await answers until the experience of the Czech Republic and Poland with DIT is long enough. One such question is whether the DIT framework has actually helped disinflation. The Czech inflation record would suggest that the switch to the DIT framework indeed did so. However, the adoption of DIT coincided with recessionary

developments in the Czech economy and a worldwide fall in commodity prices. To reiterate the results cited in Section 2.4.5, Bernanke et al. (1999) applied a simple VAR model in order to figure out whether a switch to the DIT regime could be distinguished in the inflation performance but could not reach conclusive answers because countries which did not adopt DIT also considerably improved their inflation performance. Their empirical framework is not free from caveats, but it prepares the ground for more firm conclusions. Their exercise could theoretically be applied to the Czech Republic, but the time series on NII start only in 1995 eliminating the use of time series analysis. The Polish experience amounts to just a few months, so far.

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# *The Southeast European Nonassociated Countries – Economic Developments, the Impact of the Kosovo Conflict and Relations with the EU*

Stephan Barisitz

## **I Introduction**

This study describes and analyzes economic developments during recent years in those Southeast European countries that have not concluded Europe Agreements with the EU and that have not participated in the European integration process so far. The Southeast European Nonassociated Countries – for which the abbreviation SEENACs is chosen, or coined, here<sup>1</sup>) – have been plagued by political instability, ethnic tensions, human rights abuses and even military conflicts for years, as most recently tragically highlighted by the Kosovo conflict. This political plight has often been accompanied by sluggish economic reforms and dire poverty. The countries dealt with are Albania and the successor states of former Yugoslavia, except Slovenia.

The first two introductory Chapters explain the general political background before and after the Kosovo conflict. In Chapter 3, economic developments in the individual countries are analyzed in detail. Given the diversity of relevant political and economic aspects across the region, the analysis is carried out country by country, covering the political background, GDP and output, fiscal and monetary policies, banking systems, foreign trade and current accounts, indebtedness, privatization and restructuring, FDI, unemployment and economic prospects. Since the war in Yugoslavia has had a strong impact on the economic development of all countries in the region, Chapter 4 specifically deals with estimates of the cost of the conflict, its consequences and external financial needs. Based on the displayed information and analysis, Chapter 5 attempts to derive major common economic and political characteristics of the SEENACs. Finally, the recent evolution and prospects of relations with the EU are outlined in Chapter 6.

## **2 Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, the Federal Republic of Yugoslavia: Framework of Political Instability and Economic Isolation in Europe**

### **2.1 The Situation Before the War in Yugoslavia**

Looking at the countries from the Northwest to the Southeast, Croatia, having regained full territorial sovereignty in 1997 after militarily recapturing the formerly Serb-held “Krajina” territories in 1995, is ruled by a regime which is reproached for not fully respecting democratic and human rights, in particular minority rights. In response to this situation, the advancement of Croatia in international institutions (e.g. the WTO) has been partly blocked by Western nations. Negotiations on the conclusion of a trade and cooperation agreement were suspended by the European Union in 1995 and so far have not been resumed. The disbursement of an IMF loan was suspended in July 1997 on political grounds. On the other hand, Croatia is comparatively advanced in terms of economic reforms.

After the end of the war in Bosnia and Herzegovina, the Dayton Agreement, signed in December 1995, stipulates that this country is a highly decentralized “state,” consisting of two “entities,” the Muslim-Croat “Feder-

<sup>1</sup> As mentioned below, the EU uses the term “Western Balkans” to circumscribe the region.

ation of Bosnia and Herzegovina” with about two thirds of the population, and the “Republika Srpska.” The Federation is itself rather decentralized, consisting of ten Muslim or Croat “cantons.” The two entities and three ethnic groups have lived in uneasy coexistence, supervised by international peacekeeping forces and the “Office of the High Representative.” Bosnia and Herzegovina has benefitted from an international financial assistance package of USD 5.1 billion, earmarked for the period 1996 to 1999.

The Federal Republic of Yugoslavia (FR of Yugoslavia), made up of the constituent Republics of Serbia and Montenegro, is ruled by an authoritarian regime that suppresses human rights and freedoms. This goes in particular for its activities in the formerly autonomous province of Kosovo in the Republic of Serbia; the ethnic Albanian majority of this province has been subject to brutal ethnic cleansing measures. Already economically weakened from the effects of the comprehensive UN economic blockade imposed during the Bosnian war and lifted in 1995, the FR of Yugoslavia has suffered from the continuing “outer wall” of sanctions (nonmembership in the IMF and World Bank, therefore restrained access to international financial markets). New sanctions were introduced by the EU in December 1997 (suspension of preferential trade tariffs) and June 1998 (ban on foreign investment in Serbia) in response to human rights abuses in Kosovo. The political and economic isolation of the FR of Yugoslavia is unique in Europe.

The political situation in the Former Yugoslav Republic of Macedonia (FYR of Macedonia) has so far remained remarkably calm, despite tensions between its Slavo-Macedonian majority and its ethnic Albanian minority, which makes up at least one quarter of the population. The country has shown some modest progress in economic reforms. But the FYR of Macedonia appears to be especially vulnerable to developments affecting its immediate neighbors. With Serbia as its major traditional trading partner, it suffered considerably from the UN economic blockade against that country. Another blow came from the Greek embargo imposed in 1994 and 1995.

The Republic of Albania is particularly fragile, as the state is unable to uphold public order in certain parts of the country. Modern government institutions are only in the process of being established. At times it has been necessary to enlist international security forces in order to restore internal security. It also probably continues to be the poorest country in Europe.

Slovenia is the only former Yugoslav republic that was able to emancipate itself from the problems affecting other successor states and to join the dynamics of European integration. It was able to do this owing to its more stable democratic development and to the absence of any substantial ethnic or minority problems. Slovenia today belongs to the EU accession candidates of the first wave.

As stated above, none of the five SEENACs has signed a Europe Agreement, and only two of them (Albania and the FYR of Macedonia) have trade and cooperation treaties with the European Union. The other countries have no contractual relations of this type with the European Union. Having remained on the sidelines of the European integration process, these countries might be described as a blank area in the midst of the EU and its acces-

sion candidates. In the political jargon of the Union, they are collectively referred to as the “Western Balkans.”<sup>1)</sup>

## **2.2 Outlook after the War in Yugoslavia**

On top of its political and economic isolation, the government of the FR of Yugoslavia, by rejecting the Rambouillet peace plan, made itself subject to NATO air strikes that started on March 24, 1999, and lasted 11 weeks (until June 10). By embarking on the brutal deportation of hundreds of thousands of ethnic Albanian inhabitants of the province of Kosovo and the destruction of their property, the Yugoslav regime has made itself a pariah of the (Western) international community. In May 1999 the EU and the U.S.A. imposed an oil embargo on the FR of Yugoslavia. The air strikes have inflicted immense material damage on the military and civilian infrastructure of the country; they also caused considerable human casualties.

Massive streams of refugees have poured into Albania and the FYR of Macedonia. Despite substantial international assistance for the refugees, they may overburden these small countries' economies and destabilize their political situation. The arrival of the refugees and military tensions with Yugoslav forces on the border have led to the deployment of a considerable number of Western soldiers and humanitarian personnel in Albania, which might act as a counterforce to the further deterioration of the fragile public order in this country. On the other hand, the large number of ethnic Albanian refugees in the FYR of Macedonia may exacerbate ethnic tensions in that country. Inter-ethnic and interentity relations in Bosnia and Herzegovina may likewise deteriorate, while Croatia will primarily feel economic repercussions.<sup>2)</sup>

The war in Yugoslavia has also induced the EU to reconsider its stance vis-à-vis the SEENACs, which may usher in a policy of more active involvement of the Union in fostering the recovery and development of this unfortunate European region.<sup>3)</sup> Other international organizations, like the World Bank and the IMF, have also stepped up their involvement. The IMF has recently resumed negotiations with Croatia on a stand-by arrangement.

## **3 Economic Developments: An Overview**

This Chapter gives an overview of macroeconomic and structural developments in the five countries in question in recent years. Among the topics touched are the following: output and GDP, fiscal and monetary policy, the banking sector, foreign trade and the current account, indebtedness, privatization and restructuring, FDI, unemployment and the standard of living.

### **3.1 Croatia**

The situation of Croatia is still marked by the legacy of the military conflict in the country itself and in neighboring Bosnia, which lasted until 1995. Continuing political instability and isolation with respect to integration tenden-

<sup>1</sup> See e.g. *European Council Vienna (1998)* p. 12.

<sup>2</sup> For an economic account of the (likely) effects of the Kosovo conflict on the countries of the region see Chapter 4.

<sup>3</sup> For more detailed information on the development of relations with the EU see Chapter 6.

cies in Europe characterize the present situation. Furthermore, the effects of the Kosovo crisis have to be considered.

The further European integration progresses, the more onerous Croatia's relatively isolated position becomes. Croatia's two central European neighbors, Slovenia and Hungary, are associated to the EU by Europe Agreements and are conducting accession negotiations; eight more economies in transition are candidates for membership. Croatia, however, has not even concluded a "simple" trade agreement with the EU, not to mention an Association Agreement. The EU's trade rules of origin can therefore put Croatia at a disadvantage and lead to trade diversion effects (e.g. regarding purchases of supplies and outward processing), which, in turn, can reduce incentives for FDI.

Croatia's unpleasant situation in its foreign and trade relations contrasts with an economic development in recent years that has been quite impressive, albeit not without problems. In the fall of 1993 a comprehensive macroeconomic stabilization program was launched, featuring restrictive fiscal and monetary policies and orienting the exchange rate of the Croatian kuna on the Deutsche mark (as a nominal anchor in the framework of a managed float). The authorities succeeded in strongly reducing budget deficits, containing the expansion of government debt and cutting galloping inflation to almost zero. Economic growth already reappeared in 1994 and remained robust until 1997 (about 5% to 6% a year), but weakened considerably in 1998 (to 2.7%).

In mid-1997 presidential elections took place, and the reins of economic policy slackened. The budget deficit widened from 1.3% of GDP in 1996 to 3.5% in 1997, and the inflation rate grew to 3.8% (December to December) by end-1997. The credit volume of the banking sector expanded considerably, and banks increasingly acquired debts abroad. International capital markets became more easily accessible after the major international rating agencies had granted the country investment grade marks in January 1997. State enterprises gave above-plan wage increases. The stimulation of aggregate demand thus triggered an alarming deterioration of the trade and current account balances. The current account deficit grew from 4.5% of GDP in 1996 to 12.5% in 1997. This happened despite the partial recovery of tourism and its impact on foreign exchange earnings, which rose again after the end of the Bosnian war. Gross foreign indebtedness grew from a low level to USD 6.2 billion (or about a third of GDP) at the end of 1997.

In the second half of 1997 monetary and fiscal policy were tightened again. The introduction of the value added tax improved the budgetary situation; the budget deficit in 1998 is estimated to have fallen to 1% to 1.5% of GDP. But the VAT pushed up the inflation rate in 1998 to 5.7% (December to December), which then until April 1999 fell to 3.6% (on a twelve-month basis). Apart from the contractionary measures, more difficult access to foreign capital markets and problems in the banking sector (see below) may have contributed to the slowdown of growth in 1998. The new austerity measures have (so far) not decisively alleviated the external disequilibrium. At least the trade and current account gaps have shrunk. The current account deficit in 1998 amounted to about 7.5% of GDP (USD



1.6 billion). The financing of the shortfall improved due to increased inflows of foreign direct investment. The EBRD estimated the latter to amount to USD 600 million net in 1998. But foreign liabilities rose to around USD 8.2 billion (about 40% of GDP) at the end of 1998. The trade deficit registered in January to April 1999 was only slightly lower than the corresponding figure of the first four months of 1998. The foreign exchange reserves of the Croatian National Bank have remained more or less stable in recent years and amounted to USD 2.4 billion in April 1999.

The turbulences in the emerging markets have (so far) only had limited repercussions on financial stability in Croatia, because financial markets are not well developed and because the authorities implemented short-term capital controls and tightened them in 1998. Therefore it is difficult for foreigners (and Croatians) to speculate for or against the kuna. Still, borrowing abroad became more expensive, and the unfavorable external situation of the country affected the Croatian currency in 1998 and even more in recent months. Its exchange rate moved from HRK 3.52/DEM at end-1997 to HRK 3.74/DEM at end-1998 and HRK 3.88/DEM in May 1999.<sup>1)</sup> The Croatian stock market is very small and dominated by a few relatively large privatized firms (among them the pharmaceutical group Pliva). After taking a blow in August 1998 in response to the outbreak of the Russian crisis, the market began to recover in September, and the recovery continued through the end of the year. In February 1999 Croatia successfully issued a Eurobond worth EUR 300 million; however, it had to offer a relatively high spread (375 basis points above German government bonds). Among the reasons cited were the politically unstable neighborhood and general concerns over the Balkan region in connection with the Kosovo crisis.

Owing to the tightening of monetary and fiscal policy, problems of enterprises' illiquidity came to the fore, and the government announced a package of measures, including changes of bankruptcy laws. At end-December 1998 about 26,500 enterprises' dubious debts were estimated at USD 2.25 billion (22,500 of these firms were privately owned).<sup>2)</sup> These problems are partly rooted in the dominating types of privatization, i.e. MEBOs (management and employee buy-outs) and sales to domestic citizens, which provide little fresh capital and know-how. In 1998 a long-delayed voucher privatization program was implemented, prominently featuring funds to be listed on the stock exchange. The state remains an important minority shareholder in a number of larger enterprises. The result of this state of affairs for the time being is a predominance of "insiders" in enterprises, scattered ownership, insufficient restructuring, limited competitiveness and the accumulation of payment arrears. The official jobless rate rose to about 19% in April 1999. According to the ILO definition (based on labor force surveys) unemployment came to 10% to 12% in the fall of 1998. Looming bankruptcies have triggered social protests.

Dangers for economic stability are also posed by other structural problems, e.g. the fragility of the banking sector. This was highlighted by

1 This corresponds to a nominal depreciation of 10% against the Deutsche mark since mid-1998.

2 See BBC Monitoring Service of February 4, 1999.

the insolvency in April 1998 of Croatia's fifth-largest commercial bank, Dubrovačka Banka. It was swiftly bailed out by the central bank and put on a rehabilitation scheme. This follows earlier rehabilitation measures pertaining to other banks. Despite improvements in bank governance, connected lending still appears to play a substantial role. The privatization of rehabilitated banks was launched with the sale of state shares in Slavenska Banka to the EBRD and Austria's Erste Bank in mid-1998. A new banking law which strengthens central bank supervisory powers and raises minimum capital requirements, came into force in December 1998. With about 60 banks, Croatia seems to be overbanked, and smaller credit institutions are subject to considerable consolidation pressures. At the beginning of 1999 the central bank recommended the initiation of bankruptcy procedures against nine small loss-making banks. Compensating the savers affected through the state deposit insurance will probably entail considerable budgetary costs (about HRK 3 billion or 2% of GDP).

The weakening of economic growth in the EU and the Kosovo crisis have caused the economic dynamics in Croatia to stall. After output had already contracted in the fourth quarter of 1998, industrial production (according to preliminary figures) fell by 3.0% in January to April 1999 compared to the corresponding period of 1998. Retail trade turnover shrank by 8.2% in the first four months of 1999 against the same period of 1998. The Kosovo conflict mostly affects Croatia via (expected) losses of foreign exchange revenue from tourism, negative investment effects due to rising risks, the scaring-off of foreign investors, growing financing costs on international capital markets, and trade losses and higher transportation costs (largely stemming from the need to bypass the FR of Yugoslavia in transit trade).

According to estimates of the Croatian National Bank, the losses of tourism revenue for 1999 as a whole are gauged at about USD 400 million (or about 2% of GDP). The current account deficit is expected to surpass the originally forecast level of 6% of GDP by about 1 to 2 percentage points; the shortfall would be roughly as high as in 1998. Furthermore, gross domestic product is expected to stagnate or contract by 1% in 1999.<sup>1)</sup> A study by Vladimir Gligorov and Niclas Sundström of the Vienna Institute for International Economic Studies (WIIW) published in mid-April 1999 arrives at broadly similar results.<sup>2)</sup> An IMF study, published on May 25, forecasts a negative GDP impact amounting to 2% to 3%,<sup>3)</sup> which would cause economic activity to contract by about 1% to 2% in 1999. The international rating agency Fitch IBCA downgraded Croatia's long-term foreign currency rating from BBB to BB+ at the end of April.

To counteract the unfavorable situation and the continuing external disequilibrium, raise necessary revenues for the abovementioned reimburse-

1 These figures correspond to statements made by Governor Marko Skreb of the Croatian National Bank in a lecture entitled "Recent Economic and Monetary Developments in Croatia" held at the Oesterreichische Nationalbank in Vienna on May 21, 1999.

2 See Gligorov and Sundström (1999) p. 21.

3 See International Monetary Fund (1999).

**Croatia – Selected Economic Indicators**

	1992	1993	1994	1995	1996	1997	1998
GDP growth in real terms percentage change against preceding year	– 11.7	– 8.0	5.9	6.8	6.0	6.5	2.7
CPI in percent; December to December	666.0	1,518.0	97.6	2.0	3.5	3.8	5.7
Budget balance <sup>1)</sup> percentage of GDP	x	– 1.1	– 1.2	– 2.1	– 1.3	– 3.5	– 1.3
Unemployment rate <sup>2)</sup> in percent; year end	13.2	14.8	14.5	14.5	16.4	17.5	17.6
Current account balance <sup>3)</sup> USD million	823.0	600.0	786.0	–1,283.0	– 881.0	–2,435.0	–1,554.0
percentage of GDP	8.0	5.5	5.4	– 6.8	– 4.5	– 12.5	– 7.5
Foreign debt USD million; year end	2,740.0	2,490.0	2,820.0	3,340.0	4,810.0	6,160.0	8,200.0
percentage of GDP	26.8	22.9	19.3	17.8	24.4	31.9	40.4
Foreign exchange reserves <sup>4)</sup> USD million; year end	170.0	616.0	1,405.0	1,895.0	2,314.0	2,539.0	2,820.0
IMF relations	Membership status: December 14, 1992 Quota: SDR 261.6 million Portion of Former Yugoslavia's membership: 28.49% Systemic Transformation Facility: SDR 130.8 Stand-by Arrangement: SDR 65.4 million (October 14, 1994 to April 13, 1996) Extended Fund Facility: SDR 353.2 million (March 13, 1997 to March 12, 2000; not operative since end-1997); as of June 19, 1998.						
Currency; convertibility; exchange rate regime	Kuna; introduced May 30, 1994. Prior to that date, Croatian dinar as a transitional currency; full current account convertibility according to IMF Article VIII; managed float; DEM/EUR orientation						

Data for 1998 preliminary.

Sources: EBRD, IMF, WIW, UN/ECE.

<sup>1)</sup> Consolidated central government.

<sup>2)</sup> Share of unemployed in the labor force.

<sup>3)</sup> Excluding official transfers.

<sup>4)</sup> Currency reserves of monetary authorities without gold.

ment of savers and secure transfers to pension and health funds, the government revised the budget for 1999 by cutting some current and in particular investment expenditures. Additional money should come from Eurobond proceeds, privatization revenues (from the telecom company Hrvatske Telekomunikacije, the insurer Hrvatske Sekuranje, the energy company INA and others). Furthermore, the government expects to contract a World Bank structural adjustment loan of about USD 250 million. Given that parliamentary elections are approaching (they have to be held at the latest in January 2000) and taking into account growing dissatisfaction with rising unemployment, it remains to be seen whether the fiscal consolidation measures can be sustained.

To alleviate the pressure on the kuna, the Croatian National Bank increased commercial banks' minimum reserve requirements and raised interest rates in March 1999.<sup>1)</sup> Notwithstanding the difficult economic situa-

<sup>1)</sup> On March 11, the National Bank decided to raise the reserve requirements for banks by one percentage point to 30.5% of kuna deposits and the lombard rate from 12% to 13%.

tion, the monetary authorities intend to continue their policy of retaining an exchange rate (to the euro/Deutsche mark) that is as stable as possible. This will certainly not be easy, considering that the probably still high trade deficit in 1999 in all likelihood will not be covered by tourism revenues and FDI to the same degree as last year. Against the background of the war in Yugoslavia, negotiations with the IMF on a stand-by arrangement were resumed in April 1999. Croatia hopes to receive a credit of about USD 200 million.

### 3.2 Bosnia and Herzegovina

The war in Bosnia and Herzegovina lasted from 1992 to 1995. Human casualties, expulsion and flight are thought to have reduced the country's population by about 20% to 25%. About 800,000 of the 4.5 million inhabitants now estimated to be living in Bosnia are refugees that have not yet been able to return to their home territories. According to estimates of the World Bank, capital stock (largely infrastructure) worth about USD 15 billion was destroyed in the war.<sup>1)</sup>

While the military part of the Dayton Treaty has essentially been carried out, the political realization of the agreement, i.e. the creation of Bosnian state structures, institution building and cooperation between the entities is getting on only slowly. According to the Dayton Treaty, the state has its own parliament, government and central bank. The central government (state), composed according to ethnic principles, has limited powers, and the most important decisions have to be made unanimously by the Serb, Muslim and Croat representatives. The state is in charge of foreign policy, foreign trade and customs policy, monetary and exchange rate policy, foreign debt, domestic and international communications. With respect to customs policy, the state sets customs and tariff laws, whereas the two entities carry out the customs administration. The state accounted for a mere 12% of total public spending in 1998, which was almost fully financed by mandatory transfers from the entities and the lion's share of which went to external debt service. The entities possess taxation powers; within the (Muslim-Croat) Federation of Bosnia and Herzegovina, the major taxation powers are assigned to the cantons and municipalities. All responsibilities not explicitly vested with the central government fall within the jurisdiction of the entities (subsidiarity principle). Therefore, the entities are in charge e.g. of privatization, banking supervision, the fiscal system, economic and development policies, labor legislation. Within the Federation, the cantons are responsible i.a. for tourism and natural resources exploitation.<sup>2)</sup>

The Central Bank of Bosnia and Herzegovina was created in August 1997,<sup>3)</sup> and the national currency, the "konvertibilna marka" (KM, ISO code BAM) was brought into circulation in the summer of 1998. It was linked to

1 See Stojanov (1998) p. 30.

2 Information provided by Mirko Dejanović, Assistant Minister of Foreign Trade and Economic Relations of Bosnia and Herzegovina, on occasion of the country presentation of Bosnia and Herzegovina at the annual meeting of the EBRD in London, April 20, 1999.

3 According to the constitution of Bosnia and Herzegovina, enacted as part of the Dayton peace treaty, the central bank must be run for the first six years by a governor who is named by the IMF and is neither a citizen of Bosnia nor of any of the neighboring countries.

the Deutsche mark (since January 1, 1999, it has been linked to the euro) on the basis of a currency board arrangement. The fixed exchange rate is BAM 1 for DEM 1. This strict regime was regarded as necessary to achieve quick acceptance and credibility of the new currency. Foreign reserve holdings backing domestic money circulation have been growing and amounted to DEM 313 million on April 30, 1999. For the time being, three other currencies continue to coexist on Bosnian territory: the Croatian kuna (predominantly in the cantons of the Federation with a Croatian majority), the Yugoslav dinar (mostly in the Republika Srpska) and the Deutsche mark (circulating in the entire country). The authorities intend to replace these three currencies until the end of 1999.

Centrifugal tendencies and political instability have remained strong in both parts of the country, with Serbs and Croats remaining inclined to seek special ties and agreements with Serbia and Croatia respectively. Reciprocal regional fencing-off measures of the entities against each other still exist. For instance, the electricity, water, telephone and railroad networks are still partially separate. Since 1998, some progress has been achieved in bringing the entities closer to each other, although this has most often been imposed from above, i.e. by decisions of the High Representative, as in the case of uniform Bosnian passports and license plates for cars. In April 1999 the central government unanimously decided to abolish the de facto existing different customs regimes and preferential tariffs of the entities for Croatia and the FR of Yugoslavia and to implement the common Bosnian customs tariff which came into force in 1998. While making imports more expensive, this has already boosted budget revenues. The streamlining of the regime has made it easier to thwart pervasive smuggling activities.

The International Monetary Fund, World Bank, EBRD, EU and the international community have declared their willingness to provide financial assistance to the amount of USD 5.1 billion for reconstruction in Bosnia during the period from 1996 to 1999. Some USD 4 billion had actually been pledged by the end of 1998. This support was linked to the condition that both sides cooperate. Due to the sluggish implementation of the political part of the Dayton Agreement, only USD 2.7 billion were disbursed until December 1998.<sup>1)</sup> In 1996 and 1997 the Federation received the lion's share (85%) of the disbursed money, since the authorities of the Republika Srpska have apparently been less prepared to decide on measures that would have linked their entity's economy with that of the Federation. The election of a new government of the Republika Srpska in January 1998 ushered in a degree of political opening and greater readiness to cooperate on the part of the entity, which was rewarded by a larger disbursement of funds. In May 1998 Bosnia and Herzegovina concluded a 15-month stand-by arrangement with the IMF, involving a loan of SDR 61 million. An agreement with the Paris Club in October 1998 brought generous debt relief.<sup>2)</sup> Thus, foreign

*1* Owing to reported absorption problems and less-than-transparent spending, it is not clear whether all supplied money was in fact used for the intended purposes.

*2* Thus, Bosnia and Herzegovina was granted the "Naples" conditions, implying the forgiveness of 67% of debt for particularly poor countries. This means that Bosnia is spared payments of USD 1 billion, and the servicing of remaining liabilities is stretched over 30 years.

liabilities fell from USD 4.1 billion or 120% of GDP at the end of 1997 to USD 2.9 billion or 70% of GDP at the end of 1998.

The overwhelming importance of financial assistance driving the Bosnian economy is reflected in the statistics. Whereas in 1995 the GDP of Bosnia and Herzegovina had shrunk to 20% to 25% of its prewar level, the reconstruction of the two entities has since advanced considerably, although apparently with different speeds. GDP in the Federation grew by about 120% to 130% cumulatively from 1995 to 1998, while the economy of the Republika Srpska is estimated to have expanded by two thirds in this period.<sup>1)</sup> On the whole, Bosnia's GDP is gauged to have more than doubled in this period, with growth in 1998 estimated to have amounted to about 20% compared to 1997. But the level reached in 1998 probably corresponds to no more than about half the prewar level. Wages in Deutsche mark terms in the Federation at the beginning of 1999 were estimated to be twice as high as the respective wages in the Republika Srpska. The jobless rate of the Federation has fallen from 70% to 80% of the labor force to under 40% at end-1998; less progress has been achieved in the Republika Srpska. The monetary authorities appear to have brought inflation under control: The annualized inflation rate of the konvertibilna marka fell to practically zero in April 1999. The currency board-anchored monetary policy has therefore been a notable success.<sup>2)</sup> In 1998 the consolidated (state and entity) budget deficit was estimated at 3% of GDP, and was largely externally financed.

Economic development has been stimulated by trade, construction and services, fueled in turn by large capital inflows. Large parts of Bosnia now again have functioning schools and hospitals, intact roads, bridges and buildings.<sup>3)</sup> Thus the infrastructure has largely been restored with the help of international assistance. Local and private expenditures of about 36,000 international peacekeeping soldiers and employees of relief organizations also play an important role. The large reconstruction needs reflect the fact that imports have dwarfed exports so far (in 1998 exports were less than a third of imports). The high trade deficits are being covered by financial assistance, workers' remittances and transfers from relatives abroad as well as by the accumulation of payment arrears. Notwithstanding the sizeable international financial assistance and deliveries, the country does not yet seem to have succeeded in creating any substantial competitive industrial capacities which could serve as an economic base for the further growth and development of Bosnia once the external assistance ends.

Structural reforms and privatization, which belong to the jurisdiction of the entities, are still in their initial stages. The Federation in July 1998 launched a privatization program for SMEs (via vouchers and money) and in 1999 is expected to start a voucher privatization program for large enter-

1 In contrast to the Republika Srpska, economic activity in the Federation already recovered somewhat in 1995, the last year of the Bosnian war.

2 By contrast, the annual inflation rate (December to December) of the Yugoslav dinar in the Republika Srpska came to 78% in 1998. The stable konvertibilna marka has been gaining ground in the Republika Srpska lately and has been steadily driving out the Yugoslav dinar.

3 See *Neue Zürcher Zeitung* of December 29, 1998.

prises. The Republika Srpska passed a privatization law in mid-1998, the realization of which, however, has been held up by political and technical problems. The Federation in April 1998 adopted laws on the sale or liquidation of commercial banks in public ownership. Similar bank privatization laws are in preparation in the Republika Srpska. In both cases, strategic investors are to be preferred. A new banking law consistent with international practice was enacted in the Federation in October 1998. The banking sector in both entities consists of some relatively large, mostly insolvent, state-owned banks and of a growing number of small private banks. Following the introduction of stricter operating requirements in the Federation in April 1999, the licenses of eight private banks were withdrawn. Foreign direct investment is very modest. The reopening of the Volkswagen assembly plant in Sarajevo in September 1998 had at least symbolic importance. The Kuwait Investment Agency acquired a majority stake in the steel works of Zenica (Federation) at the beginning of 1999.

The Kosovo conflict is affecting Bosnia and Herzegovina in a number of ways. The country has taken up refugees, including Serbs and Montenegrins evading military service. According to estimates of the United Nations High Commissioner for Refugees (UNHCR), as of June 14, 1999, the total number of refugees in Bosnia and Herzegovina amounted to 74,600, which corresponds to around 1% to 2% of the country's population.<sup>1)</sup> The greatest losses may stem from the contraction of trade with the FR of Yugoslavia (which accounted for approximately three quarters of the Republika Srpska's foreign trade turnover before the launching of the air strikes)<sup>2)</sup> as well as from rising transportation costs for rerouting transit trade to bypass Yugoslavia. A tentative reorientation of the Republika Srpska's foreign trade toward the Federation, and thus a tendency in favor of more domestic economic integration seems to have been triggered by the military hostilities.

Still, a difficult to gauge, but possibly massive risk is that of a flareup of political unrest, due to the continuing uneasy relationship of the ethnic groups and entities in Bosnia. So far, the situation seems to have remained stable, though. The conflict increases investment risks and may deter foreign (and domestic) investors. The study of the WIIW (Gligorov and Sundström) on the costs of the Kosovo conflict estimates the possible GDP loss for Bosnia at 5%. The respective IMF study gauges the loss at 5% to 8%. Given the ongoing foreign-financed catching-up process, this means that, in all likelihood, growth will remain positive in 1999, but may settle at around 8% to 10%. In May 1999 the international donor community promised to provide Bosnia with USD 1.05 billion of conditional assistance, the final tranche of the USD 5.1 billion program to rebuild the country.<sup>3)</sup>

1 According to UNHCR information; see UNHCR (1999).

2 Bosnian Serb exports to the FR of Yugoslavia are reported to have plunged by about 75% in January to April from the same period last year, hit by a depreciating Yugoslav dinar and the NATO bombing campaign. See Reuters News Service of May 28, 1999.

3 The European Commission pledged USD 255 million, the World Bank USD 118 million, the IMF USD 23 million. The largest bilateral donors were the U.S.A., Japan and the Netherlands.

**Bosnia and Herzegovina – Selected Economic Indicators**

	1992	1993	1994	1995	1996	1997	1998
GDP growth in real terms percentage change against preceding year	x	x	x	21.0	69.0	30.0	18.0
CPI in percent; annual average; Federation (in BAM terms) Republika Srpska (in YUD terms)	x	x	x	– 4.0 118.0	– 25.0 66.0	14.0 3.0	4.9 38.9
Budget balance <sup>1)</sup> percentage of GDP; Federation percentage of GDP; Republika Srpska	x	x	x	x	– 3.0 0.0	– 1.0 0.0	– 2.0 5.0
Unemployment rate <sup>2)</sup> in percent; year end; Federation	x	x	x	x	x	39.0	38.7
Current account balance <sup>3)</sup> USD million percentage of GDP	x	x	– 492.0 – 39.2	– 570.0 – 30.5	– 1,306.0 – 47.4	– 1,482.0 – 43.3	– 1,287.0 – 31.6
Foreign debt USD million; year end percentage of GDP	x	x	x	3,361.0 180.0	3,620.0 132.0	4,076.0 119.0	2,879.0 71.0
Foreign exchange reserves USD million; year end	x	x	92.0	207.0	458.0	279.0	338.0
IMF relations	Membership status: joined December 20, 1995 Quota: SDR 169.1 million Portion of Former Yugoslavia's membership: 13.20% Post-conflict emergency assistance: SDR 30.3 million (December 20, 1995) Stand-by Arrangement: SDR 60.6 million (May 29, 1998 to August 28, 1999); as of May 31, 1999						
Currency; convertibility; exchange rate regime	Konvertibilna marka (KM, ISO code BAM); introduced on August 11, 1997; peg to DEM/EUR under currency board arrangement; no restrictions on BAM convertibility; (kuna still used in Croat cantons of the Federation, Yugoslav dinar used in Republika Srpska; Deutsche mark used country-wide; these three currencies are to be withdrawn from circulation in Bosnia in 1999)						

Sources: EBRD, IMF, WIIW, UN/ECE.

Data for 1998 preliminary.

<sup>1)</sup> Consolidated government (Republika Srpska: without local government operations).

<sup>2)</sup> Share of unemployed in the labor force.

<sup>3)</sup> Excluding official transfers.

### 3.3 Federal Republic of Yugoslavia<sup>1)</sup>

Already before the NATO air strikes, the FR of Yugoslavia enjoyed the unenviable distinction of being the financially and politically most isolated country in Europe. Yugoslavia is still marked by the effects of more than three years of comprehensive UN economic sanctions, of hyperinflation, delayed reforms and mismanagement. The near-total economic blockade was in force from mid-1992 to November 1995 and then suspended. In spite of lively smuggling and indirect trade mostly conducted via the FYR of Macedonia and partly also via Bulgaria, many goods in Yugoslavia became scarce and very expensive. In this time of grave tensions between the successor states of

1) Data and material on this country are difficult to procure, since the FR of Yugoslavia is not a member of organizations like the EBRD, the IMF and the World Bank that compile regular reports on the economic situation of member countries. Therefore, one has to rely on other publications, including official ones, which may be biased. Thus it has to be pointed out that the quality of the data discussed below is probably not the same as for other SEENACs.



the former multiethnic country and of military hostilities, the politicians in Belgrade first tried to treat many piled-up problems in quite a simple way – by confiscating savers' foreign currency accounts and by accelerating the printing press. In 1993 and at the beginning of 1994 the country experienced one of the most severe cases of hyperinflation in world history: The monthly rate peaked at 313 million percent.<sup>1)</sup> (This corresponds to an average price rise of over 60% per day.)

With the situation so obviously unsustainable, the authorities in 1994 decided on emergency measures; they implemented a currency reform and drastically cut budget deficits. They succeeded in breaking the hyperinflation. The impressive currency reform which stabilized the Yugoslav dinar at least for some time was masterminded and overseen by the former president of the Yugoslav central bank, Dragoslav Avramovi. Further, the long, massive contraction of the economy (in 1993 GDP had descended to about 40% of the 1989 level) was halted, and a modest recovery was initiated in 1994. But the shock and the loss of confidence of the population in the economic policies of the government were not compensated. Another burden that the country had to bear is the integration of at least 200,000 Serb refugees from Croatia and Bosnia after the end of the Bosnian war.

Despite the suspension of economic sanctions after the signing of the Dayton Treaty, the “outer wall” of sanctions is still standing, which means that the country is not entitled to join the IMF or the World Bank. The U.S. government has mentioned at least three conditions for accession: collaboration with the international tribunal for war criminals in The Hague, progress in negotiations with foreign creditors on servicing former Yugoslavia's debt and an improvement of the human rights situation in Kosovo.<sup>2)</sup> Against the backdrop of the latest war in Yugoslavia and the atrocities committed by Serb forces in Kosovo, these conditions unfortunately appear to be further away from being fulfilled than ever. In any case, a fall of the “outer wall” is out of question today (status: June 25, 1999). This implies that access to international financial markets and the drawing of foreign capital remains extremely difficult.

Although economic recovery has continued since 1994 (until the launching of NATO air strikes in March 1999), growth proceeded from a very low base level and weakened in 1998. GDP is estimated to have increased by an annual average of 5% to 6% in the 1994 to 1997 period and by 2% to 3% in 1998. The level of economic activity reached in 1998 was only half that of 1989. The economic expansion seems to have been driven by a revival of domestic demand, stimulated by high government consumption, wage increases and persisting soft budget constraints for state enterprises. These developments were accommodated by fiscal and monetary policy relaxation. Thus, the consolidated budget deficit is estimated to have expanded to about 10% of GDP in 1998. The annual inflation rate (December to December) increased tenfold to 120% in 1995, fell to 19% in 1997 – mostly thanks to a tightening of price controls – and then rose to 44% in 1998. Despite

1 See Fischer *Weltalmanach '95* (1994) p. 348.

2 See Reuters News Service of December 14, 1998.

the recovery, unemployment has remained stubbornly high – around 25% – for years.

It is understandable that the large pent-up demand triggered a strong rise of imports after the lifting of the three-and-a-half-year economic blockade at the end of 1995; this increased import demand was largely of a consumptive nature, though. There was hardly any investment in the restoration of export capacities. Capital formation has remained totally insufficient. Trade and balance-of-payments deficits quickly expanded to high levels. Whereas the trade deficit of the FR of Yugoslavia was at USD 400 million in 1994, it increased to USD 2.1 billion in 1996 and came to USD 2.0 billion in 1998 (about 13% of GDP). This rise occurred despite the devaluation of the Yugoslav dinar from YUD 1/DEM in 1994 to YUD 3.3/DEM in 1997 and YUD 6.0/DEM since March 1998, which largely neutralized inflationary differentials with the main trading partners.<sup>1)</sup> The shortfalls appear to have been “financed” by services (in transit and transportation), private transfers and remittances, short-term credits, foreign investment (if of any importance), barter deals,<sup>2)</sup> the drawing down of foreign exchange reserves and the accumulation of payment arrears. In February 1999 foreign exchange reserves were estimated to amount to USD 260 million to USD 270 million, which corresponds to about three weeks of imports. Foreign debt has risen from around USD 9 billion at end-1996 to USD 11.5 billion at end-1998, coming to about three quarters of GDP.

The sale of the telecommunications monopolist Telekom Srbija to Italian (STET) and Greek (OTE) investors in 1997 brought revenues of DEM 1.57 billion. This constitutes the largest foreign investment on the territory of Serbia and Montenegro since the collapse of former Yugoslavia. The capital acquired was mostly used to clear wage and pension arrears and partly to finance the current account deficit. Neither the enterprise nor the bank sector are embedded in a market-oriented environment. The government has not yet embarked on any serious structural reforms. This gap has favored the steady expansion of pervasive corruption and black market activities. The privatization of the big state and socially-owned firms that still dominate the economy has not yet seriously started and is mostly expected to go forward through MEBOs (management and employee buyouts). On a case-by-case basis, foreign investments are also expected to play a role, if the conditions allow. The dominance of MEBOs implies that loss-making enterprises may lack urgently needed investment funds and know-how.

The Yugoslav banking system is still under strong government influence and in a sorry state. Practically all big commercial banks are insolvent and appear unwilling to give up the practice of extending credits to doubtful debtors.<sup>3)</sup> In December 1998 a law was adopted stipulating that Yugoslav savers be compensated for their confiscated foreign exchange deposits

1 *The black market exchange rate of the Deutsche mark reached YUD 9.0 to YUD 9.3 at the end of February 1999 and declined to about YUD 12 in mid-June 1999.*

2 *These are reported to cover payments for oil and gas imports from Russia, China and, possibly, from some other countries. See Gligorov (1999) p. 81.*

3 *See Pitič (1998) p. 8.*

amounting to several billion Deutsche marks. The compensation should take the form of state hard currency obligations. It is not at all clear, however, where the necessary foreign currency should come from.

In this muddled situation the political leadership of the country continued to stir up the Kosovo crisis and provoked new sanctions of the EU and the international community in 1997 and 1998, including a ban on foreign investments in Serbia imposed in mid-1998 (this ban has of course rendered any enterprise or bank purchases along the line of the Serbian telecom deal impossible, at least for EU firms). The surprising and controversial nationalization without compensation of the foreign (U.S.)-owned company ICN pharmaceuticals in February 1999 further worsened the general climate for FDI. The permanent confrontation policies of the Yugoslav regime have alienated the reform-oriented government of the Republic of Montenegro that was elected in October 1997. This government has been trying to emancipate itself from the (economic) policies of the federal authorities in Belgrade. In particular, Montenegro has ceased to apply the restrictive tax and trade policies of the federal state, and in March 1999 Montenegrin authorities "assumed" the administration of the federal customs bodies on the territory of the Republic. The Serb side has tried to punish these attempts at achieving some degree of autonomy or independence by imposing intermittent trade blockades between the two Republics and by other measures.

The eleven weeks of NATO air strikes from March to June 1999 wrought a massive destruction of infrastructure and enterprises (mostly industrial and energy-producing firms and facilities), considerable human casualties and damage to the environment in the FR of Yugoslavia. By the beginning of June, around 10,000 Yugoslav soldiers and 6,500 Serb and Montenegrin civilians are estimated to have been killed or wounded, 45 road and railroad bridges and 60% of fuel supplies destroyed.<sup>1)</sup> The brutal ethnic cleansing measures of Serb forces are thought to have pushed at least half of the population out of Kosovo, to have internally displaced a large part of the remaining population and to have resulted in tens of thousands of deaths. According to estimates, as of June 14, about 60,000 refugees had come to Serbia (about 0.6% of the Republic's population) and 74,100 to Montenegro (about 12% of the population).<sup>2)</sup> In relation to the number of its inhabitants, Montenegro is therefore one of the most affected regions harboring refugees. This is bound to entail large adverse budgetary effects. Montenegro is in a particularly unfortunate situation, since despite its government's attempts to gain more independence, it is a constituent Republic of Yugoslavia. As such, it has been a target region for NATO bombing and has received only limited international humanitarian assistance. At the end of April 1999, the EU and NATO decided to impose an oil embargo on Serbia and Montenegro.

Destroyed transport routes and the interruption of navigation on the Danube trigger high losses of revenue from transit trade and transportation,

1 See *Süddeutsche Zeitung* of June 5/6, 1999.

2 According to UNHCR information (<http://www.seerecon.org/>).

**Federal Republic of Yugoslavia – Selected Economic Indicators**

	1992	1993	1994	1995	1996	1997	1998
GDP growth in real terms percentage change against preceding year	– 27.9	–30.8	2.7	6.0	5.9	7.5	2.6
CPI in percent; December to December annual average	x 8,926.0	x 220 trillion	x 79 billion	120.0 71.8	59.9 90.5	10.3 23.2	44.3 30.4
Budget balance <sup>1)</sup> percentage of GDP	x	x	x	– 3.0	– 10.0	– 5.0	– 10.0
Unemployment rate <sup>2)</sup> in percent; year end	x	x	23.9	24.7	26.1	25.6	27.2
Current account balance percentage of GDP	x	x	– 3.0	– 6.0	– 8.0	– 12.0	– 8.0
Foreign debt USD million; year end percentage of GDP	x x	x x	x x	9,000.0 57.0	9,000.0 55.0	10,500.0 66.0	11,500.0 73.0
IMF relations	Membership status: not yet negotiated; deadline for fulfillment of requirements for membership (in consecutive six-month intervals so far) extended to June 1999 Quota: SDR 335.4 million (in theory) Portion of Former Yugoslavia's membership: 36.52%; as of June 25, 1999.						
Currency and exchange rate regime	Yugoslavian dinar pegged to DEM/EUR						

Sources: WIIW, UN/ECE, national statistics.

Data for 1998 preliminary.

<sup>1)</sup> Consolidated government.

<sup>2)</sup> Share of unemployed in the labor force.

not to speak of the adverse effects of the contraction of direct trade with Yugoslavia's neighbors. Transit trade losses hit Serbia particularly. The oil embargo has seriously affected road traffic and industrial activity. The air strikes triggered a total collapse of whatever foreign (or even domestic) investment may have been contemplated despite the ban of 1998. The declaration of the state of war in Yugoslavia brought a further tightening of price controls, stepped-up rationing and, at least over time, is bound to accelerate the printing press. Until the end of May 1999 the FR of Yugoslavia is reported to have issued YUD 500 million of federal "war bonds" (according to the official exchange rate, this corresponds to about DEM 80 million; according to the black market rate it comes to DEM 40 million). The jobless rate is thought to have doubled as a result of the war destructions (from about 25% to 50%).<sup>1)</sup>

On the other hand, the traditionally strong shadow economy and smuggling activities have expanded and have contributed somewhat to cushioning the detrimental effects of the war. Thanks to continuing generous government subsidies to agriculture, no substantial supply bottlenecks for basic food products are reported to have surfaced so far. The WIIW study assesses the total GDP losses inflicted by the war on Serbia and Montenegro in 1999

1) The Serbian government is reported to have launched an emergency assistance plan for 50,000 workers from the nine biggest factories in Serbia that were destroyed, offering them jobs in agricultural projects and SMEs. See BBC Monitoring Service of May 21, 1999, and Global Information Network of May 21, 1999.

at about 25%<sup>1</sup>). There are estimates that Serbia has been “bombed back” to the level of economic development and standard of living of 1945.<sup>2</sup>) And the steep downward spiral of the economy may be difficult to slow down quickly. The substantial brain drain that has affected Belgrade elites throughout the 1990s has also entailed serious costs. Short of a decisive change at the top of the government, there appears to be no hope for recovery, neither politically nor economically, for Yugoslavia.

### 3.4 The FYR of Macedonia

The Former Yugoslav Republic of Macedonia (FYR of Macedonia), which so far has been spared major political and economic calamities, nevertheless seems to be a victim of a particularly unpleasant geopolitical setting. The comprehensive UN economic sanctions imposed on Serbia and Montenegro from 1992 to 1995 cut the FYR of Macedonia off from traditional markets and vital transit routes to and from Western Europe. This impediment to economic activity was, however, partially offset by the key position the country occupied with respect to profitable smuggling and indirect trade with Yugoslavia. The dispute with Greece regarding state names and symbols and the closing of the Greek border for trade with the FYR of Macedonia in February 1994 hit the country directly. The lifting of the Greek trade embargo in October 1995 and the suspension of international sanctions against the FR of Yugoslavia in November of the same year ended the FYR of Macedonia’s economic isolation. Unfortunately, the country was only to enjoy a short respite of relative external stability.

In the second half of 1996 the Bulgarian economy collapsed, and in the first half of 1997 the political and economic chaos in Albania had an impact on the FYR of Macedonia. As a result of the temporary collapse of the Albanian state, about 100,000 Albanian refugees and immigrants are estimated to have come to the FYR of Macedonia, and the breakdown of Albanian savings pyramids is reported to have partly affected Macedonian savings as well. These incidents and the collapse of domestic pyramids, which contributed to the closure of the largest savings bank of the country, are thought to have cost Macedonian savers about USD 100 million. The aggravation of tensions in Kosovo that started in the spring of 1998 brought a new wave of Albanian refugees into the country. This continuing influx has strained ethnic relations in the FYR of Macedonia.<sup>3</sup>)

In spite of the adverse conditions, the successive governments of the country have prudently managed to keep the domestic political situation stable. In 1994 the country adopted and implemented a macroeconomic stabilization and austerity program which established a fixed exchange rate of the domestic currency, the denar, to the Deutsche mark (MKD 27.2/DEM) and

1 In a newer estimate, Vladimir Gligorov even puts GDP losses of the FR of Yugoslavia at about 50%. Given that economic activity in 1998 stood at around half the level of 1989 according to estimates, this would imply a drop to a quarter of the pretransition level in 1999, a record comparable only to the “achievement” of Bosnia in 1995. See *Neue Zürcher Zeitung* of June 12/13, 1999.

2 See *Handelsblatt* of April 29, 1999.

3 See Gruber (1998) p. 452.

was supported by a stand-by arrangement with the IMF. After 1995 this program reduced inflation to one of the lowest levels of all transition economies. In 1996 and 1997 the authorities achieved very low budget deficits, albeit by partly sequestering expenditures. After a long period of contraction, 1996 was the first year of economic recovery, although growth was modest (+0.8%).

The turnaround in 1996 can mainly be explained by the end of the two economic blockades and the increased inflow of foreign financial assistance. The latter mostly contributed to financing public infrastructure investments. In April 1997 the FYR of Macedonia agreed on an Extended Structural Adjustment Facility (ESAF) program with the IMF, earmarking SDR 55 million to support policies for a three-year period. Like in other countries of the region, the revival of foreign trade since 1996 has been characterized by catching-up effects and an unusually large expansion of imports, with resulting trade deficits being covered partly by financial assistance and loans, partly by private transfers and remittances from about a quarter of a million guest workers and relatives abroad. The current account deficit grew to 7.3% of GDP in 1996.

In order to reduce the external disequilibrium, the denar was devalued by 14% against the Deutsche mark in July 1997 (from MKD 27.2 to MKD 31.6/DEM). Although the strict monetary and budget policies have held inflationary repercussions of this measure within narrow bounds, GDP growth is estimated to have increased from 1.5% in 1997 to 3.0% in 1998. The authorities have not managed to reduce the trade and current account imbalances. On the contrary: According to preliminary data, the trade balance hardly budged and the current account deficit rose from 8.3% of GDP in 1997 to 9.2% in 1998. External debt is estimated to have expanded from USD 1.1 billion or 28% of GDP at end-1996 to USD 1.3 billion or over 40% of GDP at end-1998.

The persistence of the external disequilibrium is probably also due to the lack of a breakthrough in structural reform efforts. Until mid-1998 about 80% of all firms identified for privatization, mostly SMEs, were privatized. Like in other SEENACs, management and employee buyouts of mostly socially-owned enterprises have prevailed in the FYR of Macedonia, too, implying the likelihood of sluggish modernization and lagging competitiveness. Many enterprises owned by "insiders" have been reluctant toward possible participation by foreigners, since these insiders have feared a dilution of their powers. Apart from this, the difficult geopolitical situation of the country has contributed to the fact that FDI in the FYR of Macedonia has remained modest so far. But in 1998 there were some signs of an upswing of foreign investment activity due to government attempts to restructure and sell some larger companies to "strategic" outside investors.

The sale of a majority stake (55%) of the largest commercial bank of the country, Stopanska Banka, to the EBRD, the International Finance Corporation and another foreign investor has been delayed because the original third foreign partner, Erste Bank from Austria, has withdrawn. Overall, the banking sector still suffers from considerable weaknesses with respect to corporate governance and is continuing to struggle with the legacy of the loss of

confidence triggered by the pyramid affairs. A new Banking Act, effective from April 1998, provides for stricter limits on connected lending and enhances the supervisory powers of the central bank. Overall, the sector appears overbanked, with a large number of small banks, and consolidation is expected to gain ground in 1999.<sup>1)</sup> Only successful structural reforms would allow the FYR of Macedonia to decisively tackle its unemployment, which for years has been very high, even compared to other transition economies. According to the results of a labor market survey along the lines of ILO methodology, which was published in November 1998, the jobless rate in the FYR of Macedonia amounted to 34.5%.

The Kosovo conflict looks likely to interrupt the FYR of Macedonia's recovery and to inflict heavy costs on its economy. The country has been affected on a number of fronts. On June 14, 1999, the FYR of Macedonia was estimated to have harbored 243,700 refugees from Kosovo,<sup>2)</sup> almost all of them ethnic Albanians. They come to around 12% to 13% of the population of the country, and many Macedonians fear that the continued presence of the refugees will tilt the delicate demographic balance between the Slavo-Macedonian majority and the Albanian minority further in favor of the latter. About two thirds of the ethnic Albanian refugees are thought to have subsequently moved to relatives or families of the Albanian minority in the country. On top of the persistent high joblessness, which is estimated to have risen to about 40% in May 1999, this has contributed to exacerbating the already tense interethnic relations and has destabilized the ruling coalition government, although the latter has so far remained intact. Without international assistance, the cost of refugee care would overwhelm the budget.

Contrary to the situation in Albania, the presence of Western armed forces and of humanitarian organizations does not appear to have had a comparable stabilizing effect on the political situation. The country has had to bear high direct as well as indirect trade losses. Apart from the Republika Srpska of Bosnia and Herzegovina, the FYR of Macedonia is the only direct neighbor of the FR of Yugoslavia for which the latter has remained an important trading partner. Direct and transit trade through the FR of Yugoslavia represented roughly 70% of Macedonian exports in 1998. Rising political instability may deter or delay much-needed FDI and dilute the incentive to step up structural reforms (the Kosovo conflict might even serve as a pretext for softening the stance on macroeconomic stability). The WIIW study estimates the total costs for the FYR of Macedonia in terms of economic growth in 1999 at about 5% of GDP. The IMF report is more pessimistic and gauges the loss at 8% to 9% of GDP. Should this materialize, it would push the country into a – possibly strong – recession.<sup>3)</sup> The first of the donor conferences organized by the World Bank and the European Commission to

1 See EBRD (1999) p. 37.

2 According to UNHCR information (<http://www.seerecon.org/>).

3 The type of external shock the Macedonian economy is going through now is, of course, not entirely new, although it appears to be the heaviest since the country has become independent. Official trade with and transit trade through the FR of Yugoslavia were blocked during the UN economic sanctions from 1992 to 1995. Therefore, the FYR of Macedonia has already gathered some experience (and skill) in coping with this kind of impediment.

support the neighboring countries of Serbia and Montenegro affected by the Kosovo conflict was dedicated to the FYR of Macedonia and took place on May 5, 1999. Pledges for humanitarian and financial assistance totaling USD 250 million were made,<sup>1)</sup> and the country was promised further aid if necessary. After the end of armed conflict on June 10, refugees began to return to Kosovo swiftly. By June 25, more than half of all Kosovo refugees that had come to the FYR of Macedonia were estimated to have returned home. This unexpectedly quick return will not only ease budgetary pressures, but may also contribute to stabilizing the political situation.

### FYR of Macedonia - Selected Economic Indicators

	1992	1993	1994	1995	1996	1997	1998
GDP growth in real terms <i>percentage change against preceding year</i>	- 21.1	- 9.1	- 1.8	- 1.2	0.8	1.5	3.0
CPI <i>in percent; December to December</i>	1,935.0	242.0	55.0	9.0	- 0.6	2.6	- 2.4
Budget balance <sup>1)</sup> <i>percentage of GDP</i>	- 9.6	- 13.8	- 2.9	- 1.2	- 0.5	- 0.4	- 1.7
Unemployment rate <sup>2)</sup> <i>in percent; annual average</i>	27.8	28.3	31.4	37.7	31.9	36.0	34.5
Current account balance <sup>3)</sup> <i>USD million</i>	- 19.0	15.0	-180.0	- 230.0	- 288.0	- 275.0	- 285.0
<i>percentage of GDP</i>	x	0.6	- 5.7	- 5.7	- 7.3	- 8.3	- 9.2
Foreign debt <i>USD million; year end</i>	758.0	818.0	844.0	1,060.3	1,121.8	1,140.9	1,300.0
<i>percentage of GDP</i>	x	32.6	26.8	26.3	28.4	34.3	42.0
Foreign exchange reserves <sup>4)</sup> <i>USD million; year end</i>	x	105.0	149.0	257.0	249.0	254.0	320.0
IMF relations	Membership status: joined December 14, 1992 Quota: SDR 49.6 million Portion of Former Yugoslavia's membership: 5.40% Systemic Transformation Facility: SDR 24.8 million Stand-by Arrangement: SDR 22.3 million (May 5, 1995 to June 4, 1996) Extended Structural Adjustment Facility: SDR 54.56 million (April 11, 1997 to April 10, 2000); as of June 5, 1998.						
Currency; convertibility; exchange rate regime	Macedonian denar introduced April 27, 1992; internal convertibility; managed float; de facto DEM/EUR orientation						

Sources: EBRD, IMF, WIW, UN/ECE.

Data for 1998 preliminary.

<sup>1)</sup> General government (central and local government, extra-budgetary funds).

<sup>2)</sup> Share of unemployed in the labor force.

<sup>3)</sup> Excluding official transfers.

<sup>4)</sup> Currency reserves of monetary authorities without gold.

1 This assistance comprises i.a. a World Bank IDA credit of USD 50 million, a stand-by loan of USD 33 million that the IMF expected to grant shortly and budgetary support of EUR 25 million from the EU.



### 3.5 Albania

Albania has traditionally been the least developed and poorest country of the Balkans. For several decades its own national-communist regime (under former party chief Enver Hoxha) chose a path of “subsistence socialism” and near-autarky, holding the country in comprehensive isolation from the outside world. Despite foreign assistance, infrastructures have remained in a largely primitive state, and modern government and public institutions are still in the process of emerging. Given this background, the sheer range of required transition implies a very high level of insecurity and fragility in the political and social domains. Therefore, the country appears to be particularly susceptible to internal and external disruptions and upheavals.

In the first years after the collapse of socialism, some impressive macro-economic stabilization success was achieved with the assistance of the IMF and foreign financial aid. The annual inflation rate was reduced from 237% in 1992 to 6% in 1995, the general government deficit was cut from 20% of GDP to (albeit still high) 10% in the same years. Progress was also made in privatizing retail trade and parts of the large agricultural sector (the latter still constitutes about half of GDP). But these achievements were attained in an economy that was otherwise dominated by the state and devoid of any meaningful structural adjustment.

The substantial fall of the population’s standard of living after the collapse of the centrally-planned economy and high unemployment contributed to making the people receptive to enticements to invest their money in financial savings pyramids. With this form of “investment,” funds or banks promise high returns to their customers. Interest and principal are paid out of newly attracted money. Such a construction can be sustained only as long as the banks or funds succeed in drawing new savings capital (snowball principle). Once the inflow evaporates, the construction collapses. Savings pyramids existed (and still exist) in other reform countries, too; they take advantage of some people’s ignorance and of the understandable wish many people harbor to “get rich quick.” In Albania the activities of the savings pyramids were supported by the government, which, in view of the elections of 1996, relaxed budgetary and monetary policies.

The popularity of the pyramids reached its apex – one could even say: manic proportions – toward the end of 1996, and many people not only invested their entire savings, but sold their houses and other personal assets in order to put the proceeds into pyramids. It is estimated that about 75% of the entire population participated in the savings schemes and invested over USD 1 billion (or about 40% of the annual gross domestic product).<sup>1</sup> A fair share of this money also came from remittances of Albanian guest workers in Italy and other countries. The acute potential for instability brought about by the extreme concentration of funds in the pyramids meant that it was only a question of time for a spiral of deterioration to set in. In December 1996 the first pyramid collapsed; in January 1997 others followed.

In the eyes of large parts of the population, the government was responsible for the collapses, since it had promoted the pyramid schemes and some

1 See *Neue Zürcher Zeitung* of August 2/3, 1997.

of the pyramids could be linked to election campaign financing. The financial constructions are also said to have served to launder the proceeds of smuggling arms, drugs and people. Initial protests quickly grew into social unrest and riots, triggering the collapse of civil order. Rebellious groups in March 1997 brought large parts of the south of the country under their control. About 2,000 people were killed during the troubles; around 500,000 firearms were stolen from police and army barracks, many of which continue to circulate. The damage inflicted by the looting and ravaging is thought to have amounted to about USD 1 billion.

Only after the intervention of international security forces could new elections to the country's legislature be organized in June 1997 and the unrest be brought under control. The polls resulted in the victory of the opposition coalition, which formed a new government in July 1997. After a reform program had been presented, an international donor conference in October 1997 pledged a financial assistance package of USD 600 million, mostly earmarked for projects to develop the country over a period of three years. The unrest and destruction of spring 1997 had led to temporary or permanent stoppages of production, and the loss of savings reduced aggregate demand. Following the steep decline of output during the crisis, economic activity (especially construction and trade) picked up markedly in the second half of 1997. The reported contraction of economic activity amounted to 7% for the full year. The considerable depreciation of the Albanian currency, the lek, as well as the shock-like supply bottlenecks triggered by the crisis pushed the annual inflation rate (December to December) to 42% in 1997. The general government deficit rose to 13% of GDP. Albanian citizens are estimated to have lost more than 95% of their investments in the pyramids;<sup>1</sup>) several hundreds of millions of dollars are believed to have been moved out of the country. Joblessness is reported to have increased from about 12% in 1996 to 15% in 1997.

The normalization of the situation that started in the second half of 1997 went on in the first months of 1998. The economic expansion gained ground, inflation was brought under control, the exchange rate stabilized and fiscal policies were tightened again. The quicker-than-expected rebound of inflows of workers' remittances (from USD 235 million in 1997 to USD 453 million in 1998) reduced the external disequilibrium, which had mounted in recent years. The current account deficit declined from 12% of GDP in 1997 to 6% in 1998. Foreign liabilities at the end of 1998 amounted to USD 870 million or about 30% of GDP. The financial pyramid companies were closed and have been or are being liquidated. First steps were taken to reform and develop the rudimentary and weak banking system. A new banking law was drafted to enhance prudential regulation and the supervisory capabilities of the central bank and to forestall the recurrence of any pyramid schemes. The sector has been dominated by three state banks that are plagued by very high proportions of doubtful or nonperforming loans. One of these banks was put into liquidation in January 1998, the other two are being restructured, and the authorities hope to privatize them soon.

1 See EBRD (1998) p. 149.

In May 1998 the country concluded a three-year ESAF agreement with the IMF, providing for a credit of SDR 35 million. The aggravation of the Kosovo crisis and renewed bouts of strife triggered by the assassination of a prominent opposition politician in September 1998 destabilized the situation anew. Although it was possible to put down the uprisings in about two weeks, the situation remained unstable. Moreover, the continued weakness of the state has given ample room to corruption and organized crime.<sup>1)</sup> Despite the temporary unrest, real economic growth in 1998 (after the setback in 1997) increased by about 8%. Inflation on a twelve-month basis had fallen to 9% by the end of 1998 and to -0.1% by May 1999. The budget shortfall is reported to have diminished to 10.4% of GDP in 1998. The gap continues to be filled with foreign aid, loans and other kinds of assistance.<sup>2)</sup> Privatization initiatives are slowly moving forward. Out of approximately 470 state-owned SMEs identified in mid-1998, about 300 had been sold or closed by March 1999.<sup>3)</sup> The privatization of utilities is being launched.

Economic growth in 1999 is threatened by the war in Yugoslavia. The massive tide of refugees has no doubt had very serious consequences for Albania. As of June 14, 1999, Albania was reported to have received 406,000 refugees, which corresponds to about 13% to 14% of the country's population. Albania has thus been saddled with more refugees than any other neighboring country in absolute and relative terms.<sup>4)</sup> Without substantial humanitarian and financial assistance, the Albanian budget and economy could never cope with the effects of the influx. The huge number of refugees could have a considerable destabilizing political effect, which in the worst case might send the country spinning off into chaos. But the presence of foreign military contingents and thousands of representatives of humanitarian organizations on Albanian soil appears to have made some contribution to calming the political situation and upholding the public order. NATO forces are reported to have helped upgrade Tirana airport and the main port of Durrës. Furthermore, the foreigners have brought a strong injection of cash, which has propped up demand. As of the beginning of June, about two thirds of all refugees were no longer in camps but living with the resident population.

The initial reaction of Albanian budgetary policy to the Kosovo conflict was a tightening up, especially across-the-board expenditure cuts. After the promises of foreign assistance, policy was relaxed again in mid-May, which included the granting of a 10% salary increase to state officials. But budgetary investment was postponed and endemic corruption continued to keep customs proceeds, a major part of revenues, smaller than they should be. Still, the January to May budget deficit was reported to be slightly lower than the shortfall of the first five months of 1998.<sup>5)</sup> The Kosovo conflict has certainly increased investment risks in Albania and has tended to raise costs for taking up capital on international financial markets. But here, too, underlying fears

1 See *Euro-East* of December 22, 1998.

2 See *Gligorov and Sundström* (1999) p. 7.

3 See *EBRD* (1999) p. 32.

4 According to UNHCR information (<http://www.seerecon.org/>).

5 See *Reuters News Service* of June 11, 1999.

may have been somewhat alleviated by the Western and international presence. Albania's external position is expected to deteriorate in 1999. The WIIW study assesses the overall impact of the Kosovo conflict on the growth of the Albanian economy at about 2% of GDP, which could reduce the forecast expansion in 1999 to about 2% to 3% or less. The IMF study argues that the net effect on GDP will not be large, due to the minor importance of trade losses and the large degree to which refugee costs seem to be covered by humanitarian organizations in the country.<sup>1)</sup> A donor conference for Albania, organized by the World Bank and the European Commission, took place on May 27, 1999, and brought pledges of humanitarian and financial assistance of USD 200 million.<sup>2)</sup> After the end of the armed conflict, refugees started to return to Kosovo quickly. By June 25, almost half of all Kosovo refugees were estimated to have returned to their home province. This quick return has considerably eased the strain on Albania's economy.

### Albania – Selected Economic Indicators

	1992	1993	1994	1995	1996	1997	1998
GDP growth in real terms <i>percentage change against preceding year</i>	- 7.2	9.6	9.4	8.9	9.1	- 7.2	8.0
CPI <i>in percent; December to December</i>	237.0	30.9	15.8	6.0	17.4	42.1	8.7
Budget balance <sup>1)</sup> <i>percentage of GDP</i>	- 20.3	- 14.4	- 12.4	- 10.3	- 11.7	- 12.6	- 10.4
Unemployment rate <sup>2)</sup> <i>in percent; year end</i>	27.9	29.0	19.6	16.9	12.4	15.0	17.6
Current account balance <sup>3)</sup> <i>USD million</i>	-434.0	-365.0	- 279.0	-176.0	-245.0	-276.0	-187.0
<i>percentage of GDP</i>	- 61.1	- 29.4	- 14.1	- 7.3	- 9.1	- 12.2	- 6.1
Foreign debt <i>USD million; year end</i>	811.0	936.0	1,012.0	683.0	732.0	757.0	874.0
<i>percentage of GDP</i>	114.2	75.4	51.0	28.6	28.6	33.5	28.5
Foreign exchange reserves <sup>4)</sup> <i>USD million; year end</i>	72.0	147.0	204.0	240.0	275.0	306.0	384.0
IMF relations	Membership status: joined October 15, 1991 Quota: SDR 75.3 million Stand-by Arrangement: SDR 20.0 million (August 26, 1992 - July 14, 1993) Extended Structural Adjustment Facility (ESAF): SDR 42.4 (July 14, 1993 to July 13, 1996; disbursements discontinued in 1995) Post-conflict emergency assistance: SDR 8.8 million (November 1997) ESAF: SDR 35.3 million (May 13, 1998 to May 12, 2001); as of May 28, 1999.						
Currency; convertibility; exchange rate regime	Lek; full current account convertibility; managed float						
Sources: EBRD, IMF, WIIW, UNICEE. Data for 1998 preliminary. <sup>1)</sup> General government (central and local government, extra-budgetary funds). <sup>2)</sup> Share of unemployed in the labor force. <sup>3)</sup> Excluding official transfers. <sup>4)</sup> Currency reserves of monetary authorities without gold.							

1 See International Monetary Fund (1999) p. 12.

2 This assistance consists i.a. of an amount of USD 68 million provided by the EU and of a World Bank credit of USD 30 million. A great deal of the assistance pledged is made up of grants.

#### **4 An Economic View of the Kosovo Conflict**

##### **4.1 The Economic Consequences of the War in Yugoslavia**

The Kosovo conflict has various repercussions on the countries of the region (the following statements refer not only to the SEENACs):

- *Direct budgetary and demand effects* were triggered by the massive streams of refugees.
- *A massive destruction of capital stock* occurred in the FR of Yugoslavia and caused environmental damage.
- *Trade and current account effects* were caused by the contraction of trade with the FR of Yugoslavia and particularly by the blockage of transit trade through this country and the concurrent increase of transportation costs; also, tourism declined.
- *Investment and the capital account* were affected by the reduction or delay of foreign (direct or portfolio) and domestic investment, and increasing financing costs on international capital markets reflected greater investment risks.
- *Political and economic policy effects* comprised the increase of political instability, the possible deterioration of governance as well as the possible slowing down or postponement of structural reforms (given a decline in FDI) and loosening of macroeconomic stabilization measures.

The consequences differ from country to country:

- The refugee influx has mostly touched Albania, the FYR of Macedonia, the Yugoslav constituent Republic of Montenegro and, to a lesser degree, Bosnia and Herzegovina.
- The destruction of capital stock has devastated the FR of Yugoslavia, and the environmental consequences for the entire region cannot be fully assessed yet.
- The major victims of the contraction of trade with the FR of Yugoslavia are the FYR of Macedonia and the Srpska Republika in Bosnia and Herzegovina. Losses from the collapse of the much larger transit trade through the FR of Yugoslavia have to be sustained by the FYR of Macedonia, Bulgaria and, to a lesser degree, Bosnia and Herzegovina and Romania.<sup>1)</sup> Croatia's, Slovenia's, Greece's, Turkey's and Ukraine's losses from transit trade are relatively small. Croatia will have to put up with a considerable fall of revenues from tourism. Bulgaria, Romania, and to a limited degree, Hungary, Slovenia and Greece will also suffer losses in this respect.
- The whole region may be hit by delays in structural reforms (e.g. regarding privatizations with participation of foreigners) and by incentives to weaken stabilization policies (e.g. to monetize unexpectedly high budgetary shortfalls). The decline of foreign and domestic investment and more expensive credits on financial markets will affect all countries of the region.

<sup>1</sup> Romania's losses are, however, partly offset by increased revenue from rerouted transit deliveries from Bulgaria, Greece, Turkey and other countries.

- The FYR of Macedonia, Albania, and Bosnia and Herzegovina are the main candidates among the neighbors of the FR of Yugoslavia for an increase in political instability. The massive tide of ethnic Albanian refugees and high unemployment could further fuel ethnic tensions in the FYR of Macedonia. Albania has to cope with the largest influx of refugees, and the weak Albanian state appears to be overwhelmed. But the strong presence of humanitarian organizations and Western troops has had a stabilizing influence. Bosnia and Herzegovina is potentially massively threatened by confrontation between its ethnic groups and entities. But so far the situation has remained under control. A major political upheaval in the FR of Yugoslavia cannot be ruled out.

Taking into consideration ex ante vulnerability, apart from the FR of Yugoslavia itself, the FYR of Macedonia, Albania and Bosnia and Herzegovina seem to be most exposed to the effects of the Kosovo conflict. In this connection, the FYR of Macedonia appears to have been affected on particularly many fronts.

#### 4.2 The Estimated Costs of the Conflict and External Financial Needs

Although measuring the economic costs of the conflict is difficult due to poor and insufficient data, the IMF, the European Commission and the WIIW have undertaken indicative estimates. In its study published in mid-April 1999,<sup>1)</sup> the WIIW estimated the probable GDP losses in the FR of Yugoslavia at 25%, at 5% in both Bosnia and Herzegovina and the FYR of Macedonia, at 2% in Bulgaria and Albania and at 1% in Croatia. The Commission's study (published on April 28)<sup>2)</sup> calculated total humanitarian costs (mostly for taking care of the refugees, including budgetary costs) at USD 340 million to USD 780 million, the (updated) IMF study (published on May 25)<sup>3)</sup> estimated respective costs of USD 400 million to USD 760 million. The IMF study gauged balance-of-payments losses (balance-of-payments gaps, excluding budgetary costs) for all Southeast European neighboring countries at USD 900 million to USD 1,460 million. The Commission's study estimated the costs of reconstruction (rehabilitation costs) in Kosovo by taking into account economic traits of the province and drawing a comparison to the financial framework of the international reconstruction program in Bosnia; it calculated an amount of USD 2.0 billion to USD 3.5 billion. The European Commission has tentatively estimated the total costs of reconstruction in the entire region at about USD 30 billion. A study of Deutsche Bank Research arrives at more or less the same results.<sup>4)</sup>

According to the Commission's study, the following range of assistance measures can be outlined:

- *Macrofinancial assistance.* The World Bank and the European Commission have organized international donor conferences under participation of numerous countries and multilateral organizations that have pledged

1 See Gligorov and Sundström (1999) p. 21.

2 See European Commission (1999) p. 5.

3 See International Monetary Fund (1999) p. 6.

4 See Süddeutsche Zeitung of June 11, 1999.

humanitarian and financial assistance. Such a meeting devoted to Bulgaria was held on April 21 and produced pledges of USD 275 million of balance-of-payments assistance. Another meeting, devoted to the FYR of Macedonia, was held on May 5 and brought pledges of USD 250 million. A conference on May 27 resulted in promised assistance of USD 200 million for Albania. While it appears that these pledges are insufficient to cover expected balance-of-payments gaps in the mentioned countries in 1999, further assistance has been promised if required.

- *Debt relief.* The Paris Club has suspended debt service for Albania and the FYR of Macedonia during the period from April 1, 1999, to March 31, 2000.
- *Infrastructure and investment financing.* For entitled countries, this is possible through financial means of the EU's PHARE program. However, given the dimensions of destruction in the FR of Yugoslavia and the impoverished state of this isolated country, a major international reconstruction effort would be urgently needed. The EU will no doubt have to play a prominent role with respect to this issue.
- *Humanitarian assistance and direct budgetary grants.* Apart from substantial aid from humanitarian organizations, the EU has adopted assistance measures for Albania, the FYR of Macedonia and the constituent Yugoslav Republic of Montenegro.
- *Contractual relations.* The EU intends to offer a new type of agreement, "association and stabilization treaties," to SEENACs, including Yugoslavia – if they meet certain political and economic conditions. Negotiations on the conclusion of such agreements with the FYR of Macedonia and Albania are likely to start in 1999. The Union may also concede trade preferences to Albania along the lines of those extended to former Yugoslav republics.

On June 10, a Stability Pact for the Balkans was adopted at an international conference in Cologne with participation of the EU, the U.S.A., Russia, Japan, the UN, NATO, the IMF, the World Bank, the EBRD, the EIB and other countries and organizations. Its aims are to reduce tensions and crises in the region, to promote democracy, good neighborliness and multiethnicity, to create functioning market economies, to combat organized crime and ethnic cleansing. Long-term integration in Euro-Atlantic structures is promised. However, so far no concrete projects and pledges of financial assistance within the framework of the Stability Pact have been decided. This will be left to an international donor conference which has yet to be organized. The Stability Pact seems to duplicate at least some existing structures of international assistance. A practical and political problem of reconstruction in Kosovo and Yugoslavia as a whole is that Kosovo is not a sovereign country and the FR of Yugoslavia does not have contractual relations with the EU, nor is it a member of the IMF, the World Bank or the EBRD; even its UN membership has been suspended, not to speak of various other sanctions attached to the country.

## 5 Conclusions: Some Common Traits of the SEENACs

Drawing from the above analyses and comparisons, some common characteristics of the SEENACs are outlined below. These common characteristics, at the same time, tend to distinguish them from other economies in transition and may contribute to explaining why they have fallen so far behind in the process of European integration.

### 5.1 Political Traits

- *Pronounced minority “links.”* All SEENACs are “linked” to each other by ethnic minorities or groups belonging to a respective neighbor’s titular nation. This implies that sustainable solutions to political problems or crises in one country can often only be found if that country’s relations to its neighboring SEENAC are included in the solution.
- *Exposure to massive external shocks.* All SEENACs have been and continue to be exposed to massive external shocks stemming from regional political or military impacts. The violent collapse of former Yugoslavia in 1991 was followed by a war in Croatia in 1992, the Bosnian war and the economic blockade of Serbia and Montenegro from 1992 to 1995, the Greek blockade of the FYR of Macedonia in 1994/95 and the Kosovo crisis and Yugoslav war of 1998/99. Nowhere else in Europe have economies in transition had to cope with so many adverse shocks.
- *Strong political and partly even military tensions between the countries.* Relations between some neighboring SEENACs are heavily burdened by the legacy of the bloody history of wars and ethnic cleansing accompanying the disintegration of the former multinational Yugoslavia during the 1990s. Suspicion and distrust are not only the background of inter-governmental relations, but are also rooted in the minds of ordinary people.
- *Pronounced political instability.* Given the communist past and the armed conflicts and upheavals that have plagued the region recently, it is little wonder that the political systems of the SEENACs tend to be unstable. In some of the countries, authoritarian rule has not yet been (fully) overcome, and human and minority rights are not sufficiently respected.

### 5.2 Economic Traits

- *Little restructuring so far, large FDI needs.* Although privatization and bank reform have advanced in some countries, enterprise restructuring has still not achieved a decisive breakthrough in any SEENAC. The widespread practice of MEBOs has probably not helped in that respect. Inter-enterprise and credit arrears continue to provide soft budget constraints, while investment, in particular FDI, remain scarce.
- *Persistent external disequilibria.* In recent years all SEENACs have incurred considerable trade and current account deficits, which, given low foreign investment, have pushed up foreign indebtedness. Limited competitiveness due to insufficient restructuring may be one of the main causes of this unsatisfactory state of affairs. While in some of the countries foreign financial assistance helps to cover the disequilibrium, this is not sustainable in the long term.



- *Regional trade disruption.* Given the frequent and deep shocks engulfing the region and the high level of uncertainty and volatility engendered as well as various trade barriers erected between the countries in question, trade has been diverted out of the region.<sup>1)</sup>
- *High investment risks.* These risks, along with the external shocks and political instability as well as the relative isolation of the SEENACs from the EU, may contribute to explaining the low level of domestic investment and FDI. This situation is also reflected in lower ratings by international rating agencies and high spreads for credits taken up on international capital markets.
- *Very high unemployment.* This reflects sluggish growth in most of the economies, coupled with a lack of restructuring.
- *High currency substitution.* The extent of currency substitution remains high even in the economies that have established good records of anti-inflationary policy in recent years. This may reflect lasting memories of hyperinflation and some lingering lack of popular trust in governments' policies.

Given that many of the abovementioned factors seem to be mutually reinforcing, external support may be necessary to break the vicious circle of political instability – isolation from the EU – lack of restructuring and FDI – slow growth. The EU could take the decisive step from the outside by reconsidering its general stance vis-à-vis the SEENACs, providing some enhanced perspective of integration and opening up its markets more to these countries. But integration is, of course, a two-way street, and efforts by the EU would have to be matched/ followed by respective reform measures in the countries concerned. Thus, a first step taken by the EU could be a stimulant for quicker reforms by demonstrating that European integration might not be as far off as these countries may have had the impression.

## **6 Economic Prospects and Relations with the EU**

### **6.1 The “Common Regional Approach” of the European Union**

In April 1997 the EU decided to adopt a “common regional approach” vis-à-vis Albania and the successor states of the former Socialist Federative Republic of Yugoslavia, without Slovenia.<sup>2)</sup> The common regional approach makes it a prerequisite for these countries to meet certain political and economic conditions before an upgrading of their relations with the EU is deemed possible. This refers to contractual and trade relations as well as to EU financial assistance. The conditions include safeguarding the rights of minorities, good relations with neighboring countries and the general development and strengthening of democracy and the market economy.

Albania and the FYR of Macedonia are the only countries that have concluded trade and cooperation treaties with the EU and fully benefit from the PHARE program. The EU does not entertain contractual relations, nor is it negotiating such relations, with Croatia, Bosnia and Herzegovina, or the FR

<sup>1</sup> See Gligorov (1998/99) p. 13.

<sup>2</sup> As mentioned in Chapter 2, Slovenia is comparatively well-developed and is among the EU accession candidates of the “first wave.”

of Yugoslavia. Bosnia and Herzegovina can claim PHARE resources only for projects which directly support the peace process (reconstruction, creation of institutions and infrastructural links between entities, refugee return). Croatia has been suspended from PHARE assistance, while Serbia and Montenegro are considered ineligible.

All former Yugoslav republics, except the FR of Yugoslavia, benefit from autonomous trade preferences of the EU, which have replaced the preferential trade regime the European Community granted the former multinational state. The autonomous trade preferences constitute the exemption from EU customs charges on imports of industrial products originating in the countries in question (some sensitive products, e.g. iron and steel, textiles and apparel, are excluded from the customs exemptions). The EU suspended preferences for Serbia and Montenegro at the end of 1997 in reaction to the mounting human rights abuses in Kosovo. In mid-1998 the EU imposed further sanctions on Belgrade (ban of foreign investments in Serbia, freeze of assets of the Yugoslav and Serbian governments abroad, ban of flights by Yugoslav airline carriers between the FR of Yugoslavia and the EU). After the launching of NATO air strikes, the Union decided at the end of April 1999 to impose an oil embargo on Serbia and Montenegro and to extend the flight ban for Yugoslav carriers to a general ban on flights between EU countries and the FR of Yugoslavia.

## 6.2 EU Relations with the Individual Countries

Croatia is probably the one country that could potentially achieve the greatest progress toward joining the integration tendencies in Europe. However, it would have to overcome a number of obstacles first (i.a. the insufficient freedom of expression, unsatisfactory minority rights, inadequate refugee resettlement policies). The refugee repatriation program passed in June 1998 has apparently averted the possible revocation of autonomous trade preferences in October of the same year. According to the EU Council of Ministers, the conditions for lifting the suspension of PHARE aid have “not yet been fulfilled,” and a resumption of negotiations on a trade and cooperation treaty would “likewise be premature.”<sup>1</sup>) This at least was the state of affairs before the outbreak of the military conflict in the FR of Yugoslavia.

Its fragile institutions, limited sovereignty, strongly decentralized state structure and centrifugal political forces restrain the authority of Bosnia and Herzegovina as a state. Before the NATO air strikes, the stance of the EU was as follows: Until its central government authority is strengthened and the Dayton Accord is fully implemented, including refugee return, the establishment of independent media and the enhancement of conditions of a market economy, Bosnia and Herzegovina does not appear “mature” enough for further rapprochement to the EU. This also refers to its limited claim to PHARE support.

With the tightening of sanctions and, in particular, the air strikes in the spring of 1999, the relationship between the EU and the FR of Yugoslavia has reached its lowest point so far. After the beginning of the hostilities, the

1 See *Uniting Europe* of November 16, 1998, p. 8.

Yugoslav government severed diplomatic relations with the U.S.A., the United Kingdom, France and Germany.<sup>1)</sup> The EU has criticized that the Federal Republic of Yugoslavia, and particularly Serbia, do not practice free elections and do not allow freedom of expression and free media. The continuing violation of Kosovo-Albanians' human rights has culminated in the crimes and atrocities committed in the province during the military hostilities. As to economics, the authorities have shown no credible commitment to market-oriented reforms. However, it also has to be pointed out that the FR of Yugoslavia is the only country of the region that has not expressed a wish to move closer to or integrate with the European Union. It appears that only an overthrow of the current Yugoslav regime would offer any prospect of an improvement of relations.

Since the election of its new government in 1997, the constituent republic of Montenegro has been striving for more autonomy from the central government in Belgrade and has shown itself more open to reforms in politics and the economy. Therefore the EU has attempted to support reform efforts in Montenegro as far as possible. In April 1998 the EU decided to grant the Montenegrin government financial assistance of ECU 3 million to help it cover arrears in welfare payments. In January 1999 Montenegro Airlines was exempted from the flight ban between Yugoslavia and the EU. However, the NATO air strikes have also targeted Montenegro and put EU-Montenegrin relations under a considerable strain.

The Trade and Cooperation Treaty between the EU and the FYR of Macedonia came into force on January 1, 1998. With respect to trade regulations, it provides for the exemption of industrial products of Macedonian origin, save some sensitive goods, from customs tariffs and quotas. Thus, the autonomous trade preferences of the Union are de facto included in the agreement. Otherwise, the treaty quite generally outlines avenues for economic, technical and financial cooperation without specifically committing itself. The FYR of Macedonia has been a beneficiary of the PHARE program since 1996. The EU would like to see further progress in the reform of public administration, better educational possibilities for the Albanian minority, as well as a stronger presence of the minorities in the security forces.<sup>2)</sup> A problem for the rapprochement of the FYR of Macedonia that has not been mentioned by the authorities of the Union may be the highly unstable neighborhood in which the country is embedded.

The Trade and Cooperation Agreement between Albania and the EU was already concluded in 1992. Possibly due to this early date and most likely because of the fact that Albania is not a former Yugoslav republic and therefore has not benefitted from trade preferences, the treaty is more restrictive than the respective agreement with the FYR of Macedonia. It does not include any substantial trade policy concessions on the part of the EU and is limited to general measures of economic, technical and financial cooper-

<sup>1</sup> Speaking strictly in legal terms of economic relations, the situation was even worse at the time of the economic blockade of the UN, under which almost all economic relations of the outside world with the FR of Yugoslavia were banned.

<sup>2</sup> See *Uniting Europe* of April 20, 1998, p. 3; and of November 16, 1998, pp. 8/9.

ation. According to the EU Commission, the institutional structure of the new Albanian state is weak, the public administration, security forces, public order, judiciary institutions and the enforcement of law are insufficiently established. Progress in these areas as well as in the realm of economic reforms are regarded as essential milestones on the road toward an intensification of relations with the Union.

### 6.3 Toward a New Approach?

Confronted with the war in Yugoslavia, the EU appears to be going through a reappraisal of its policies toward the “Western Balkans.” Apart from stepping up humanitarian and macroeconomic assistance, Brussels seems to be willing to make it easier for SEENACs to deepen their institutional relationships with the EU. This could enhance incentives to push forward with political and economic reforms. Given that continuing isolation of the region will serve neither side, the European Commission has suggested offering a new type of agreement, so-called association and stabilization agreements, to SEENACs – including Yugoslavia – if they meet certain political and economic conditions. These conditions include human and minority rights, free elections, the launching of economic reforms, in particular privatization, as well as good neighborly relations.

Negotiations on the conclusion of such agreements with the FYR of Macedonia and Albania now appear likely to start in 1999. With respect to Albania, the EU has i.a. promised to put forward a proposal granting trade preferences along the lines of those extended to the FYR of Macedonia and other former Yugoslav republics.<sup>1)</sup> The conditions alluded to more or less correspond to the premises so far laid out by the “common approach” of the Union for upgrading relations. The major difference now appears to be the higher level of treaty that is being aimed at as well as the speed with which negotiations can be initiated. To what degree this approach is really a new one will depend on the flexibility the EU will be willing to display at the negotiations, the substance of the envisaged association and stabilization treaties, and on how much the EU will be prepared to open its markets.

A proposal that may be worth considering was recently put forward by the Brussels-based Center for European Policy Studies<sup>2)</sup>. It recommends as short-term measures the establishment of two strong economic links between the EU and the countries concerned: The latter should swiftly link their currencies to the euro via currency boards and join the customs union of the EU. The EU should support this radical approach by providing financial assistance in two ways: by compensating lost tariff proceeds (an important revenue source for countries of the region) and by providing emergency loans to give currency boards the necessary backing. The currency boards should graduate to full “euroization” some years later.

The already existing currency boards in Bulgaria and in Bosnia and Herzegovina have no doubt enjoyed quick and so far sustained success. But

1 See Consultancy Europe Associates Ltd of May 17, 1999.

2 See CEPS (1999). *Companion paper by Daniel Gros: An Economic System for Post-War South-East Europe* (both papers at: <http://www.ceps.be>).

apart from the FR of Yugoslavia, the SEENACs have been relatively successful with their current monetary policies, because they have kept inflation low. Still, the high level of currency substitution and potential monetary instability may merit adopting currency boards in all SEENACs with the possible exception of Croatia, which has already established a relatively long track record of stability.<sup>1)</sup> The only conceivable danger of such a region-wide currency board scenario might be the transmission of contagion effects through international financial markets from one currency board experiencing problems to the others. The inclusion of the respective countries in the EU customs union would provide these countries with tangible advantages, without endangering EU markets, since trade with Southeastern Europe makes up no more than about 1% of the EU's total foreign trade turnover. Initial concerns about the lack of competitiveness of Southeastern European industries could be allayed with asymmetric liberalization rules in favor of these countries, comparable to those in Europe Agreements. Of course, if the SEENACs were to be included in the EU customs union, the accession candidates would also have to be given this status/option. This would imply the creation of an almost Europe-wide customs union as one further intermediary step in European integration.

Editorial close: June 25, 1999.

*1* Yet even the Croatian monetary authorities have recently discussed advantages and drawbacks of adopting the euro. See *Wall Street Journal* of June 17, 1999.

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O E N B    A C T I V I T I E S



# Lectures Organized by the Oesterreichische Nationalbank

The OeNB continued its series of lectures dealing with transition economies and related topics. It hosted several presentations at the end of 1998 and in the first half of 1999. On December 9, 1998, Martin Raiser, Senior Economist at the European Bank for Reconstruction and Development, gave an in-depth presentation of the EBRD's Transition Report 1998, with a special emphasis on analyzing the impact of the Russian crisis. Grzegorz W. Kolodko, visiting scholar at the Fiscal Department of the IMF and former Deputy Prime Minister and Minister of Finance of Poland from 1994 to 1997, discussed the relationship between fiscal policy, savings, capital formation and growth in transition economies at a lecture on April 30, 1999. Professor Vladimir Lavrac of the Institute for Economic Research, University of Ljubljana, held a lecture at the OeNB on May 7, 1999, to discuss Slovenia's monetary policy and monetary integration into the European Union. For the last of the lectures held during the review period, Marko Skreb, the Governor of the National Bank of Croatia, visited the OeNB on May 21, 1999, to discuss the recent economic and monetary developments in Croatia. He presented and analyzed the main economic indicators – GDP growth, inflation developments, the current account deficit, foreign trade, the external debt position, foreign exchange reserves, capital inflows, the exchange rate regime, money supply and the problems of the banking sector.

Each of the presentations was followed by a highly animated discussion, the major issues of which will be touched upon only briefly below due to the constraints on the length of this publication. The following overviews are intended to give the reader an insight into the conclusions drawn by renowned economists and experts about specific developments in transition countries.

## **Lecture by Martin Raiser**

### **The EBRD's 1998 Transition Report**

Martin Raiser, Senior Economist at the European Bank for Reconstruction and Development, gave a lecture at the OeNB at which he presented the EBRD's "Transition Report 1998" on December 9, 1998. He recalled that 1998 was a year of tensions and contrasts, highlighted by the outbreak of the Russian financial and economic crisis in August. This crisis demonstrated both the vulnerability and the resilience of transition economies. According to the reform indicators for 1998 compiled in the report, progress in transformation was slower and more uneven than in all preceding years since the fall of the Berlin Wall. Some countries, like Hungary and Poland, achieved further progress in institutional areas of transformation, in particular, financial sector reform and enterprise restructuring. Other economies, e.g. Armenia, Azerbaijan, Bosnia and Herzegovina, and Tajikistan have managed to overcome delays inflicted by onerous armed conflicts and to catch up in the fields of liberalization and privatization. Political setbacks have become more frequent, either – like in Russia – in reaction to a crisis, or – like in Belarus, Turkmenistan and Uzbekistan – due to the limited will to reform on the part of governments. Progress in institutional reforms, e.g. with respect to corporate governance and privatization, financial sector reform,

competition policy, judicial reform and the development of market-oriented infrastructures, continues to be sluggish overall. These weaknesses tend to overshadow hard-won progress of earlier years of transition. The EBRD estimates a region-wide fall in production of about 1% in 1998 and 2% in 1999. This is mainly due to recession in Russia, where production was forecast to contract by 5% in 1998 and by 7% in 1999. Growth prospects are positive for most countries, though. The central European economies and the Baltics were expected to grow by 3% in 1998 and by 3.5% in 1999. The newest Transition Report devoted a special chapter to financial sector transformation. Due to instability and a lack of effective legal systems, the banking sector has remained rudimentary in many countries, and commercial banks frequently fulfill their function of financial intermediary between savers and the private sector only inadequately. Securities and capital markets are even less developed and depend on progress in privatization.

The discussion largely focused on the crisis in Russia. According to Mr. Raiser, the stage for this crisis was set by an imbalance between primary reforms (e.g. liberalization) and later reforms (e.g. institutional measures). This imbalance has generated possibilities of rent-seeking behavior and has facilitated attempts by the “oligarchs” to influence the reform process. Relatively quick enterprise privatization in Russia has not brought about substantial restructuring so far. On the contrary, soft budget constraints have survived as a result of barter and ubiquitous payment arrears, with the government setting a bad example by sequestering its own expenditures and thus not observing the law. The Russian bank restructuring program, while constituting a good basis for action, has unfortunately been running up against serious implementation problems. Since August 1998 reforms have not only come to a standstill, but the authorities have in fact been partly backsliding. For example, foreign exchange restrictions were introduced in October 1998, and various regional administrations put in place price controls and even established “export controls” for products “exported” out of their territories. Mr. Raiser then reiterated the general importance of a stable and credible regulatory framework for economic development. Commenting on economic problems in the Czech Republic, he pointed out that the EBRD had already warned of potential dangers for corporate governance back in 1994. The (past) lack of adequate regulatory policy in the Czech Republic may have been linked to the aversion former Prime Minister Klaus had to regulations of any kind. With few exceptions (e.g. Poland), “insiders” have so far not succeeded in restructuring enterprises. Mr. Raiser’s general conclusion was that the transition process has proved to be longer and more complicated than originally expected and that those countries that have pushed ahead with substantial structural and institutional reforms have weathered the crisis of confidence in emerging markets best.

## Lecture by Grzegorz Kolodko

### Fiscal Policy and Capital Formation in Transition Economies

Grzegorz Kolodko, visiting scholar at the Fiscal Department of the IMF and former Deputy Prime Minister and Minister of Finance of Poland from 1994 to 1997, discussed the relationship between fiscal policy, savings, capital formation and growth in transition economies at a lecture he held on April 30, 1999.

The speaker's interest in the relationship between fiscal policy and capital formation stems from the fact that the shift of transition economies from the financial destabilization and economic slowdown typical of the late centrally planned period toward stabilization and growth is not complete and in many cases remains a daunting task.

Grzegorz Kolodko started by specifying the main aims of the fiscal reforms and policies during transition. The first step consisted in macroeconomic stabilization, i.e. improvement of the budget situation along with the stabilization of inflation. Next, fiscal regimes were overhauled to gear them toward the needs of a market economy; for instance, new tax regimes were introduced in which personal income taxes and VAT took precedence over corporate taxes, formerly a key source of revenue. Despite the efforts to widen the tax base, the revenues proved insufficient to cover even downward adjusted expenditure, so that persistent budget deficits arose.

The issue of increasing the propensity to save and of enhancing capital formation has not received sufficient attention so far. This is especially true for the early years of transition: It was assumed that capital formation would be boosted automatically in the wake of stabilization and the implementation of critical structural reforms. However, this has not been the case. It was supposed that liberalization and privatization would entail a more efficient allocation of resources, which would offset the decline in high rates of (forced) savings from the socialist era and would cause growth to accelerate. This kind of thinking has started to change now, as new sources of inefficiencies linked to poor institutionalization of the new economic systems emerged and savings plummeted when output contracted. Therefore the transition countries must resort to fiscal policy to fill the vacuum. Fiscal measures such as the adaptation of the tax structure and accompanying deductions can be instrumental in raising the marginal propensity to save and therefore the investment in human capital. The speaker advocated tax systems which shift from direct to indirect taxation (taxation of money spent, not money earned) to gradually reduce the corporate tax burden, narrow the personal tax brackets and widen the tax base. He favors lenient taxation of capital gains in transition, or none at all. The rules regulating the pace and scope of asset depreciation should allow for accelerated depreciation of the productive assets to facilitate the process of capital reproduction. Fiscal policy should also encourage inflows of long-term nondebt capital. Mr. Kolodko also questioned the argument that diminishing the state role is conducive to growth. Whereas he agrees with reducing the role of the state if state expenditure goes to unproductive uses, such as maintaining the redundant bureaucracy,

he maintains that when state outlays are directed to investment in human capital (education, health care, research and development) and infrastructure, they enhance a country's growth capacity. In his lecture, Grzegorz Kolodko emphasized the role of human capital as a growth factor and the damage state withdrawal from financing education has inflicted. He favors keeping tax deductions to encourage a higher share of private households' expenditure on education during the transition process.

Mr. Kolodko emphasized that at the end of the 1990s, the group of the former socialist countries is even more diversified than it was at the beginning of the decade. Thus, fiscal policies cannot be uniform. In the countries which are still lagging behind with systemic transformation and development strategies, the priority of fiscal policy still has to be stabilization, but these policies should be subject to a test of their influence on long-term capital formation. Mr. Kolodko concluded by indicating that in more advanced transition economies, the time was ripe to reassess the role of fiscal policy also as a developmental tool.

### **Lecture by Vladimir Lavrac**

#### **Slovenia: Monetary Policy and Monetary Integration into the EU**

On May 7, 1999, Professor Vladimir Lavrac of the Institute for Economic Research, University of Ljubljana, held a lecture at the OeNB to discuss Slovenia's monetary policy and monetary integration into the European Union. Starting from the present state of preparations for monetary integration in the Central European EU candidate countries, Vladimir Lavrac pointed to a paradox that could be observed in the recent past. These countries, which are supposed to be moving towards fixed exchange rates and completely liberalized capital flows in their monetary integration process, are actually showing signs of moving in the other direction, namely towards more flexible exchange rate arrangements and upholding existing capital controls. Clearly, this is associated with increased international financial instability, which calls for the use of additional "protective" instruments, including exchange rate flexibility and capital control measures. This trend, however, represents a new challenge to these countries as they prepare for monetary integration, namely how and when they should meet EU and EMU requirements on exchange rate stability and the liberalization of capital flows.

Slovenian monetary policy continues to operate in the framework of general macroeconomic stability, characterized by a balanced current account, fiscal stability with moderate budget deficits of up to 1% of GDP, and an inflation rate of currently below 5% annually. The monetary strategy of the central bank consists in monetary targeting, so the control of monetary aggregates dominates alternative possible targets, such as the exchange rate or the interest rate. Slovenia formally targets the broad monetary aggregate M3, but much attention is paid to the developments in the narrower monetary aggregate M1 and the money base.

In 1998 interest rates, both indexed and real rates, declined substantially. The interbank agreement, which was quite instrumental in bringing the interest rate down, was substituted by a somewhat looser recommendation by the Banking Association in 1999. As a result of lower interest rates as well as increased international financial instability, net capital inflows to Slovenia practically stopped. This enabled Slovenia to further liberalize its capital flows. Capital account liberalization is also the consequence of the entry into force of the Europe Agreement in February 1999, which calls for the complete liberalization of capital flows by 2003. Within this context, the non-interest-bearing deposit on financial borrowing has been transformed into an emergency measure to be activated only if the need arises, so it is currently not in use. The capital controls on portfolio investment were also relaxed somewhat.

According to the optimum currency area theory, Slovenia is in many respects a model country suitable for monetary integration. Its economy is small and open, its production and exports are diversified, and its trade is highly concentrated on the EU. Furthermore, some first attempts at empirical research of the possible shocks show that Slovenia is not supposed to be exposed to specific asymmetric shocks, as its trade structure is similar to that of the EU and as its economy is rather closely synchronized with the EU. Therefore, Slovenia sees benefits from joining EMU and would like to be in the first group of the candidate countries to join the euro area.<sup>1)</sup>

In the EMU chapter of negotiations with the EU, Slovenia asked for an exemption from the *acquis communautaire* on EMU, something other candidates did not request: The country specifically asked that the factual stability of the tolar in line with the requirements of the ERM II should be treated as formal compliance with the Maastricht convergence criterion on exchange rate stability. In this way, if it meets all the other Maastricht criteria, Slovenia would like to avoid having to wait two years on formal grounds to join the euro area after acceding to the EU. This could be particularly painful if an Eastern enlargement of the EU was seriously delayed, which for the moment cannot be excluded.

The alternative Mr. Lavrac prefers is to let the candidate countries join the ERM II earlier, even before they become EU members, perhaps after concluding the negotiations with the EU and while waiting for the completion of the ratification procedure. In Mr. Lavrac's view, the advantages of this early membership in the ERM II are the following: First, these countries could overcome the abovementioned legalistic rigidity of having to wait for two years before being able to join the euro area, even if there were no economic reasons for such a delay. Second, in this way the ERM II as an institution would gain more substance, meaning and weight. Otherwise, the ERM II might even have zero participation in the next few years, with obvious consequences for its significance. Third, it may be better to have the candidate countries inside rather than outside the system. In such an arrangement, these countries could become accustomed to the exchange rate

<sup>1</sup> For more on this and related issues see De Grauwe, Paul and Vladimir Lavrac, *Inclusion of Central European Countries in the European Monetary Union*, Kluwer Academic Publishers, 1999.

discipline and solidarity, in other words view their exchange rate policy as a matter of common concern, which is also a requirement of the *acquis communautaire* on EMU. In this way, they could better prepare themselves for participation in the euro area.

Finally, the path or the sequence of steps through which Slovenia should move from the present floating exchange rate system to an irrevocably fixed exchange rate and to adopting the euro is not yet clear. A variety of scenarios exist: floating until adopting the euro, a unilateral switch to a fixed, but adjustable exchange rate regime, the move to the ERM II, a unilateral de facto monetary union of the Austrian type. There could also be an approach that either blends some of these elements or sequences them in some fashion.

The lecture was followed by a lively discussion on a broad range of issues from Slovenia's new banking legislation, recent banking sector developments and the role of Slovenia as a bridge to the other parts of former Yugoslavia to the issue of "euroization."

### Lecture by Marko Skreb

#### Recent Economic and Monetary Developments in Croatia

On May 21, 1999, Marko Skreb, the Governor of the National Bank of Croatia, held a lecture at the OeNB to discuss the recent economic and monetary developments in Croatia. He presented and analyzed the main economic indicators – GDP growth, inflation developments, the current account deficit, foreign trade, the external debt position, foreign exchange reserves, capital inflows, the exchange rate regime, monetary policy and the problems of the banking sector. Marko Skreb noted that the Croatian economy slowed in 1998 and, in fact, experienced recession late that year and at the beginning of 1999 with two consecutive quarters of negative GDP growth. There are three main factors which explain the contraction, an international and two domestic ones. The international reason is related to the emerging market crises which led to the decline in foreign borrowing by Croatia's private sector. The domestic factors are cooling the economy by the macroeconomic policy pursued due to the unsustainable level of the current account deficit, and the banking crisis that started in 1998 and continued in 1999. The central bank expects growth to pick up in the second half of 1999, but much hinges on the developments of the Kosovo conflict, successful bank rehabilitation and the pickup of economic activity in the EU.

In 1998, CPI inflation rose above 5% in Croatia, which was due to the introduction of the VAT in January 1998. This one-time effect phased out, and in 1999 the inflation rate is expected to return to a range of between 3% and 4%, where it had been from 1995 until last year. The good inflation record is a remarkable achievement, as one should bear in mind that former Yugoslavia had a history of high inflation and strong currency substitution. The managed floating regime, with ex post data showing that the kuna/Deutsche mark rate was fluctuating within a very narrow band (6.2% until recently) has been instrumental in this record. However, the stability of the exchange rate did not lead to any real appreciation of the kuna; calculations of the real effective exchange rate indicate PPI-deflated appreciation of about

9% from the introduction of the kuna in May 1994 until April 1999. Thus, the kuna's real exchange rate cannot be a factor in the burgeoning of the current account deficit to 12.5% of GDP in 1997. Furthermore, devaluation is not an option, because the price elasticity of exports has been found to be low relative to the passthrough elasticity of devaluation to import prices. This is because the import content of Croatian exports is very high. It should be borne in mind that Croatia is a small, open economy where indexation is still widespread. Moreover, until 1998 the kuna had been under upward pressure; it depreciated by about 10% against the Deutsche mark only later. In 1998, policy measures succeeded in reducing the current account deficit to about 7.5% of GDP, but no further reduction is expected in 1999, as the loss of tourist receipts because of the Kosovo conflict will have an adverse impact on the current account. The sustainability of the current account deficit will hinge also on successful privatizations: The planned sale of a 25% stake in the state telecom company is crucial. The current account gap is fully explained by the trade deficit, as Croatia has a surplus on services (tourism is a major source of income). The shortfall on trade was caused by rapidly rising imports due to pent-up consumer and investment demand. At the same time, the external financial constraint was loosened after Croatia obtained a credit rating in 1997 and was able to tap external markets. This led to a credit boom which had to be contained by means of higher interest rates. Croatia also introduced Chile-type measures, i.e. retention deposits, to curtail the growth of foreign borrowing. As a result of the credit boom in 1997, the foreign-debt-to-GDP ratio increased rapidly (to about 35% in 1998), and the total debt service rose slowly (to about 11% in 1998), but the levels are still moderate. Short-term debt is below 5% of total foreign debt. It should also be emphasized that Croatia has inherited part of former Yugoslavia's foreign obligations.

Until late 1998, Croatia operated a *de facto* currency board system, because foreign exchange reserves fully covered the monetary base and M1. The central bank granted practically no domestic loans. This started to change in late 1998, when the recession unfolded and budget revenues dwindled. In April 1999, apart from the claims on the government, the central bank also held claims on commercial banks. It had to open a lending facility to the credit institutions to bridge the liquidity problems which arose when a number of banks became insolvent. The Croatian National Bank recently asked the courts to start bankruptcy procedures for nine private commercial banks and savings banks whose assets represent about 8% of the banking system's total assets. The cleanup costs will be a substantial burden for the state budget, as insured deposits amount to about 2% of GDP. These costs will compound the budget difficulties triggered by the drop in revenues caused by the recession. The government is currently in the process of revising the budget for 1999. This revision is necessary not only to counteract the abovementioned problems, but also to bridge financing gaps in quasi-budget social funds, i.e. pension and health care funds. To bridge the gap in liquidity, Croatia is negotiating loans from the World Bank (SAL facility) and a standby arrangement from the IMF. These negotiations have to be concluded swiftly, because parliamentary elections scheduled

for the end of 1999 could reduce the scope for political action. In the area of banking, the bankruptcy of nine banks, some of which engaged in illegal activities such as money laundering, and their restructuring represents an important issue which is being addressed. Furthermore, three state-owned banks which had been rehabilitated in 1995/96 are to be privatized in 1999. A new banking law was adopted in December 1998. Unlike the old law, it enables the central bank to react swiftly to banking problems. The central bank, in turn, is strengthening its supervision department.

During the discussion which followed the lecture, problems of enterprise restructuring and corporate governance, the impact of the Kosovo conflict on Croatia's economy, exchange rate policy issues and Croatia's plans with regard to European integration were raised.



# The “East Jour Fixe” of the Oesterreichische Nationalbank – A Forum for Discussion

The East Jour Fixe of the Oesterreichische Nationalbank is a series of meetings initiated in 1991 as a forum in which economists, members of academia, government officials and other experts on Eastern Europe meet to discuss specific transition issues. The series was continued with two presentations on April 23, 1999. In keeping with the established practice, the East Jour Fixe meeting was opened with speeches held by experts about key topical issues related to transition economies. High-profile discussants commented on the contributions, followed by an exchange of views between policy-makers, analysts and researchers during the general discussion.

Judit Neményi, member of the board of the National Bank of Hungary (NBH) and Managing Director of the Economics and Research Department of the NBH, held a lecture about “Monetary Transmission in Advanced Transition Economies: The Case of Hungary” at the OeNB’s 34th East Jour Fixe on April 23, 1999. Ms. Neményi’s presentation was chaired by Olga Radzyner, Head of the OeNB’s Foreign Research Division. At the same East Jour Fixe on April 23, 1999, Alexis Derviz, senior economist in the monetary department of the Czech National Bank (CNB), gave a presentation about the monetary transmission mechanism in the Czech Republic, which, like Hungary, belongs to the group of advanced transition countries, but pursues a different monetary policy. This presentation, too, was chaired by Olga Radzyner, Head of the OeNB’s Foreign Research Division. The main findings of the most recent East Jour Fixe meetings are reviewed below.

## **Contribution by Judit Neményi**

### **Monetary Transmission**

#### **in Advanced Transition Economies: The Case of Hungary**

Judit Neményi, member of the board of the National Bank of Hungary (NBH) and Managing Director of the Economics and Research Department of the NBH, held a lecture about “Monetary Transmission in Advanced Transition Economies: The Case of Hungary” at the OeNB’s 34th East Jour Fixe on April 23, 1999. Ms. Neményi’s presentation was chaired by Olga Radzyner, Head of the OeNB’s Foreign Research Division.

From the very outset, Ms. Neményi stressed the importance of “sustainability” in the NBH’s disinflation efforts. Due to Hungary’s large external debt burden, which prohibits the running of high current account deficits, Hungary’s central bank has to pay special attention to the preservation of Hungary’s international competitiveness when setting its exchange rate policy. The ongoing price liberalization makes it impossible to lower the inflation rate quickly at bearable economic costs. Although strong empirical evidence is hard to produce, it seems that fiscal policy has the most decisive impact on domestic demand and that the development of the exchange rate is an important factor for the inflation rate.

According to Ms. Neményi, it is essential that the introduction of indirect methods for monetary transmission correspond to the development of the financial markets (existence of an interbank market or of a government securities market) in a country. During the 1990s, progress in the fiscal stance, microeconomic restructuring and the easing of capital controls have

enabled the NBH to gradually increase its use of indirect instruments for the conduct of monetary policy.

The evolution of markets and financial instruments results in changes in the demand for money in a transition economy. Thus, after the elimination of the main pricing distortions which produce inflationary pressures, the exchange rate is the most suitable choice as the economy's nominal anchor in a small, open economy. Considering, furthermore, Hungary's tight balance-of-payments constraint, exchange rate targeting seemed to be best suited to the NBH's goal of achieving a gradual lowering of the inflation rate while keeping the external balances in check. In 1995, the NBH switched to a crawling peg exchange rate system with a preannounced continuous devaluation of the forint, which is superior in terms of credibility to the old system of devaluation on an irregular basis.

Conducting a policy of exchange rate targeting under conditions of full capital mobility, a central bank would lose its control over interest rates. However, Hungarian financial markets are not yet fully integrated into world markets, which gives the NBH some maneuvering room for interest rate policy. Since 1995, Hungarian interest rates have not always been perfectly in line with foreign interest rates and the projected devaluation of the forint. Consequently, the NBH has managed to exert some influence on monetary aggregates and domestic demand. However, in the early years of transition, the crowding-out effect of the budget, the implementation of the bankruptcy law and bad debt problems had a strong impact on commercial banks' lending decisions, reducing the importance of the credit channel in the transmission mechanism. At present, the structure of household savings and corporate finance in Hungary is leading to a relatively low interest-rate sensitivity of domestic demand. Thus, the exchange rate channel of the transmission mechanism is much more important.

Before 1995 market interest rates were mainly determined by the marginal costs of borrowing (active repo and open market operations). Since 1995, and especially since 1996, the NBH has had to deal with strong capital inflows. As a result, the alternative investment facility of the reverse repo rate became the most important determinant of market interest rates.

During the discussion, Ms. Neményi, asked what the time span for achieving convergence would be, stated that the NBH was aiming at a gradual reduction of the inflation rate to 5% in two to three years, which would give the NBH the option of fixing the forint to the euro (in a wider band). On the topic of inflation targeting, Judit Neményi emphasized that inflation targeting in Hungary would require a lot of preparation, however, "dirty" inflation targeting would be a possibility. In her view, monetary aggregates are interesting indicators, but not suited to forming a target in Hungary.

## Contribution by Alexis Derviz

### Monetary Transmission in Advanced Transition Economies: The Case of the Czech Republic

Also at the OeNB's 34th East Jour Fixe on April 23, 1999, Alexis Derviz, senior economist in the monetary department of the Czech National Bank (CNB), gave a presentation about the monetary transmission mechanism in the Czech Republic which (like Hungary) belongs to the advanced transition countries, but pursues a different monetary policy. This presentation, too, was chaired by Olga Radzyner, head of the OeNB's Foreign Research Division.

Mr. Derviz related that the CNB had used several different targets in its conduct of monetary policy since its establishment in 1993:

- The exchange rate. The exchange rate was pegged to a currency basket until February 1996.
- The monetary base. First, the standard central bank money aggregate M0 was targeted, which was later (1994) replaced by the narrower aggregate of commercial bank reserves.
- Inflation, more specifically, so-called net inflation, which does not include changes in regulated prices, trade tariffs and indirect taxes. Inflation targeting has been effective since December 1997.

The CNB's most important monetary policy instrument is a two-week repo tender. The two-week interbank rate is determined by this key rate; it also has a strong impact on the interbank rates up to maturities of about six months. Interest rates for newly granted credits tend to follow the CNB's repo rate quite closely, whereas the development of the rates for new medium and long-term credits depend much less on the two-week repo.

In a standard environment, the volume of new credits should be strongly influenced by the level of interest rates. However, in the Czech Republic short-term credits are growing at a high pace, but show little sensitivity towards rises in interest rates. Medium- and long-term credits are not reacting strongly to interest rate changes either, but they are expanding at a much slower pace. This in turn means that the share of short-term credits is increasing, which is a worrisome development. The peculiar lender-creditor relationship in the Czech Republic may offer an explanation for this phenomenon: A few large corporations seem to enjoy access to credit regardless of their financial situation, which breaks the transmission link between interest rates and new credit volume. In the present phase of easing interest rates, the credit channel does not seem to be working properly, either. Eased monetary conditions have translated into a rise in the level of CNB bills in commercial banks' portfolios rather than fueling an increase in new credits. Unsurprisingly, new investment and production show hardly any correlation with interest rates on new credits. The same seems to be true of the relationship between interest rates for new credits and prices.

For a small, open economy like the Czech Republic, the exchange rate can be expected to have a strong impact on prices. Indeed, the fixed exchange rate in the early 1990s seems to have contributed to the lowering of inflation which took place in the Czech Republic (i.e. Czechoslovakia up

until 1993) at that time. However, the strong disinflationary trend which began in the second half of 1998 is believed to be mainly the result of cyclical factors.

As there is a link between the exchange rate and prices in the Czech Republic, the question of whether Czech interest rates can influence the CZK/EUR (formerly DEM) rate arises. Clearly the uncovered parity condition for these two currencies does not hold for short-term interest rates. However, the correlation between the five-year government bond yield differential and the exchange rate is very strong. Although five-year government bond yields are not moving perfectly in line with the CNB's repo rate, the yield differential/exchange rate channel of the monetary transmission channel is relevant in the Czech Republic.

International financing in the form of credits from private foreign entities to private Czech borrowers is becoming increasingly important. In Mr. Derviz' view, this development could help to surmount the problems in the Czech financial sector by providing funds to producers who bear the brunt of insufficient capacity in the banking sector.

# *Technical Cooperation of the Oesterreichische Nationalbank with Countries in Transition*

In 1999, the OeNB is continuing its cooperation activities with Central and Eastern European countries and CIS republics both on a bilateral and on a multilateral level.

On a bilateral level, the OeNB will continue the series of highly specialized seminars for central bankers started in 1997 with four one-week seminars on the following topics: Human Resource Management (August 1999), The Analysis of Industrial Enterprises and Banks from a Central Bank Viewpoint (August/September 1999), Financial and Balance-of-Payments Statistics (October 1999), and EU/EMU – One Year of Experience (December 1999). In addition to these seminars, bilateral contacts are upheld in a series of information visits and study tours. In October 1998, a delegation from Mongolia came to Vienna to attend a two-week seminar on the role of public relations in monetary policy. In the last weeks of 1998, representatives from the Bank of Estonia visited Vienna to receive information on Austria's monetary policy. Moreover, a delegation of experts on prudential supervision from Hungary was welcomed, and an information visit on organizational structures and the OeNB branch network was organized for specialists from the National Bank of Slovakia. Furthermore, the OeNB has established an intensive cooperation with the National Bank of Georgia (NBG). Also, in February 1999, a delegation from the Central Bank of Bosnia and Herzegovina came to Vienna to exchange views on foreign exchange policy.

On a multilateral level, the OeNB takes part in the EU-financed technical assistance program for the Central Bank of Russia (CBR). In March 1999, the OeNB hosted a one-week study tour on balance-of-payments and financial statistics for employees of the CBR. Within the PHARE framework, the OeNB hosted three study visits for experts from the National Bank of Poland in the second half of 1998, the first on international organizations (July 1998), the second on legal and technical aspects of cross-border payments (October 1998) and the third on organizational issues and strategic planning (October 1998). Within the framework of IMF-coordinated technical assistance, a senior staff member took part in IMF missions to Albania on payment systems issues in September and November 1998.

In 1998, the Joint Vienna Institute's (JVI) mandate was prolonged for another five years. For these second five years of operation of the JVI, the Austrian authorities were asked to increase their contribution to the academic program. Therefore, in 1999, the new course in Applied Economic Policy (AEP), the successor of the former Comprehensive Course, for the first time had an "Austrian segment." In the first part of this segment, which is jointly financed by the Austrian Ministry of Finance and the OeNB, experts from a variety of academic and organizational backgrounds spent 2½ days presenting lectures devoted to specific features of Austria's market economy, such as the political and economic structure, social partnership, issues of fiscal federalism, incomes policies, Austria's experience with EU accession and the introduction of the euro. In the second part, the so-called study tour, participants spend three days visiting companies, state and local government authorities, banks, media centers and the like to gain an insight into the structures of Austria's economy and administration.

The program for each study tour is organized by the OeNB. Moreover, Austria has agreed to increase its contribution to the seminar program of the JVI. In addition to the four one-week seminars held by the OeNB every year, the OeNB and the Ministry of Finance will jointly organize two one-week seminars. The topics of these Austrian seminars in 1999 will be as follows: The Changing Role of Government in Economic Reforms (October 1999), and Foreign Direct Investment and Privatization Policies (December 1999). Austria's increased contribution to the JVI's academic program is a logical continuation of its long-standing support of the Institute.



S T A T I S T I C A L     A N N E X



## Gross Domestic Product

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
Annual change in %											
1989	- 1.9	+ 4.5	x	+ 0.7	x	x	+ 0.2	- 5.8	x	+ 1.0	-1.8
1990	- 9.1	- 1.2	x	- 3.5	x	x	-11.6	- 5.6	- 3.0	- 2.5	-4.7
1991	-11.7	-11.5	x	-11.9	x	x	- 7.0	-12.9	- 5.0	-14.5	-8.9
1992	- 7.3	- 3.3	-12.4	- 3.1	x	x	+ 2.6	- 8.7	-14.5	- 6.5	-5.5
1993	- 1.5	+ 0.6	- 8.5	- 0.6	-14.9	-16.2	+ 3.8	+ 1.5	- 8.7	- 3.7	+2.8
1994	+ 1.8	+ 3.2	- 1.8	+ 2.9	+ 0.6	- 9.8	+ 5.2	+ 4.0	-12.7	+ 4.9	+5.3
1995	+ 2.9	+ 6.4	+ 4.3	+ 1.5	- 0.8	+ 3.3	+ 7.0	+ 7.2	- 4.1	+ 6.9	+4.1
1996	-10.1	+ 3.9	+ 4.0	+ 1.3	+ 3.3	+ 4.7	+ 6.0	+ 3.9	- 3.5	+ 6.6	+3.3
1997	- 6.9	+ 1.0	+11.4	+ 4.4	+ 8.6	+ 6.1	+ 6.8	- 6.6	+ 0.8	+ 6.5	+4.6
1998	+ 3.5	- 2.7	+ 4.0	+ 5.1	+ 3.6	+ 4.4	+ 4.8	- 7.3	- 4.6	+ 4.4	+3.9
1996											
3rd quarter	x	+ 3.6	+ 4.5	+ 1.0	+ 5.1	x	+ 7.3	x	- 7.3	+ 6.9	+3.4
4th quarter	x	+ 4.7	+ 7.3	+ 3.0	+ 3.5	x	+ 7.7	x	- 5.7	+ 6.7	+4.0
1997											
1st quarter	-11.7	+ 1.5	+10.8	+ 2.1	+ 5.0	+ 5.2	+ 7.0	x	+ 0.3	+ 6.3	+3.2
2nd quarter	- 8.3	+ 0.5	+12.4	+ 4.3	+ 8.5	+ 9.0	+ 7.6	x	- 0.6	+ 6.2	+5.4
3rd quarter	-10.0	- 0.1	+11.5	+ 5.1	+10.0	+ 6.4	+ 6.8	x	+ 1.0	+ 6.6	+3.0
4th quarter	+ 2.4	+ 2.2	+13.5	+ 5.3	+10.7	+ 4.5	+ 6.5	x	+ 2.6	+ 6.9	+6.5
1998											
1st quarter	+18.5	- 0.9	+ 9.3	+ 4.5	+ 8.9	+ 6.9	+ 6.5	- 9.4	- 0.6	+ 6.2	+6.4
2nd quarter	+ 6.3	- 2.4	+ 4.4	+ 5.1	+ 5.6	+ 9.7	+ 5.3	- 1.0	- 1.4	+ 6.1	+3.0
3rd quarter	- 5.9	- 2.9	+ 1.7	+ 5.6	+ 2.2	+ 3.2	+ 4.9	..	- 7.2	+ 5.1	+4.0
4th quarter	- 1.0	- 4.1	+ 0.2	+ 5.2	- 1.9	+ 0.5	+ 2.9	..	- 7.8	+ 0.5	+3.0

Source: WIIW (Vienna Institute for International Economic Studies); Estonia, Latvia, Lithuania: IMF; Estonia: national source from 1997. Quarterly data: national sources.

## Industrial Production

	Bulgaria	Czech Republic	Estonia <sup>1)</sup>	Hungary	Latvia	Lithuania <sup>1)</sup>	Poland	Romania	Russia	Slovak Republic	Slovenia
Annual change in %											
1989	- 1.1	+ 1.7	x	- 2.1	x	x	- 0.5	- 2.1	+ 1.4	- 0.7	+ 1.1
1990	-16.7	- 3.3	x	-10.2	x	x	-24.2	-19.0	- 0.1	- 4.0	-10.5
1991	-20.2	-21.2	x	-16.6	x	- 4.9	- 8.0	-22.8	- 8.0	-19.4	-12.4
1992	-18.4	- 7.9	x	- 9.7	-34.6	-51.6	+ 2.8	-21.9	-18.0	- 9.3	-13.2
1993	- 9.8	- 5.3	x	+ 4.0	-38.1	-34.7	+ 6.4	+ 1.3	-14.1	- 3.8	- 2.8
1994	+10.6	+ 2.1	- 2.1	+ 9.5	- 9.5	-29.8	+12.1	+ 3.3	-20.9	+ 4.8	+ 6.4
1995	+ 4.5	+ 8.7	+ 2.0	+ 4.6	- 6.3	+ 0.9	+ 9.7	+ 9.4	- 3.3	+ 8.3	+ 2.0
1996	+ 5.0	+ 2.0	+ 3.5	+ 3.4	+ 1.4	+ 3.5	+ 8.3	+ 6.3	- 4.0	+ 2.5	+ 1.0
1997	-10.0	+ 4.5	+13.0	+11.1	+ 6.1	+ 8.0	+11.5	- 7.2	+ 1.9	+ 2.7	+ 1.0
1998	-12.7	+ 1.6	+ 0.8	+12.6	+ 2.0	+ 7.0	+ 4.8	-16.8	- 5.2	+ 5.0	+ 3.7
1998											
January	-12.0	+ 6.5	+ 9.0	+ 9.3	+13.9	+ 1.6	+ 7.7	-24.0	+ 1.5	+ 0.6	+ 8.0
February	+21.0	+ 8.8	+10.2	+10.3	+13.3	+12.4	+10.3	-24.1	+ 1.4	+ 2.4	+ 8.9
March	+ 6.8	+11.2	+14.5	+13.6	+16.6	+22.0	+15.0	-17.8	+ 1.2	+10.9	+12.5
April	- 5.0	+ 3.5	+ 1.2	+12.6	+ 2.8	+ 5.0	+ 3.9	-18.2	+ 0.8	+ 5.6	- 6.3
May	-11.0	+ 9.7	+ 4.6	+13.5	+11.8	+10.4	+ 9.5	-16.8	- 2.1	+ 7.5	+ 3.0
June	- 4.0	+ 6.4	+ 7.4	+13.6	+10.3	+ 6.7	+ 4.8	-13.7	- 2.5	+ 4.6	+ 4.2
July	-14.0	+ 7.5	+ 1.3	+13.9	+ 3.0	+ 5.4	+ 6.0	-15.8	- 9.4	+ 8.8	+ 1.1
August	-15.0	+ 3.3	- 2.2	+13.9	+ 3.3	+ 5.1	+ 6.0	-16.8	-11.5	+ 9.3	+ 8.6
September	-23.0	+ 1.3	-10.7	+13.6	- 7.8	+ 5.6	+ 1.1	- 5.8	-14.5	+ 7.8	+ 3.4
October	-19.0	- 4.6	-13.7	+13.0	-12.1	+ 5.4	- 1.0	-14.4	-11.1	+ 1.0	+ 0.9
November	- 9.0	- 4.9	- 8.4	+12.8	- 9.0	+ 2.0	- 1.3	-21.6	- 9.1	+ 0.2	+ 4.5
December	-15.6	- 8.1	+ 3.6	+12.6	-13.1	-15.5	- 2.1	-11.7	- 6.6	- 1.6	- 2.0
1999											
January	-23.0	-11.1	-15.2	..	-14.2	-11.3	- 6.0	-12.8	- 4.9	- 1.0	- 3.3
February	-14.0	..	-11.7	..	-12.0	-13.0	- 5.6	- 9.5	- 3.7	- 8.3	- 9.6
March	-11.0	..	- 8.4	..	-11.6	- 4.5	+ 3.4	-10.4	+ 1.4	- 6.8	- 1.1

Source: Annual data: WIIW; Estonia, Latvia, Lithuania: national sources. Monthly data: national sources.

<sup>1)</sup> Industrial sales.

<sup>2)</sup> In 1999 change in % against 1998 monthly average.

## Unemployment Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>End of period (in %)</i>											
1989	x	x	x	0.4	x	x	x	x	x	x	3.5
1990	1.7	0.8	x	1.9	x	x	6.3	x	x	1.6	5.8
1991	11.1	4.1	x	7.8	x	x	11.8	3.0	x	11.8	10.1
1992	15.2	2.6	x	13.2	2.3	x	13.6	8.2	4.8	10.4	13.4
1993	16.4	3.5	4.1	13.3	5.8	3.4	16.4	10.4	5.7	14.4	15.4
1994	12.8	3.2	4.1	11.4	6.5	3.8	16.0	10.9	7.5	14.8	14.2
1995	11.1	2.9	4.0	11.1	6.6	6.1	14.9	9.5	8.8	13.1	14.5
1996	12.5	3.5	4.3	10.7	7.2	7.1	13.2	6.6	9.9	12.8	14.4
1997	13.7	5.2	3.6	10.4	7.0	6.7	10.3	8.8	11.3	12.5	14.8
1998	12.2	7.5	4.0	9.6	7.6	6.9	10.4	10.3	12.4	15.6	14.6
1998											
January	14.2	5.6	3.9	11.4	7.0	7.4	10.7	9.3	11.4	13.4	15.0
February	14.3	5.6	3.9	11.2	7.0	7.5	10.6	9.7	11.6	13.6	14.9
March	13.7	5.5	4.1	10.9	7.1	7.5	10.4	9.6	11.7	13.4	14.7
April	13.0	5.4	4.0	10.4	7.1	6.9	10.0	9.4	11.7	13.2	14.4
May	12.1	5.3	3.7	10.0	7.0	6.2	9.7	9.2	11.5	12.9	14.3
June	11.4	5.6	3.4	9.7	7.2	5.5	9.6	8.9	11.3	13.5	14.1
July	11.1	6.1	3.4	9.7	7.3	5.4	9.6	8.8	11.3	14.1	14.2
August	10.8	6.4	3.3	9.5	7.4	5.4	9.5	8.7	11.6	13.8	14.2
September	10.7	6.8	3.5	9.5	7.6	5.6	9.6	8.7	11.9	13.8	14.3
October	11.1	6.8	3.7	9.3	8.2	6.0	9.7	9.0	12.3	13.9	14.6
November	11.8	7.0	3.7	9.3	8.8	6.5	9.9	9.5	12.3	14.5	14.5
December	12.2	7.5	4.0	9.6	9.2	6.9	10.4	10.3	12.4	15.6	14.6
1999											
January	12.9	8.1	4.5	10.3	9.4	7.7	11.4	11.1	12.4	16.3	14.5
February	13.2	8.3	4.8	10.5	9.8	8.1	11.9	12.0	12.4	16.5	14.3
March	13.2	8.4	5.3	10.4	10.1	8.5	12.1	12.0	12.4	16.7	..

Source: WIIW; Estonia, Latvia, Lithuania: national sources.

## Consumer Price Index

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>Period average (annual change in %)</i>											
1989	x	+ 1.4	x	+17.0	x	x	+251.1	+ 1.1	x	x	x
1990	+ 23.8	+ 9.7	x	+28.9	x	x	+585.8	+ 5.1	+ 5.3	+10.4	x
1991	+ 338.5	+56.6	x	+35.0	x	x	+ 70.3	+170.2	+ 92.6	+61.2	x
1992	+ 91.2	+11.1	x	+23.0	+243.6	x	+ 43.0	+210.4	+1,526.6	+10.0	+207.3
1993	+ 72.8	+20.8	+89.8	+22.5	+108.8	+409.6	+ 35.3	+256.1	+ 873.5	+23.2	+ 32.9
1994	+ 96.0	+10.0	+47.7	+18.8	+ 35.9	+ 72.1	+ 32.2	+136.8	+ 307.6	+13.4	+ 21.0
1995	+ 62.1	+ 9.1	+28.8	+28.2	+ 25.0	+ 39.7	+ 27.8	+ 32.3	+ 197.5	+ 9.9	+ 13.5
1996	+ 123.0	+ 8.8	+23.1	+23.6	+ 17.6	+ 24.6	+ 19.9	+ 38.8	+ 47.8	+ 5.8	+ 9.9
1997	+1,082.2	+ 8.5	+10.6	+18.3	+ 8.4	+ 8.9	+ 14.9	+154.8	+ 14.8	+ 6.1	+ 8.4
1998	+ 22.3	+10.7	+10.7	+14.3	+ 4.6	+ 5.1	+ 11.8	+ 59.1	+ 27.6	+ 6.7	+ 8.6
1998											
January	+ 382.1	+13.1	+10.9	+17.7	+ 6.3	+ 6.5	+ 13.6	+131.9	+ 10.1	+ 7.2	+ 9.0
February	+ 43.1	+13.4	+13.1	+17.1	+ 6.2	+ 6.4	+ 14.2	+109.3	+ 9.3	+ 7.5	+ 9.1
March	+ 27.4	+13.4	+13.3	+16.4	+ 6.0	+ 6.7	+ 13.9	+ 66.1	+ 8.5	+ 7.2	+ 9.4
April	+ 28.4	+13.1	+12.6	+16.0	+ 6.0	+ 7.0	+ 13.7	+ 59.6	+ 8.0	+ 7.0	+ 9.1
May	+ 22.1	+13.0	+10.8	+15.8	+ 5.4	+ 6.7	+ 13.3	+ 56.6	+ 7.5	+ 7.6	+ 8.3
June	+ 18.9	+12.0	+11.0	+14.2	+ 5.9	+ 6.0	+ 12.2	+ 55.0	+ 6.4	+ 7.4	+ 8.3
July	+ 13.0	+10.4	+10.5	+14.1	+ 4.6	+ 5.1	+ 11.9	+ 56.0	+ 5.6	+ 7.0	+ 7.7
August	+ 6.1	+ 9.4	+10.3	+13.5	+ 3.7	+ 4.4	+ 11.3	+ 51.7	+ 9.5	+ 5.7	+ 7.6
September	+ 5.5	+ 8.8	+ 9.6	+12.5	+ 3.5	+ 3.7	+ 10.6	+ 50.8	+ 52.2	+ 5.9	+ 7.1
October	+ 4.7	+ 8.2	+ 9.1	+12.3	+ 2.9	+ 3.7	+ 9.9	+ 47.1	+ 58.8	+ 6.2	+ 6.9
November	+ 3.2	+ 7.5	+ 8.1	+11.2	+ 2.8	+ 2.7	+ 9.2	+ 43.8	+ 66.7	+ 5.9	+ 6.4
December	+ 1.0	+ 6.8	+ 7.3	+10.3	+ 2.8	+ 2.4	+ 8.6	+ 40.6	+ 84.4	+ 5.6	+ 6.5
1999											
January	+ 0.6	+ 3.5	+ 7.7	+ 9.8	+ 2.6	+ 2.4	+ 6.9	+ 38.1	+ 97.1	+ 6.8	+ 6.1
February	- 1.7	+ 2.8	+ 4.9	+ 9.4	+ 2.6	+ 1.9	+ 5.6	+ 32.6	+ 103.4	+ 6.9	+ 5.6
March	- 2.6	+ 2.5	+ 3.6	+ 9.3	+ 2.3	+ 1.3	+ 6.2	+ 35.9	+ 107.8	+ 7.0	+ 5.1

Source: WIIW; Estonia, Latvia, Lithuania: IMF; Lithuania: national source from March 1999.

## Trade Balance

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
USD million											
1989	x	x	x	537.0	x	x	x	x	x	x	x
1990	x	x	x	348.0	x	x	x	-3.427.0	x	x	x
1991	x	x	x	189.0	x	x	x	-1.106.0	x	x	x
1992	x	x	x	- 48.0	- 40.3	x	x	-1.421.0	x	x	791.1
1993	x	- 525.3	- 144.8	-3.247.0	18.6	- 153.1	- 2.293.0	-1.128.0	x	- 932.0	-154.2
1994	x	-1.381.2	- 356.9	-3.635.0	- 301.1	- 201.6	- 836.0	- 411.0	17.675.0	58.5	-337.5
1995	x	-3.677.9	- 666.1	-2.442.0	- 580.7	- 192.1	- 1.827.0	-1.577.0	20.476.0	- 227.5	-954.3
1996	187.6	-5.877.3	-1.019.4	-2.645.0	- 799.1	- 896.2	- 8.154.0	-2.470.0	22.933.0	-2.292.6	-881.7
1997	380.4	-4.540.4	- 349.1	-1.734.0	- 849.6	-1.147.5	-11.320.0	-1.980.0	17.440.0	-2.081.0	-771.6
1998	-315.6	-2.580.7	-1.115.3	-2.121.0	-1.126.8	-1.518.3	-13.667.0	-2.611.0	17.306.0	-2.292.5	-774.9
1998											
January	- 38.7	x	x	- 175.0	x	x	- 1.445.0	- 61.0	x	x	- 86.6
February	74.3	x	x	- 16.0	x	x	- 813.0	- 12.0	x	x	- 85.7
March	- 34.1	- 512.0	- 248.5	- 112.0	- 192.4	- 274.0	- 986.0	- 184.0	908.0	- 468.5	-104.5
April	21.8	x	x	- 71.0	x	x	- 1.028.0	- 227.0	x	x	- 90.1
May	- 71.8	x	x	- 85.0	x	x	- 901.0	- 294.0	x	x	- 89.4
June	- 19.5	- 540.0	- 314.3	- 237.0	- 278.0	- 370.2	- 946.0	- 241.0	1.584.0	- 517.2	- 39.0
July	- 46.3	x	x	- 264.0	x	x	- 988.0	- 280.0	x	x	- 7.9
August	- 36.1	x	x	- 159.0	x	x	- 780.0	- 147.0	x	x	- 30.6
September	- 21.5	- 456.7	- 315.7	- 263.0	- 308.5	- 411.6	- 1.528.0	- 324.0	4.814.0	- 163.5	- 7.8
October	- 23.3	x	x	- 188.0	x	x	- 1.375.0	- 263.0	x	x	- 59.0
November	- 62.2	x	x	- 252.0	x	x	- 1.326.0	- 201.0	x	x	- 58.3
December	- 58.3	-1.117.5	- 236.8	- 300.0	- 362.7	- 462.5	- 1.604.0	- 354.0	10.000.0	- 486.1	-116.1
1999											
January	- 97.3	x	x	- 96.0	x	x	- 1.235.0	..	x	x	- 3.2
February	- 36.5	x	x	- 83.0	x	x	- 744.0	..	x	x	- 79.8

Source: national central banks; Latvia: Central Statistical Office.

1) Up to December 1997: quarterly data.

## Current Account

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
USD million											
1989	x	x	x	-1.437.0	x	x	x	x	x	x	x
1990	x	x	x	127.0	x	x	x	-3.337.0	x	x	x
1991	x	x	x	267.0	x	x	-1.359.0	-1.012.0	x	x	x
1992	x	x	x	324.0	191.4	x	- 269.0	-1.564.0	x	x	926.2
1993	x	455.8	21.6	-3.455.0	428.0	- 83.5	-2.329.0	-1.174.0	12.792.0	- 601.2	191.9
1994	x	- 786.8	-166.5	-3.911.0	200.8	- 90.4	- 944.0	- 428.0	8.880.0	664.9	600.1
1995	x	-1.369.1	-157.9	-2.480.0	- 17.9	- 56.6	5.455.0	-1.774.0	7.778.0	391.4	- 22.8
1996	x	-4.292.2	-397.9	-1.678.0	-280.0	- 722.6	-1.352.0	-2.571.0	12.011.0	- 601.2	39.0
1997	426.7	-3.211.0	-563.4	- 981.0	-346.2	- 981.3	-4.312.0	-2.137.0	4.049.0	-1.952.3	36.6
1998	-251.1	-1.046.1	-446.9	-2.298.0	-707.8	-1.298.0	-6.810.0	-3.010.0	17.306.0	-2.063.1	- 3.8
1998											
January	-149.5	x	x	- 210.0	x	x	- 965.0	- 91.0	x	x	- 15.7
February	98.8	x	x	- 16.0	x	x	- 278.0	11.0	x	x	- 31.5
March	- 38.1	- 348.8	-142.6	- 155.0	- 83.2	- 228.7	- 755.0	- 212.0	- 1.508.0	- 475.7	- 31.9
April	62.3	x	x	- 63.0	x	x	- 455.0	- 274.0	x	x	- 18.8
May	- 61.4	x	x	18.0	x	x	- 201.0	- 335.0	x	x	- 17.8
June	1.1	- 99.3	-119.6	- 478.0	-130.1	- 292.3	- 9.0	- 174.0	- 3.587.0	- 498.2	5.6
July	- 76.0	x	x	- 167.0	x	x	- 201.0	- 248.0	x	x	30.5
August	22.2	x	x	61.0	x	x	281.0	- 155.0	x	x	58.2
September	- 14.4	- 17.6	-106.3	- 326.0	-217.2	- 376.5	-1.295.0	- 370.0	900.0	- 81.9	72.7
October	- 25.1	x	x	- 108.0	x	x	- 963.0	- 381.0	x	x	1.1
November	- 48.9	x	x	- 159.0	x	x	- 830.0	- 278.0	x	x	- 4.9
December	- 22.1	- 600.3	- 78.4	- 694.0	-286.6	- 400.5	-1.187.0	- 479.0	6.640.0	- 287.3	- 51.3
1999											
January	-208.5	x	x	- 175.0	x	x	- 855.0	..	x	x	74.8
February	- 43.1	x	x	- 64.0	x	x	- 460.0	..	x	x	- 30.9

Source: national central banks; Latvia: Central Statistical Office.

## Total Reserves Minus Gold

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
<i>End of period (USD million)</i>											
1989	x	x	x	1,246.0	x	x	2,314.3	1,859	x	x	x
1990	x	x	x	1,069	x	x	4,492.1	524	x	x	x
1991	311	x	x	3,934	x	x	3,632.6	695	x	x	112.1
1992	902	755.0	170.2	4,425	x	45.3	4,099.1	826	x	x	715.5
1993	655	3,789.4	386.1	6,700	431.6	350.3	4,091.9	995	5,835.0	415.7	787.8
1994	1,002	6,144.5	443.4	6,735	545.2	525.5	5,841.8	2,086	3,980.4	1,691.2	1,499.0
1995	1,236	13,843.0	579.9	11,974	505.7	757.1	14,774.1	1,579	14,382.8	3,363.9	1,820.8
1996	484	12,352.0	636.8	9,720	654.1	772.3	17,844.0	2,103	11,276.4	3,418.9	2,297.4
1997	2,249	9,733.7	757.7	8,408	704.0	1,010.0	20,407.2	3,803	12,894.7	3,230.3	3,314.7
1998	2,831	12,542.1	810.6	9,319	728.2	1,409.1	26,432.3	2,865	7,801.4	2,868.8	3,638.5
1998											
January	2,081	9,872	677.9	8,610	699.2	997.5	20,407.2	3,584	10,479.7	3,106.6	3,261.4
February	2,267	10,420	714.0	9,102	708.2	1,021.7	22,649.1	3,587	10,212.1	3,147.6	3,299.3
March	2,337	10,621	659.1	9,496	743.0	1,096.2	22,789.4	3,311	11,910.5	3,088.3	3,286.1
April	2,385	11,092	700.4	10,011	763.8	1,096.9	23,889.5	3,294	10,956.6	3,294.5	3,350.2
May	2,635	10,996	757.8	10,124	792.2	1,112.8	24,454.0	3,244	9,625.6	3,668.3	4,054.5
June	2,670	10,760	815.8	9,606	805.1	1,109.8	24,278.5	3,270	11,160.5	3,735.6	3,656.4
July	2,679	11,393	734.7	9,746	814.3	1,669.1	25,810.6	3,210	13,805.1	3,715.5	3,568.1
August	2,508	11,435	830.2	9,400	815.3	1,621.3	26,106.9	3,122	8,197.6	3,567.0	3,570.6
September	2,551	12,345	783.8	8,790	739.2	1,472.2	26,112.0	2,872	8,840.3	3,055.8	3,821.8
October	2,599	12,704	754.4	8,249	685.2	1,438.5	26,148.6	2,687	9,656.1	2,932.2	3,852.9
November	2,620	12,351	724.2	8,704	714.0	1,377.1	26,455.6	2,376	8,174.8	2,884.1	3,731.5
December	2,831	12,542	810.6	9,319	728.2	1,409.1	26,432.3	2,865	7,801.4	2,868.8	3,638.5
1999											
January	2,623	12,400	759.0	8,983	724.3	1,309.7	26,141.6	2,746	7,078.2	2,805.8	3,543.8
February	2,629	12,100	730.3	9,432	720.1	1,284.6	25,858.7	2,397	7,284.2	2,855.6	3,523.3
March	2,599	11,900	705.0	..	746.0	1,339.2	25,674.2	2,393	6,678.5	2,759.8	3,868.1

Source: IMF.

## Central Government Surplus / Deficit

	Bulgaria	Czech Republic	Estonia <sup>1)</sup>	Hungary	Latvia	Lithuania	Poland <sup>2)</sup>	Romania <sup>3)</sup>	Russia	Slovak Republic	Slovenia <sup>4)</sup>
<i>% of GDP</i>											
1989	x	-1.2	x	- 3.1	x	x	-3.0	+7.5	x	-0.5	x
1990	x	-0.2	x	- 0.1	x	x	+0.4	-0.4	x	-0.2	x
1991	x	-2.0	x	- 4.6	x	x	-3.8	-1.9	x	-3.4	+2.6
1992	- 5.8	-0.2	x	- 6.7	-3.0	x	-6.0	-4.4	-10.4	-2.8	+0.2
1993	-11.0	+0.1	-0.4	- 5.6	-0.2	x	-2.8	-1.7	- 6.5	-6.2	+0.3
1994	- 6.2	+0.9	-0.6	- 5.5	-1.9	-1.9	-2.7	-4.2	-11.4	-5.2	-0.2
1995	- 6.6	+0.5	+0.3	- 5.5	-3.8	-1.8	-2.4	-4.1	- 5.4	-1.6	+0.0
1996	-10.9	-0.1	-1.6	- 1.9	-0.8	-2.5	-2.4	-4.9	- 7.9	-4.4	+0.3
1997	- 3.9	-1.0	+1.5	- 4.0	+1.2	-1.0	-1.3	-3.6	- 7.0	-5.7	-1.1
1998	+ 0.9	-1.7	-1.8	- 3.3	+0.2	..	-2.4	-3.1	- 6.0	-2.7	-0.6
1997											
1st quarter	- 7.4	-2.2	-0.7	- 5.8	+1.4	-0.5	-3.5	-4.8	x	-2.9	x
2nd quarter	- 3.8	-1.5	-0.4	- 2.6	+2.1	-1.0	-3.7	-2.1	x	-6.0	x
3rd quarter	- 0.9	+1.1	+4.6	- 3.8	+1.4	+1.3	+1.7	-4.2	x	-8.7	x
4th quarter	- 2.6	-1.1	+2.3	- 4.2	-0.1	-3.5	+0.1	-3.5	x	-5.2	x
1998											
1st quarter	+ 7.2	+2.0	-0.7	- 7.6	+3.1	-0.7	-3.0	-3.4	x	+0.7	x
2nd quarter	- 5.7	-1.3	-0.1	- 0.7	+1.0	-0.7	-4.4	-4.9	x	-2.7	x
3rd quarter	+ 6.6	+1.0	-1.5	- 3.0	+0.8	+0.3	-0.8	-0.2	x	-2.4	x
4th quarter	- 2.7	-7.2	-4.9	-10.1	-3.8	-3.9	-1.8	-3.0	x	-5.9	x
1999											
1st quarter	+ 1.6	+0.5	-7.7	- 8.3	+0.3	..	-6.7	..	x	+0.6	x

Source: WIIW; Russia: IMF; Latvia, Lithuania: national sources; Estonia: national sources from 1996. Quarterly data: national sources.

<sup>1)</sup> Including social budget in 1993 and 1994.

<sup>2)</sup> Up to 1990: general government surplus/deficit; since 1998: privatization receipts treated as financing items.

<sup>3)</sup> 1990: including social insurance budget.

<sup>4)</sup> General government deficit; 1998: according to old methodology.

## Gross Debt in Convertible Currencies

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania <sup>1)</sup>	Russia	Slovak Republic	Slovenia
USD million											
1989	9.201.0	x	x	20.751.0	x	x	40.800.0	1.062.0	52.400.0	x	x
1990	10.007.0	x	x	21.505.0	x	x	48.475.0	1.140.0	56.200.0	x	1.954.0
1991	12.247.1	x	x	22.812.0	x	x	48.412.0	2.131.0	70.100.0	x	1.866.0
1992	13.805.7	7.762.3	58.4	21.644.0	64.6	56.0	47.044.0	3.240.0	80.200.0	2.981.0	1.741.0
1993	13.836.4	9.604.9	153.9	24.566.0	235.8	328.0	47.246.0	4.249.0	112.784.0	3.626.0	1.873.0
1994	11.338.4	12.209.7	186.0	28.526.0	373.8	494.0	42.174.0	5.563.0	121.600.0	4.310.0	2.258.0
1995	10.148.0	17.190.3	286.4	31.660.0	462.6	763.0	43.957.0	6.482.0	120.500.0	5.827.0	2.970.0
1996	9.513.9	21.180.5	405.3	27.552.0	472.2	1.286.0	40.558.0	8.345.0	125.000.0	7.810.0	4.010.0
1997	9.676.6	21.616.5	658.0	23.747.0	503.0	1.541.0	38.495.7	9.502.0	130.800.0	10.700.0	4.176.0
1998	10.071.7	24.347.7	..	26.746.8	..	..	42.687.2	9.638.0	145.000.0	11.804.0	4.935.0

Source: WIW; Estonia, Latvia, Lithuania: World Bank; Czech Republic: national sources from 1997.

<sup>1)</sup> Medium- and long-term gross debt.

<sup>2)</sup> The official level of foreign debt was USD 9.9 billion; however this figure was artificially influenced by an accounting operation.

## Exchange Rate

	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Russia	Slovak Republic	Slovenia
Period average (ATS per 100 units of national currency)											
1989	1.575.08	x	x	22.40	x	x	9.194.37	88.68	x	x	x
1990	519.17	x	x	17.99	x	x	1.196.82	50.69	x	x	x
1991	65.63	x	x	15.62	x	x	1.104.00	15.28	x	x	42.35
1992	47.08	x	x	13.91	1.492.10	620.86	806.49	3.57	x	x	13.52
1993	42.16	39.90	87.97	12.65	1.722.52	268.02	642.13	1.53	1.162.41	37.80	10.27
1994	21.10	39.67	87.92	10.86	2.040.70	286.98	502.65	0.69	516.66	35.65	8.87
1995	15.01	37.99	87.93	8.02	1.910.82	252.04	415.73	0.50	219.13	33.93	8.51
1996	5.95	39.01	87.97	6.94	1.922.39	264.67	392.66	0.34	204.87	34.54	7.82
1997	0.73	38.50	87.91	6.53	2.100.91	305.11	372.16	0.17	209.07	36.30	7.64
1998	0.70	38.34	87.95	5.77	2.098.86	309.48	356.19	0.14	127.55	35.14	7.45
1998											
January	0.70	36.13	87.95	6.19	2.147.23	319.40	361.05	0.15	213.11	36.36	7.46
February	0.70	36.95	87.90	6.14	2.155.84	319.07	360.67	0.16	210.96	36.13	7.45
March	0.70	37.80	87.97	6.10	2.163.67	321.31	371.53	0.16	211.05	36.68	7.46
April	0.70	37.79	87.95	6.04	2.142.27	319.20	373.40	0.15	208.50	36.50	7.48
May	0.70	38.40	88.01	5.93	2.098.86	312.21	365.28	0.15	203.11	36.48	7.52
June	0.70	37.89	88.00	5.84	2.101.05	315.16	362.36	0.15	204.00	36.22	7.52
July	0.70	39.59	87.93	5.81	2.104.36	316.18	365.61	0.15	203.45	36.20	7.48
August	0.70	39.12	87.99	5.68	2.086.73	314.58	350.99	0.14	186.43	35.70	7.46
September	0.70	39.00	87.94	5.44	2.041.60	299.61	332.29	0.13	82.50	34.38	7.44
October	0.70	39.38	87.90	5.34	2.020.51	287.92	329.48	0.12	72.33	32.03	7.43
November	0.70	39.75	87.97	5.43	2.060.85	295.73	367.47	0.12	71.82	32.79	7.39
December	0.70	39.04	87.92	5.40	2.055.17	293.38	336.65	0.11	58.70	32.41	7.32
1999											
January	0.05	2.81	6.39	0.40	151.14	21.54	24.33	0.01	3.87	2.34	0.53
February	0.05	2.66	6.40	0.40	154.13	22.31	23.52	0.01	3.90	2.33	0.53
March	0.05	2.64	6.40	0.39	156.54	22.97	23.30	0.01	3.91	2.26	0.53
April	0.05	2.63	6.39	0.40	160.10	23.36	23.47	0.01	3.90	2.23	0.52
May	0.05	2.65	6.39	0.40	160.19	23.50	23.92	0.01	3.92	2.18	0.52

Source: IMF; Czech Republic: national sources from January 1999; Estonia, Lithuania, Slovak Republic, Slovenia: national sources from April 1999; Hungary, Poland: OeNB from April 1999; Bulgaria, Latvia, Romania, Russia: OeNB, end of period from April 1999.

<sup>1)</sup> Up to December 31, 1998 in ATS; as of January 1, 1999, in EUR.

# Official Lending Rate<sup>1)</sup>

	Bulgaria	Czech Republic	Estonia	Hungary <sup>2)</sup>	Latvia	Lithuania	Poland	Romania	Russia <sup>3)</sup>	Slovak Republic	Slovenia
<i>End of period</i>											
1989	x	x	x	17.0	x	x	104.0	x	x	x	x
1990	4.5	x	x	22.0	x	x	48.0	x	x	x	x
1991	54.0	9.5	x	22.0	x	x	36.0	18.0	5.0	9.5	x
1992	41.0	9.5	x	21.0	120.0	x	32.0	70.0	80.0	9.5	25.0
1993	52.0	8.0	x	22.0	27.0	x	29.0	70.0	210.0	12.0	18.0
1994	72.0	8.5	x	25.0	25.0	x	28.0	58.0	180.0	12.0	16.0
1995	34.0	9.5	x	28.0	24.0	x	25.0	35.0	160.0	9.8	10.0
1996	180.0	10.5	x	23.0	9.5	x	22.0	35.0	48.0	8.8	10.0
1997	6.7	13.0	x	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
1998	5.1	7.5	x	17.0	4.0	13.0	18.3	35.0	60.0	8.8	10.0
1998											
January	6.1	13.0	x	20.5	4.0	13.0	24.5	40.0	28.0	8.8	10.0
February	5.5	13.0	x	20.0	4.0	13.0	24.5	40.0	39.0	8.8	10.0
March	5.3	13.0	x	20.0	4.0	13.0	24.5	40.0	30.0	8.8	10.0
April	5.4	13.0	x	19.5	4.0	13.0	24.5	40.0	30.0	8.8	10.0
May	5.1	13.0	x	19.5	4.0	13.0	23.5	40.0	150.0	8.8	10.0
June	5.2	13.0	x	19.0	4.0	13.0	23.5	40.0	80.0	8.8	10.0
July	5.2	13.0	x	19.0	4.0	13.0	21.5	40.0	60.0	8.8	10.0
August	5.1	11.5	x	18.0	4.0	13.0	21.5	35.0	60.0	8.8	10.0
September	5.1	11.5	x	18.0	4.0	13.0	21.5	35.0	60.0	8.8	10.0
October	5.3	10.0	x	18.0	4.0	13.0	20.0	35.0	60.0	8.8	10.0
November	5.1	10.0	x	18.0	4.0	13.0	20.0	35.0	60.0	8.8	10.0
December	5.1	7.5	x	17.0	4.0	13.0	18.3	35.0	60.0	8.8	10.0
1999											
January	5.0	7.5	x	17.0	4.0	13.0	15.5	35.0	60.0	8.8	8.0
February	4.9	7.5	x	16.0	4.0	13.0	15.5	35.0	60.0	8.8	8.0
March	4.8	7.5	x	16.0	4.0	13.0	15.5	35.0	60.0	8.8	8.0
April	..	..	x	..	4.0	..	15.5	..	..	..	8.0
May	..	..	x	..	4.0	..	15.5	..	..	..	8.0

Source: IMF; Poland, Russia: national sources; Lithuania, Romania: OECD.

<sup>1)</sup> Due to currency board arrangements, the Bank of Estonia and the Bank of Lithuania do not lend to the government or enterprises. Therefore these two countries do not define or publish discount rates.

On October 9, 1997, the Bank of Lithuania introduced an official lending rate: weighted average rate on domestic currency lending to residents.

<sup>2)</sup> Base rate.

<sup>3)</sup> Refinancing rate.

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