Exchange Rate Arrangements and Monetary Policy in Southeastern Europe and Turkey: Some Stylized Facts

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This paper offers an analytical overview of exchange rate regimes and monetary policy frameworks in the countries of Southeastern Europe and Turkey. The following ten countries/nonsovereign territories are analyzed here: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo,[2] the Former Yugoslav Republic of Macedonia (FYROM), Montenegro, Romania, Serbia and Turkey. Hard pegs and nominal exchange rate anchors feature in four cases, managed floats and money growth targeting in three cases, unilaterally euroized regimes in two cases, and a managed float and real exchange rate anchor in one case. The paper deals with the institutional importance as well as the unofficial role of the euro in Southeastern Europe. Furthermore, individual countries'/territories' economic developments in recent years (2001–04) and current monetary and exchange rate policies, instruments, issues and outcomes are explored in more detail. Inflation is found to have been on a declining and monetization on a rising trend across the region. In a number of cases, inflation performance can be explained by the stabilizing influence of the exchange rate as an external anchor. But some countries with money growth targeting strategies and loosely managed floats have also boasted low price rises. Overall monetary and economic policy credibility and perseverance may be the key to success here. The paper concludes with a brief outlook focusing on the euro as a stable anchor and point of convergence.

1 Introduction

The following article attempts to give an analytical overview of exchange rate regimes and monetary policy frameworks in the countries of Southeastern Europe and Turkey. Since Serbia and Montenegro (as a subject of international law) comprises three separately managed currency areas, namely the republics of Serbia and of Montenegro and the province of Kosovo, these three political entities will be dealt with separately in the following study, notwithstanding the fact that none of the three constitute a sovereign country. Accordingly, the following ten countries/nonsovereign territories are analyzed here: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, the Former Yugoslav Republic of Macedonia (FYROM), Montenegro, Romania, Serbia and Turkey.

Section 2 provides a general overview of the demographic and economic sizes and per capita incomes of the ten quite heterogeneous countries/territories of the region. Section 3 presents a global descriptive outline of the paper's topic and also sketches the institutional importance of the euro as an economic factor or anchor for these countries. Section 4 focuses on the unofficial role of the euro in Southeastern Europe, euro legacy currencies circulating inside and outside banking sectors (up to end-2001), the effect of the euro cash changeover (of end-2001) and euro-denominated deposits (up to end-2002). Individual countries'/territories' economic developments in recent years (2001 to September 2004) and current monetary and exchange rate policies, instruments, issues and outcomes are dealt with in somewhat more detail in section 5. Section 6 gives a summarizing comparison of major results of the preceding section and draws some overall conclusions.

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2 *In this study, the term Kosovo denotes Kosovo/Kosova.*

2 Basic Traits of the Region's Countries and Territories

Compared to the European Union, the Southeastern European countries are economically small to miniscule players. As can be seen from table 1, Southeastern Europe – without Turkey – comprises a territory of about 15% the size of the EU-25's territory; its population comes to 12% of that of the EU-25, and its GDP equals just 1.2% of the GDP[3] of the EU-25. The largest former socialist country of the region, Romania, has an economy whose size corresponds to roughly 0.5% percent of that of the EU-25. The smallest (nonsovereign) republic, Montenegro, accounts for 0.012% of the EU-25's GDP. Average per capita GDP in Southeastern Europe without Turkey comes to about a tenth of the average level of the European Union.

Adding Turkey changes the equation quite a bit. Not only in terms of territory, but also with respect to population and economic power does Turkey outweigh all other Southeastern European countries taken together. Turkey's GDP per capita is somewhat higher than Southeastern Europe's average. Including Turkey, the region's territory comes to 35% of that of the EU-25; its population would reach 27%, but again, the size of its economy would remain relatively modest – slightly above 3% of that of the EU-25.[4]

Table 1

Southeastern European Countries' and Territories'

Basic Characteristics

Country	Territory (km^2)	Population (2002, million)	GDP (2002, EUR billion)	GDP per capita (2002, EUR)
Albania	28,700	3.15	5.13	1,630
Bosnia and Herzegovina	51,100	4.11	5.94	1,445
Bulgaria	111,000	7.97	16.43	2,060
Croatia	56,500	4.47	23.80	5,325
Kosovo (Serbia)	10,900	1.96	1.40[1]	715[1]
FYROM	25,700	2.02	4.02	2,000
Montenegro	13,800	0.65	1.20[1]	1,850[1]
Romania	238,400	21.75	48.52	2,230
Serbia (without Kosovo)	77,500	7.52	14.00[1]	1,860[1]
Southeastern Europe without Turkey	**613,000**	**53.60**	**120.44[1]**	**2,245[1]**
Turkey	779,500	69.63	194.87	2,800
Southeastern Europe with Turkey	**1,393,100**	**123.2**	**315.3[1]**	**2,560[1]**
EU-15	3,234,500	379.7	9,234.3	24,320
New Member States	738,600	74.5	438.1	5,880
EU-25[2]	3,973,100	454.2	9,672.4	21,295

Source: Fischer Weltalmanach 2005, IMF and author's own estimates.
[1] Estimate.
[2] EU-25 refers to all old and new EU Member States after the enlargement of May 1, 2004.

3 Exchange Rate Regimes and Monetary Policy Frameworks in the Region

The euro plays an important official and/or unofficial[5] role for the economies and economic policies of Southeastern European countries. Five of the ten analyzed countries – namely successor countries/territories to the former Socialist Federal Republic of Yugoslavia – changed their currencies in the 1990s. Seven of

[3] *The GDP ratio is calculated on the basis of exchange rates. If purchasing power parities were used, the ratio might be two to four times as large. See also Gligorov, 2004, p. 52.*

[4] *The size of Southeastern Europe's plus Turkey's economy would likely exceed 6% of that of the EU-25 if purchasing power parities were taken into account.*

[5] *See section 4.*

Table 2

Southeastern European Countries' and Territories' Monetary Characteristics

Country	Current currency; previous currency	Current exchange rate regime; previous regime	Convertibility	Current monetary policy framework; previous framework
Albania	Albanian lek (ALL)	Loosely managed float (since the early 1990s), major reference currencies: EUR (up to January 1, 1999: DEM), USD	Not yet unrestricted current account convertibility (IMF Article XIV status)	Informal inflation targeting through money growth targeting (since 1998)
Bosnia and Herzegovina	Konvertibilna marka (BAM, since June 1998); YUD and HRK (used regionally), DEM (country-wide) (until December 1999); YUD (until the early 1990s)	Currency board, peg to EUR (up to January 1, 1999: DEM) (formally introduced: August 1997, de facto since mid-1998); multiple currencies	Full (or almost full) convertibility	Nominal exchange rate anchor EUR (DEM) (since August 1997)
Bulgaria	Bulgarian lev (BGL)	Currency board, peg to EUR (up to January 1, 1999: DEM) (since July 1997); managed float	Full (or almost full) convertibility (IMF Article VIII acceptance: September 1998)	Nominal exchange rate anchor EUR (DEM) (since July 1997); money growth targeting
Croatia	Croatian kuna (HRK) (since May 1994); Croatian dinar (transitionally); YUD	Tightly managed float, reference currency: EUR (up to January 1, 1999: DEM) (since October 1993)	Almost full convertibility (IMF Article VIII acceptance: May 1995, capital flows, except short-term, liberalized)	Nominal exchange rate anchor EUR (DEM) (since October 1993)
Kosovo (Serbia)	All foreign currencies legalized for transactions, EUR (DEM) predominant, YUD used regionally (since September 1999); YUD	All foreign currencies legalized for transactions, EUR (DEM) predominant, YUD used regionally (since September 1999); YUD	Full (or almost full) convertibility	EUR legal tender (since September 1999)
Former Yugoslav Republic of Macedonia	Macedonian denar (since April 1992); YUD	Peg to EUR (up to January 1, 1999: DEM) (since the early 1990s)	Current account convertibility (IMF Article VIII acceptance: June 1998)	Nominal exchange rate anchor EUR (since the early 1990s)
Montenegro	Unilaterally euroized/EUR (since November 2000); November 1999–2000: EUR (DEM) parallel currency to YUD; previously: YUD	Unilaterally euroized/EUR (since November 2000); November 1999–2000: EUR (DEM) parallel currency to YUD; previously: YUD	Full (or almost full) convertibility	EUR legal tender (since November 1999/2000)
Romania	Romanian leu (ROL)	Managed float (since 1991), reference basket: EUR (75%), USD (25%) (since early 2004), EUR (60%), USD (40%) (since early 2002); previously: reference currency: USD	Current account convertibility (IMF Article VIII acceptance: March 1998)	Money growth targeting (since the early 1990s)
Serbia (without Kosovo)	(Yugoslav) dinar (YUD)	Managed float (since January 2003); previously: tightly managed float, reference currency: EUR (as of December 2000); peg to EUR (DEM)	Current account convertibility (IMF Article VIII acceptance: May 2002)	Real exchange rate anchor (since January 2003); previously: nominal anchor EUR (DEM) (as of 1994)
Turkey	Turkish lira (TRL)	Loosely managed float (since February 2001); crawling peg, reference basket: USD (56%), EUR (44%) (as of December 1999); previously: managed float (as of early 1998)	Full (or almost full) convertibility (IMF Article VIII acceptance: March 1990)	Money growth targeting, informal inflation targeting (since February 2001); exchange rate anchor (USD/EUR basket); monetary targeting

Source: Author's own compilations.

the ten countries have tied their monetary policy to an external anchor. This external anchor is – without exception – the euro, as shown in table 2. Two of these seven countries (Bosnia and Herzegovina, and Bulgaria) operate under currency board arrangements, and two (nonsovereign) territories (Montenegro and Kosovo) have adopted the euro as their legal tender. Macedonia has pegged its currency to the euro, Croatia and Serbia have conducted tightly managed floats (with the euro as the reference currency). In early 2003, Serbia somewhat loosened its stance and can now be characterized as pursuing a real exchange rate anchor.[6]

Three countries (Albania, Romania and Turkey) have practiced managed or loosely managed floats, coupled with money growth targeting (table 2). Romania uses a reference basket for its float in which the euro has the largest weight. The three countries are aiming for inflation targeting at a future stage. The currencies of six countries/territories (Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Montenegro as well as Turkey) are fully (or almost fully) convertible. Three other countries' currencies (Macedonia, Romania and Serbia) are convertible for current account transactions. The Albanian currency does not yet feature unrestricted current account convertibility (IMF, 2003, pp. 24–28).

4 Unofficial Euroization in Southeastern Europe

Southeastern European countries are among the transition countries where the levels of foreign currency held by residents are highest. According to recent estimates (Feige, 2002), the share of foreign currency holdings in broad money amounts to about 75% in Croatia, 55% in Bulgaria, more than 40% in Turkey and over 35% in Romania. The foreign currencies held in the region primarily include the euro and to a smaller extent U.S. dollars, Swiss francs, etc. In this sense one can also speak of euroization, more precisely of unofficial euroization – as opposed to official or unilateral euroization, which is the reality for the Republic of Montenegro, or as opposed to the official introduction of the euro as a dominant legal tender in the province of Kosovo. The latter can be regarded as a de facto unilateral euroization, even if the decision-making body in this case was the UN provisional administration.

The EUR 36 billion of euro banknotes shipped by banks to destinations outside the euro area between December 2001 and June 2003 provide another approximate indicator of the amount of euro banknotes circulating abroad. These account for around 10% of the total volume of euro in circulation. To give some details on the implications and effects of the cash changeover, Turkey and Croatia ranked above (in absolute terms) all of the EU's other eastern and southern neighbors as regards euro-denominated bank accounts at end-2001. In Turkey they amounted to over EUR 12 billion, in Croatia to around EUR 8 billion. In Croatia the share of euro-denominated deposits in total deposits rose from 56% in December 2000 to 62% in December 2001, then declined to 57% at end-2002. In Bosnia the respective share expanded from 38% to 50%, then receded to 46%; in Bulgaria it moved from 12% via 18% to 16% and in Turkey from 12% via 15% to 16%. In Kosovo and Montenegro, the share was, of course, (almost) 100%, and in Serbia it was also very high (81% at end-2002) (ECB, 2003, pp. 50–52).

This change implies that the sum of cash euros in circulation in the region has decreased. Banks have benefited from the surge of euro deposits, which also bears witness to the enhanced trust the public of various countries has in the banking sector. Given that the majority owners of most Southeastern European

[6] *For more information on the – quite eventful – historical background of economic developments in the countries of the Western Balkans see Barisitz, 1999.*

countries' banking sectors are financial institutions of euro area countries, it is also likely that financial links between banks of the EU's neighboring regions and of the euro area have further strengthened.

Outside bank accounts, on the whole about EUR 19 billion of euro legacy currencies were exchanged for euro cash in connection with the cash changeover. Up to EUR 10 billion of legacy currencies, by contrast, may have been exchanged for other international currencies, mainly the U.S. dollar, implying a switch from currency substitution based on the euro to currency substitution based on other international currencies. But since 2002 and the euro's appreciation against the U.S. dollar, the common European currency seems to have gained ground and popularity in the region. According to surveys commissioned by the Oesterreichische Nationalbank and undertaken by the Gallup Institute in Croatia, Slovenia and Central European countries in late 2002, mid-2003 and late 2003, the euro is perceived as more stable than the American currency. This view is also likely to be held in other parts of Southeastern Europe and Turkey. Experts estimate euro cash in circulation (outside banks) to come to EUR 1.6 billion in Croatia, EUR 440 million in Kosovo and EUR 250 million in Montenegro.

5 Individual Countries' and Territories' Economic Developments and Current Monetary Policy Issues

5.1 Albania

Albania has witnessed robust growth in recent years, although the country remains saddled with serious structural shortcomings, particularly in the area of governance and rule of law. Administrative barriers to investment and business creation remain massive and so does the scale of the informal economy. Albania's macroeconomic weakness is reflected by its sizeable twin deficits (general government budget and current account), even after (declining) official grants are accounted for. In 2002 and 2003, net FDI inflows covered around half of the current account shortfall. In 2004, this share is likely to be higher. Notwithstanding the external disequilibrium, foreign liabilities are relatively low.

Table 3

Albania: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	6.5	4.7	6.0	6.3
General government budget balance (% of GDP)				
before grants	−8.2	−6.7	−4.7	−6.2
after grants	−7.6	−6.1	−4.1	−5.7
Trade balance (% of GDP)	−24.2	−23.8	−21.9	−21.5
Current account balance (% of GDP)				
before grants	−6.2	−9.0	−7.6	−7.8
after grants	−3.2	−6.5	−5.1	−6.0
Net FDI inflows (% of GDP)	4.8	2.8	2.9	4.5
Gross foreign debt (end-year, % of GDP)	28.0	24.2	23.0	21.5
Gross central bank reserves (excluding gold, end-year, % of GDP)	17.8	17.8	16.5	15.0
Repo rate (end-year, %)	7.0	8.5	6.5	. .
Broad money growth (nominal, end-year over preceding end-year, %)	20. Feb	5.7	7.7	11.0
CPI inflation (end-year, %)	3.5	2.1	3.3	3.3
Average exchange rate: ALL/EUR	128.5	132.4	137.5	135
Average exchange rate: ALL/USD	143.5	140.2	121.9	. .
Unemployment rate (registered, end-year, %)	16.4	15.8	15.2	14.5

Source: National statistics, Bank of Albania, IMF, European Commission, EBRD, BIS.
[1] *Preliminary data or estimates.*
[2] *Forecasts.*

The Albanian central bank's cautious monetary policy has contributed to keeping inflation at low single-digit levels in recent years. The central bank has conducted a policy of informal inflation targeting and in 2002 and 2003 successfully committed to holding CPI end-year inflation within a band of 2% to 4%. To achieve this, the monetary aggregate M3 and interest rates have been targeted. The monetary authorities intervene by varying their net domestic assets and net international reserves, by changing repo (repurchase agreement) rates as well as reverse repo rates and by conducting open market operations. Albania's money growth targeting is complemented by its flexible exchange rate regime (loosely managed float). The central bank buys and sells on the foreign exchange market to smooth out speculation or sudden movements (relative to the euro and the U.S. dollar). However, the exchange rate can also become a (secondary) policy objective, but only if inflation remains comfortably within the set band.

The fragility of Albania's banking system was exposed by bank runs and massive deposit withdrawals in the spring of 2002. These runs had been triggered by the failed attempt to privatize the largest Albanian credit institution, the state-owned Savings Bank, and by public misunderstanding and confusion over the parliamentary discussion of the draft law on deposit insurance, coupled with heightened political instability in the shadow of the memory of the pyramid scheme collapse of 1997. The Albanian central bank addressed the crisis by granting liquidity assistance to some large distressed credit institutions and by strongly increasing the repo rate.

Credit institutions' liquidity problems were overcome in the second half of 2002; deposits returned and over the course of 2003 the repo rate was reduced again in successive stages to beyond its pre-crisis level. Contrary to 2002, 2003 and early 2004 saw the lek come under appreciation pressure, which was countered by central bank interventions and further interest rate cuts. The purchases on the foreign exchange market were not fully sterilized to give room for money demand to recover. Still, by mid-2004, the real effective exchange rate of the lek was about 10% higher than a year earlier, which put pressure on the competitiveness of Albanian exports. In April 2004, after painful restructuring measures, the country's largest bank, the Savings Bank (representing over half of total bank deposits), was finally and successfully privatized and sold to a foreign strategic investor, i.e. the Austrian Raiffeisen Zentralbank. This should contribute to improving confidence. Although Albania is still underbanked – even compared to other Southeastern European countries – lending is now in a process of dynamic expansion.

5.2 Bosnia and Herzegovina

Since the end of the war of 1992–95, Bosnia and Herzegovina has received considerable, if declining, international reconstruction assistance (roughly EUR 6 billion so far). Despite this assistance, the country has not yet been able to develop viable and competitive export-oriented capacities. The state's political structure remains strongly decentralized, fragile and segmented in the two ethnically defined entities – the Muslim-Croat Federation (Federation of Bosnia and Herzegovina) and the Republika Srpska. However, initiatives aimed at selective centralization in some areas, including military control, customs

Table 4

Bosnia and Herzegovina:

Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	4.4	5.5	3.5	4.6
General government budget balance (% of GDP)				
before grants	−10.4	−7.3	−3.0	−3.4
after grants	−3.3	−2.2	0.4	−0.1
Trade balance (% of GDP)	−32.8	−36.8	−34.5	−30.3
Current account balance (% of GDP)				
before grants	−23.3	−23.8	−21.3	. .
after grants	−16.2	−18.5	−17.4	−15.8
Net FDI inflows (% of GDP)	2.6	4.1	4.5	4.8
Gross foreign debt (end-year, % of GDP)	49.8	41.3	34.7	33.0
Gross central bank reserves (excluding gold, end-year, % of GDP)	24.6	21.5	22.8	23.2
Broad money growth (nominal, end-year over preceding end-year, %)	89.3	8.6	8.3	. .
CPI inflation (annual average, %)	3.2	0.3	0.1	0.9
Federation of Bosnia and Herzegovina	1.9	−0.2	−0.5	0.8
Republika Srpska	7.0	1.7	1.9	1.4
Average exchange rate: BAM/EUR	1.96	1.96	1.96	1.96
Average exchange rate: BAM/USD	2.19	2.08	1.73	. .
Unemployment rate (registered, end-year, %)	40.3	40.9	42.0	. .

Source: National statistics, Centralna banka Bosne i Herzegovine, IMF, European Commission, EBRD, BIS.
[1] *Preliminary data or estimates.*
[2] *Forecasts.*

administration and indirect taxation, have recently proven successful. The gradual reduction of external assistance has been accompanied by lower economic growth in recent years.

Attempts to dismantle bureaucratic barriers and to improve the business environment contributed to a doubling of FDI inflows in 2002, but the latter remain far from matching the huge and persistent current account shortfalls. Fiscal as well as monetary policies have been prudent in recent years, though; in particular the currency board regime has become a stabilizing anchor for the economy. Foreign debt has been on the decline. But the authorities have recently come under mounting pressure to step up spending on pensions, war veterans' benefits and other domestic claims.

Centralna banka Bosne i Herzegovine has functioned as a currency board since 1998, irrevocably fixing the exchange rate of the konvertibilna marka to the Deutsche mark (later: euro) and backing up unlimited convertibility of the domestic currency to the reserve currency by an adequate amount of foreign exchange reserves. No independent monetary policy is conducted; the central bank can neither grant credits to the government, nor act as a lender of last resort to banks. The monetary authorities can neither change the exchange rate, nor are they in control of the quantity of money. Managing reserve requirements is the only monetary policy tool currently at the disposal of the central bank. The latter has been quite successful in contributing to keeping inflation at low levels. The overall price level hardly increased in 2002 and 2003 – which even implied slight deflation in the Federation. In recent years, price level changes have also been on a converging tendency between the Federation and the Republika Srpska, whose economic structures are quite different. This may be a sign of increasing domestic economic integration. The monetary authorities seem to perceive the currency board also as a kind of "structural whip" which puts pressure on the corporate sector to modernize.

Still, the level of unofficial euroization in Bosnia and Herzegovina is among the highest in the region. In the wake of bank privatization and in connection with the euro changeover, bank deposits soared, and bank loans to households more than doubled in 2002 (albeit from a low base). This pushed up imports and called for intervention by the central bank, which reformed and raised reserve requirements, thereby tightening its monetary stance. The tightening is estimated to have slowed down credit growth and to have slightly reduced the external disequilibrium in 2003. New, more restrictive bank capital requirements were preannounced to take effect at end-2003. The banking sector is one of the few areas in which substantial progress in structural reform has been achieved. The official unemployment rate amounted to around 40% in 2002 and 2003, but owing to the large number of people in the informal economy, unofficial estimates put the actual rate at around 20%. The extensive joblessness renders thorough restructuring efforts and layoffs quite difficult.

5.3 Bulgaria

Following a deep financial and economic crisis in 1996–97, Bulgaria has since July 1997 strictly adhered to a Deutsche mark/euro-based currency board regime. In recent years, the Bulgarian economy has witnessed overall favorable macroeconomic developments. GDP has on average expanded by 4% to 5% annually. The current account deficit has been consistently high and increased further in 2003, but FDI inflows have also been substantial and covered most of the shortfall, although the gap has widened just recently and has given rise to concern. Triggered by sizeable modernization investments, competitiveness has been sustained. Foreign debt, which used to be at unsustainably high levels, has contracted as a share of GDP. Currency reserves have been on the rise. Inflation is modest, but accelerated somewhat in late 2003 and early 2004 due to food price rises in the wake of an exceptionally poor harvest, oil price hikes, excise tax adjustments and demand pressures. Fiscal policy is cautious; deficits have recently reached about half a percent of GDP, and in 2004 a surplus of the same magnitude is expected. Still, poverty and public dissatisfaction continue to be widespread.

Table 5

Bulgaria: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	4.1	4.9	4.3	5.2
General government budget balance (% of GDP)	−0.9	−0.6	−0.3	0.5
Trade balance (% of GDP)	−11.7	−10.3	−12.5	−13.5
Current account balance (% of GDP)	−7.3	−5.6	−8.5	−8.6
Net FDI inflows (% of GDP)	5.9	5.5	7.0	7.7
Gross foreign debt (end-year, % of GDP)	79.4	65.1	59.1	56.4
Gross central bank reserves (excluding gold, end-year, % of GDP)	26.8	27.7	30.2	30.0
Base rate (end-year, %)	4.7	3.4	2.9	. .
Broad money growth (nominal, end-year over preceding end-year, %)	25.8	11.7	19.6	21.0
CPI inflation (end-year, %)	4.8	3.8	5.6	4.7
Average exchange rate: BGL/EUR	1.96	1.96	1.96	1.96
Average exchange rate: BGL/USD	2.18	2.08	1.73	1.7
Unemployment rate (according to labor force survey, average, %)	19.7	17.8	13.7	13.1

Source: National statistics, Bulgarian National Bank, wiiw, IMF, EBRD, BIS.
[1] Preliminary data or estimates.
[2] Forecasts.

Monetization of the economy is increasing and financial intermediation by the banking sector, which has been very weak for years, is gaining momentum and reflecting a catching-up process. 2002 and 2003 even witnessed a credit boom – with growth in bank claims on enterprises and households accelerating from 31% in 2002 to 44% in 2003 and around 47% in the first half of 2004 (year on year in real terms) – which has entailed vigorous inflows of imports and contributed to the deterioration of the current account and to inflationary pressures. There are, however, indications of a slight slowdown for the summer of 2004. The credit boom was partly triggered by the increase of bank deposits linked to the euro changeover, partly by a repatriation of banks' lower-earning foreign assets, and partly by the overall favorable macroeconomic situation and strengthened confidence in the banking system. As of end-2003, the banking sector was fully privatized, with the overwhelming share of assets being held by foreign banks.

While prudential indicators have not yet shown signs of deterioration, the monetary authorities have strengthened supervisory oversight and standards to encourage prudent lending. In early 2004, capital adequacy requirements for credit institutions were tightened, which mandated banks to set aside larger provisions. Given the Bulgarian currency board regime, the monetary authorities do not have many instruments which allow them to directly intervene to cool down money demand. In April 2004 the government announced a package of measures to calm monetary pressures. One of these measures was the withdrawal of government funds (part of its fiscal reserve) deposited with credit institutions in order to reduce the level of liquidity in the banking system. At the beginning of July, the Bulgarian central bank broadened the coverage of reserve requirements. However, after rising in May, interbank money market rates declined again in the summer months. The authorities stand ready to resort to further liquidity tightening measures if necessary, including credit ceilings.

5.4 Croatia

The Croatian economy has steadily grown since the turn of the millenium. Inflation has almost without exception been in the low single digits for a decade now. But Croatia has suffered from twin deficits (budget and current account) in recent years. Net FDI inflows have been high, but not always sufficient to cover the current account gap. Gross foreign liabilities have swiftly expanded and are likely to surpass 75% of GDP in 2004, which is cause for concern. The largest part of the recent debt expansion stems from credit institutions' borrowing from parent banks abroad, followed by borrowing abroad by the state and companies. Gross foreign currency reserves, while sizeable and clearly exceeding money in circulation, have recently declined.

Notwithstanding the country's sustained low inflation performance, the extent of unofficial euroization in Croatia remains among the highest in the world. This restricts the degree of freedom for an independent monetary policy. Since the lion's share of Croatian banks' liabilities is made up of foreign currency, banks need to match their currency position by extending loans, mostly in foreign exchange. They may also offer foreign currency-indexed (mostly euro) kuna loans. In this way, they transfer most of the foreign exchange risk

Table 6

Croatia: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	4.4	5.2	4.3	3.6
General government budget balance (% of GDP)	−6.8	−5.0	−6.3	−4.5
Trade balance (% of GDP)	−20.9	−24.3	−27.0	−26.0
Current account balance (% of GDP)	−3.7	−8.5	−6.6	−5.7
Net FDI inflows (% of GDP)	7.2	4.4	5.3	3.5
Gross foreign debt (end-year, % of GDP)	57.9	60.9	73.3	76.5
Gross central bank reserves (excluding gold, end-year, % of GDP)	24.1	23.3	25.5	22.9
Discount rate (end-year, %)	5.9	4.5	4.5	. .
Broad money growth (nominal, end-year over preceding end-year, %)	45.2	9.5	11.0	9.4
CPI inflation (end-year, %)	2.6	2.3	1.8	2.8
Average exchange rate: HRK/EUR	7.47	7.41	7.56	7.6
Average exchange rate: HRK/USD	8.34	7.86	6.70	. .
Unemployment rate (according to labor force survey, average, %)	15.9	14.8	14.3	14.0

Source: National statistics, Hrvatska narodna banka, wiiw, IMF, European Commission, EBRD, BIS.
[1] *Preliminary data or estimates.*
[2] *Forecasts.*

to their often unhedged clients. Thus, the exchange rate risk becomes part of banks' credit risk. The stability of the banking sector may become dependent on the stability of the domestic currency.

Croatia practices a tightly managed float with the euro as an exchange rate anchor. In fact, for the last ten years (since October 1993) the exchange rate of the kuna has been fluctuating in a corridor of approximately ±8% around the euro. Monetary policy is predominantly carried out through foreign exchange market interventions. Given the dominance of capital inflows in recent years, interventions have increased liquidity, which subsequently had to be sterilized by selling central bank bills or treasury bills. At the beginning of 2003, foreign currency reserves came to approximately twice the value of base money and to one and a half times M1. But the central bank has not fixed the exchange rate. Thus, a limited degree of exchange rate flexibility has been retained so far, also to discourage one-sided bets of speculators.

Any substantial appreciation of the kuna would endanger Croatian enterprises' already fragile competitiveness, while a depreciation would increase real indebtedness and jeopardize banks' balance sheets. The Croatian central bank has not intensively used interest rate policy, but reserve requirements have been frequently applied, sometimes even as an instrument to sterilize local currency liquidity, support the exchange rate and break speculation. This has happened recently, with the goal of reining in strong credit expansion partly linked to the rise in bank deposits in connection with the euro changeover. The credit boom threatened to aggravate the current account imbalance and foreign indebtedness.

In response, monetary policy became increasingly restrictive: As of early 2003, banks were required to hold 20% of the reserve requirement on foreign currency in kuna. By December 2003, this ratio had successively been ratcheted up to 42%. An administrative measure introduced the compulsory purchase of central bank bills if a credit institution's loans expanded at a rate higher than 16% per annum. In the fourth quarter of 2003 the monetary authorities also repeatedly intervened on the foreign exchange market to support the kuna. As a consequence, nominal credit growth appears to have declined from 31% in 2002 to an estimated 11% in February 2004 (year on year). Especially in late

2003 and early 2004, private consumption and investment lost some steam. In the first months of 2004, upward pressures on the kuna reemerged, spurred by market need to adjust to the mentioned monetary policy measures. A substantial impact of the monetary tightening on foreign indebtedness has yet to materialize.

5.5 Kosovo (Serbia)

Kosovo's economic recovery from the war of 1999 was almost totally driven by foreign financial aid and remittances from the Kosovar diaspora. The decline of external donor assistance in 2002 and 2003 contributed to a sharp slowdown of GDP growth in these two years. Foreign grants have shrunk from over 100% to less than 50% of GDP. Workers' remittances equal around 40% to 45% of the size of the economy and have been essential to the survival of many Kosovar families. A viable export sector is not yet in sight. Per capita income is still among the lowest and the jobless rate among the highest in Europe. Given a weak business climate, insufficient rule of law, shaky security, sluggish privatization and structural reforms as well as uncertainty about the province's future status, foreign investors have been extremely reticent so far. Overall investment in productive structures has remained feeble.

Table 7

Kosovo: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]
GDP growth (real, %)	11.0	7.0	4.6
Consolidated government[2] budget balance (% of GDP)			
before grants	3.6	5.9	1.4
after grants	10.9	8.4	3.6
Trade balance (% of GDP)	−112.7	−88.8	−81.4
Current account balance (% of GDP)			
before grants	−110.2	−88.7	−70.1
after grants	−19.1	−30.8	−29.4
Net FDI inflows (% of GDP)	0.3	0.6	. .
Gross central bank reserves (excluding gold, end-year, % of GDP)	18.7	20.5	. .
Broad money growth (nominal, end-year over preceding end-year, %)	21.9	0.2	−18.3
CPI inflation (end-year, %)	11.7	3.6	1.5
Unemployment rate (%)		50−55[1]	

Source: Banking and Payments Authority of Kosovo (BPK), European Commission, IMF.
[1] Preliminary data or estimates.
[2] Comprises central government and municipalities.

On a more positive note, the private service sector, although largely operating in the informal economy, is reported to be vibrant. Small-scale agricultural production has also rebounded. Prudent fiscal policy has even created budget surpluses. The UN administration of Kosovo, more precisely the EU-led Pillar IV (Reconstruction and Economic Development)[7] has replaced the complex and distortionary tax regime inherited from former Yugoslavia by a simple system based on customs duties, excises and VAT. To some degree, however, fiscal success has merely resulted from applying customs duties to aid-financed imports.

[7] *The United Nations Interim Administration Mission in Kosovo (UNMIK), created in June 1999 by Security Council resolution 1244, consists of four pillars, namely Pillar I: Police and Justice, under the direct leadership of the UN; Pillar II: Civil Administration, under the direct leadership of the UN; Pillar III: Democratization and Institution Building, led by the OSCE; Pillar IV: Reconstruction and Economic Development, led by the EU.*

Another bright spot is Kosovo's inflation performance, recently boasting low single digits. The province was de facto euroized in September 1999, when the UN administration, to be precise the EU-led Pillar IV, permitted the free use of foreign currencies beside the Yugoslav dinar. The administration pays its employees solely in euro, levies taxes and carries out its transactions in euro. Transactions in other currencies are subject to a processing fee. The euro has thus become the dominant legal tender. The dinar is still used in some areas, though. The Banking and Payments Authority of Kosovo (BPK) was set up in November 1999 to provide a system for domestic payments and to license and supervise credit institutions. Private banking has developed quickly and deposits and loan portfolios have expanded swiftly, albeit from a tiny base. The decelerating dynamics of broad money can be explained by the rising trend of deposits and by fluctuating but contracting cash in circulation.

5.6 Former Yugoslav Republic of Macedonia

The Macedonian economy has so far witnessed a rather hesitant recovery in the wake of the economic destabilization triggered by the ethnic and security crisis of 2001. Notwithstanding private and official transfers, the current account disequilibrium remains substantial. Apart from the spike of privatization proceeds linked to the sale of the national telecom operator in 2001, FDI has featured disappointingly low levels. This reflects continued high political risk, weak governance, slow structural adjustment and a difficult business climate. Macroeconomic policies have, however, been prudent in recent years: The budget deficit has been considerably reduced and a generally tight monetary stance has kept inflation under control.

Table 8

FYROM: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	−4.5	0.9	3.1	3.6
General government budget balance (% of GDP)	−7.2	−5.7	−1.6	−2.0
Trade balance (% of GDP)	−15.6	−23.7	−19.9	−19.6
Current account balance (% of GDP)				
before grants	−8.2	−11.3	−8.3	−8.9
after grants	−6.9	−8.5	−6.0	−7.6
Net FDI inflows (% of GDP)	12.8	2.0	2.0	2.3
Gross foreign debt (end-year, % of GDP)	39.8	40.2	36.1	36.5
Gross central bank reserves (excluding gold, end-year, % of GDP)	21.9	19.2	19.3	19.1
Basic interest rate of the central bank (end-year, %)	10.7	10.7	6.5	6.8
Broad money growth (nominal, end-year over preceding end-year, %)	64.0	−9.3	17.8	18.0
CPI inflation (end-year, %)	3.7	1.1	2.6	3.1
Average exchange rate: MKD/EUR	60.91	60.98	61.26	62.0
Average exchange rate: MKD/USD	68.04	64.73	54.90	. .
Unemployment rate (average, % of labor force)	30.5	31.9	36.7	36.0

Source: National statistics, National Bank of the Republic of Macedonia, IMF, European Commission, wiiw, EBRD.
[1] *Preliminary data or estimates.*
[2] *Forecasts.*

The monetary authorities pegged the Macedonian denar to the Deutsche mark in the early 1990s, and this peg has since been upheld despite a few devaluations that took place in the mid-1990s. During the crisis of 2001, the authorities successfully defended the parity with the euro. Given the continuing weakness of exports, the exchange rate of the denar remained under pressure during much of 2002. The Macedonian central bank countered this pressure by repeatedly intervening on the foreign exchange market, which triggered contractionary effects on the money supply. After a new Stand-By Arrangement had been reached with the IMF in February 2003, the central bank eased the monetary reins to some degree. It lowered the discount rate, and the interest rate for central bank bills declined.

However, some downward pressure on the currency reemerged in late 2003, which triggered renewed central bank foreign exchange market interventions. In early 2004, policy rates were raised a bit again. Liquidity was withdrawn through auctions of central bank bills and through augmenting the government's denar deposits with the monetary authorities. In January, treasury bills were introduced to the Macedonian financial market. Meanwhile, the ULC-based real effective exchange rate does not appear to have appreciated in the last four years, suggesting that the nominal peg to the euro has, so far, not harmed competitiveness. Commercial banks' deposits and credits are steadily expanding, which reflects the fact that reintermediation is gathering momentum and that confidence in credit institutions is growing. But there is a mismatch between predominantly foreign currency-denominated deposits (almost two-thirds) and mostly denar-denominated loans (about 85%). The Macedonian jobless rate is one of the highest in the region and is continuing to increase.

5.7 Montenegro

Montenegro's recovery following the Kosovo war of 1999 has been feeble but may be somewhat underestimated by official statistics, since the gray economy is estimated to come to about a third of economic activities. In 2003, growth slightly picked up. Like other countries of the region, Montenegro is plagued by twin deficits (budget and current account) and declining foreign financial assistance. The overwhelming share of the republic's exports and about half of its GDP are made up of products of a big and somewhat antiquated aluminum plant (KAP) whose viability is doubtful. Save for a spike in 2002 (linked to the privatization of Jugopetrol and some hotels), FDI has been meager and insufficient to cover the current account gap. Political instability, bureaucracy and pervasive corruption contribute to this state of affairs.

Table 9

Montenegro: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]
GDP growth (real, %)	1.0	0.8	2.3
Consolidated government budget balance (% of GDP)			
before grants	−4.7	−4.3	−5.3
after grants	−1.6	−2.1	−4.0
Trade balance (% of GDP)	−46.5	−34.9	−25.0
Current account balance (% of GDP)			
before transfers	−32.8	−21.1	. .
after transfers	−18.6	−12.6	−10.0
Net FDI inflows (% of GDP)	0.9	7.1	3.2
Gross foreign debt (end-year, % of GDP)	. .	42.0	40.5
Gross central bank reserves (excluding gold, end-year, % of GDP)	. .	4.7	. .
CPI inflation (end-year, %)	28.0	9.4	6.7
Unemployment rate (average, %)	24.8	23.3	21.0

Source: National statistics, Centralna banka Crne Gore, wiiw, IMF.
[1] Preliminary data or estimates.

In order to escape the inflationary policies of Belgrade and become more independent of the Milosevic regime, Podgorica introduced the Deutsche mark as a parallel currency to the dinar on Montenegrin territory in November 1999 and a year later fully withdrew the dinar. Thereby Montenegro was officially and unilaterally euroized. There is no common payment system for Serbia and Montenegro. The central bank of Montenegro started to function in early 2001. Its gross reserves are (still) very modest. Its major monetary policy instrument is the regulation of commercial banks' mandatory reserves, which were fixed at a high level at the beginning of 2002 and then gradually reduced. In 2003, bank loans expanded by over 50% in real terms (albeit from a low point of departure). The increase of loans was preceded by an improvement of the macroeconomic environment and positive developments in the banking sector including privatization.

While the monetary authorities have succeeded in breaking the very high inflation of the past, price levels are still increasing at a speed that is cause for concern for a euroized economy and jeopardizes Montenegro's modest competitiveness. Inflation is partly fueled by the high level of public expenditures and the attendant sizeable budget deficit. In this situation, barring substantial productivity-enhancing investments, the only way to increase competitiveness would be painful nominal adjustments of wages and prices.

5.8 Romania

After a protracted period of sluggish reforms and stagnation, followed by an economic and financial crisis (1997–99), Romania has experienced some robust growth since 2001. However, the country has so far been saddled with its twin deficit problem. While budget shortfalls have been on a downward trend recently, the current account gap sharply widened in 2003. This deterioration was driven by an acceleration of domestic consumption and investment stemming from rapid wage growth and the swift expansion of credit to the private sector. FDI, which in some years covered over two-thirds of the external disequilibrium and which has brought about some important gains in structural adjustment, productivity and competitiveness, made up for about half of the imbalance in 2003. Administration and courts still suffer from serious transparency and enforcement problems, and payments discipline remains unsatisfactory in a number of areas.

Table 10

Romania: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	5.7	5.0	4.9	5.8
General government budget balance (% of GDP)	−3.3	−2.5	−2.2	−1.8
Trade balance (% of GDP)	−7.4	−5.7	−7.9	−7.9
Current account balance (% of GDP)	−5.5	−3.3	−5.8	−5.5
Net FDI inflows (% of GDP)	2.9	2.4	3.0	3.4
Gross foreign debt (end-year, % of GDP)	31.2	30.8	30.9	33.5
Gross central bank reserves (excluding gold, end-year, % of GDP)	9.9	12.3	12.7	13.2
Discount rate (end-year, %)	35.0	29.0	20.4	19.0
Broad money growth (nominal, end-year over preceding end-year, %)	46.2	38.1	23.3	29.0
CPI inflation (end-year, %)	30.3	17.8	14.1	10.5
Average exchange rate: ROL/EUR	26,027	31,255	37,556	41,000
Average exchange rate: ROL/USD	29,061	33,056	33,200	. .
Unemployment rate (according to labor force survey, average, %)	6.6	8.4	7.0	8.0

Source: National statistics, Banca Naţională a României, wiiw, IMF, EBRD, BIS.
[1] Preliminary data or estimates.
[2] Forecasts.

The Romanian monetary authorities have conducted a managed float reflecting nominal depreciation tendencies of the leu throughout the last decade, which, on the whole, have resulted in a certain degree of stability of the real effective exchange rate. In the past the Romanian central bank's monetary policies were often subject to varying intense pressures from different sides, reflecting the overall fragile state of the economy. Although its general goal is to control inflation, the central bank has at times found itself compelled to accelerate the nominal devaluation of the leu to alleviate price competitiveness problems of industry, to ease liquidity constraints of the domestic financial market to make room for unforeseen deficit spending needs on the part of the fiscal authorities, or to fulfill its lender-of-last-resort function to preserve the banking system from collapse.

An overall tighter and steadier monetary policy stance finally emerged in 2000. Since early 2002, the reference unit for the managed float has been a euro/U.S. dollar currency basket (with EUR 60%/USD 40% weights), which was adjusted in early 2004 (to EUR 75%/USD 25%). The Romanian central bank's most important instruments have been reserve requirements, foreign exchange and open market interventions and interest rate policy. Throughout most of 2002 the Romanian currency was under appreciation pressure, which was partially countered by the buildup of foreign exchange reserves and sterilizing interventions (deposit-taking operations and transactions with government securities). Considerable amounts of liquidity were mopped up by open market operations. Inflation declined from 41% in 2000 to 14% in 2003 (end-year) and 12% in July 2004 (year on year), which is, however, still higher than in all of Romania's Southeastern European neighbors, not to speak of Central European transition countries. In response to the downward trend of inflation, the central bank lowered its interest rates substantially until early 2003.

2003 saw a sharp rise of minimum wages at the beginning of the year (by 25% in real terms) and a strong and accelerating expansion of credit (albeit from a low level of departure), favored by the improved macroeconomic situation, enhanced business confidence and lower interest rates. Driven primarily by consumer and mortgage credit, loans to the private sector expanded by 50% in real terms in the twelve months to January 2004 and contributed to aggravating the trade and current account balances, thereby reversing the situation and putting downward pressure on the leu. The surge of loans also rendered disinflation in 2003 more difficult. Given that a sizeable share of the credit volume consists of foreign exchange-denominated loans, there is a risk that unhedged borrowers could trigger financial problems for banks.

The Romanian central bank responded by hiking its reference rate repeatedly (from 17.4% in April to 21.3% in November 2003) and by intervening in the foreign exchange market to support the domestic currency. Banking supervisory procedures and regulations were strengthened, and further measures aiming at restricting consumer credit were introduced in February 2004. These efforts appear to have had an impact, since lending to the private sector decelerated markedly in the second quarter of 2004 and household borrowing stagnated in the first months of the year. Most recently, the current account gap has been narrowing somewhat again, and appreciation pressures have reemerged. In June 2004 the reference rate was lowered by half a percentage point, followed by further cuts in August.

In 2005 the authorities intend to change their official policy from monetary to inflation targeting. As yet some prerequisites for the latter strategy do not appear to be fully in place. These would include further progress in eliminating fiscal constraints, better price predictability and the reduction of pressures stemming from external imbalances.

5.9 Serbia (without Kosovo)

Serbia's economic recovery from the 1999 war was stronger than Montenegro's, but arguably remained subdued in view of the depth to which the country had been pushed throughout the 1990s by a string of wars, international sanctions and political and economic mismanagement. Genuine reforms and recovery did not materialize until the regime change in late 2000. Like other countries of the region, Serbia suffers from twin deficits, particularly from a high current account shortfall. Some improvements have been registered lately with respect to the fiscal, the banking and the external economic spheres.

Table 11

Serbia: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GDP growth (real, %)	5.8	4.1	2.8	4.2
Republican government budget balance (% of GDP)				
before grants	−1.2	−4.6	−4.0	−3.7
after grants	−0.8	−3.6	−3.0	−2.5
Trade balance (% of GDP)	−26.6	−27.4	−25.5	−24.0
Current account balance (% of GDP)				
before grants	−11.6	−15.6	−12.7	−11.4
after grants	−6.1	−12.1	−10.2	−9.8
Net FDI inflows (% of GDP)	1.4	3.3	6.5	4.0
Gross foreign debt (end-year, % of GDP)	104.0	78.2	71.0	67.0
Gross central bank reserves (excluding gold, end-year, % of GDP)	9.4	15.2	18.7	16.0
Discount rate (end-year, %)	16.4	9.5	9.0	. .
Broad money growth				
(M2, nominal, end-year over preceding end-year, %)	106.7	63.0	12.9	10.5
CPI inflation (end-year, %)	40.7	14.8	7.8	8.5
Average exchange rate: YUD/EUR	59.44	60.79	65.26	72.0
Average exchange rate: YUD/USD	66.84	64.19	57.44	. .
Unemployment rate (average, % of labor force)[1]	12.9	13.8	14.0	15.5

Source: National statistics, Narodna banka Srbije, wiiw, IMF, OECD, European Commission, EBRD.
[1] *Preliminary data or estimates.*
[2] *Forecasts.*

Tax reforms strengthened fiscal administration, and FDI gathered some momentum in 2003, driven by a few large, successful privatizations. Numerous small firms were also privatized in 2003. The enhancement of the supervisory and regulatory frameworks has improved the financial performance of credit institutions. Restructuring has triggered some, at least transitory, output losses. Given the country's still very high foreign debt and its debt service obligations, which are scheduled to rise in the coming years, and the decade-long neglect of its industries and concomitant huge structural catching-up needs, it appears most important that the above-mentioned momentum in attracting FDI is upheld. Given renewed political instability and the continuing weak rule of law, this will not be easy.

The Serbian monetary authorities have contributed to improving the weak investment climate by breaking with the lax monetary policies and very high inflation rates of the past. At end-2000 the central bank launched a tightly managed float of the dinar with reference to the Deutsche mark/euro as an external nominal anchor. This has sharply reduced inflationary expectations and engendered growing money demand and a remonetization of the economy. Although inflation has been brought down, the dinar appreciated by about 50% in real-effective terms in the two years until end-2002 (if from an undervalued base).

To better tackle the Serbian economy's external constraints and forestall a further deterioration of its price competitiveness, the central bank chose to somewhat loosen the dinar's float at the beginning of 2003. In the course of the year, the Serbian currency nominally depreciated by about 11% against the euro (and nominally appreciated by around 7% against the U.S. dollar), but the dinar's real effective exchange rate remained broadly unchanged. In the first four months of 2004, the dinar depreciated by 3% against the euro and by 2% in real effective terms. Thus, in striking a balance between inflation and external competitiveness, the monetary authorities have recently assigned somewhat more weight to the external objective.

The exchange rate should now be considered a real rather than a nominal anchor. When the loose union of Serbia and Montenegro replaced the Federal Republic of Yugoslavia in February 2003, Narodna banka Jugoslavije (NBJ), which had already lost control of euroized Montenegro in 2000, was renamed Narodna banka Srbije (NBS). The most important monetary policy instruments of the central bank are reserve requirements, open market transactions with NBS bills and the discount rate as the NBS's key interest rate. Given a surplus of liquid assets in the banking system in 2002 and 2003, the monetary authorities' dominant form of open market intervention has been auction sales of its bills. Thereby the expansion of the money supply was reined in. With inflation on the decline, the central bank cut the discount rate several times (from 16.4% at the beginning of 2002 to 8.5% in January 2004).

However, in the first quarter of 2004 downward pressures on the dinar gathered momentum, prompting the central bank to intervene in the foreign exchange market and to raise NBS bill rates in order to support the domestic currency. Although foreign exchange reserves have remained at a relatively high level, the overall external position continues to be fragile. IMF and international donor support remain essential for Serbia. Since early 2004 its central bank has been developing new instruments and institutions, such as a formal interbank money market, repos and reverse repos.

5.10 Turkey

In the last decade the Turkish economy has been characterized by erratic bouts of rapid short-term growth which were followed by sharp recessions. The authorities did not really manage to get inflation under control. Fiscal profligacy was one of the major roots of monetary instability. Recently, there has been a succession of three stabilization programs, the latest of which has been most promising and has already yielded some unexpected results. Overall unstable developments in preceding years were followed by a disinflation program launched in early 1998, which relied on monetary targeting and hiking interest rates while floating the lira. But the program proved inadequate to reduce high fiscal deficits and to proceed with serious structural reforms.

Table 12

Turkey: Key Macroeconomic and Monetary Policy Indicators

	2001	2002	2003[1]	2004[2]
GNP growth (real, %)	–7.5	7.9	5.9	6.5
Consolidated budget balance (% of GNP)	–15.8	–14.2	–11.5	–10.0
primary balance	5.5	4.1	6.3	6.5
Trade balance (including shuttle trade, % of GNP)	–3.2	–4.6	–5.8	–6.9
Current account balance (including shuttle trade, % of GNP)	2.4	–0.8	–2.8	–3.9
Net FDI inflows (% of GNP)	1.9	0.5	0.4	0.5
Gross foreign debt (end-year, % of GNP)	79.0	72.1	61.8	53.2
Net public sector debt (end-year, % of GNP)	75.6	68.7	65.9	65.7
Gross central bank reserves (excluding gold, end-year, % of GNP)	13.7	15.4	14.8	12.1
One-year treasury bill rate (average, end-year, %)	71.9	55.7	31.5	22.6
Broad money growth (nominal, end-year over preceding end-year, %)	86.2	29.1	14.2	15.0
CPI inflation (end-year, %)	68.5	29.7	18.4	11.5
End-year exchange rate: TRL/EUR	1,290	1,734	1,763	1,850
End-year exchange rate: TRL/USD	1,450	1,655	1,393	1,520
Unemployment rate (according to labor force survey, %)	8.4	10.3	10.6	10.5

Source: National statistics, Türkiye Cumhuriyet Merkez Bankası, IMF, OECD.
[1] Preliminary data or estimates.
[2] Forecasts.

At end-1999 the country embarked on a new ambitious strategy relying on a crawling peg exchange rate anchor (with a reference basket consisting of the U.S. dollar and the euro). The program contributed to a strong recovery in 2000. But the vulnerability of the banking sector, weak governance and management practices, sensitivity of foreign confidence to a widening current account deficit and the generally feeble structural environment set the stage for the eruption of a severe banking and then currency crisis in late 2000 and early 2001, which triggered the collapse of the exchange rate-based program.

The lira was floated in February 2001. The exchange rate of the Turkish currency immediately fell by about one-third, and ultimately by almost two-thirds against both the U.S. dollar and the euro before eventually recovering. A new program was elaborated in the course of 2001 and drew IMF support in the fall of the year. The IMF has remained financially committed to Turkey so far (September 2004). The new program has focused more deeply than previous ones on public sector, fiscal and tax reforms and on shaping up the banking sector. Monetary policy reverted to money growth targeting, while a loosely managed float of the lira was maintained.

Some success has already been achieved. The macroeconomic situation has stabilized more quickly than expected. In 2002 the economy almost fully made up for the sharp slump it had suffered in 2001 and continued its brisk expansion in 2003 and 2004. The main driving forces were private sector consumption and investment. Capital formation accelerated in the first half of 2004, which contributed to a depreciating trend of the ULC-based real effective exchange rate over the past three years. Notwithstanding sizeable primary surpluses, budget deficits have traditionally been huge in Turkey, given very high interest and debt service payments (in the order of 15% to 20% of annual GNP in recent years). The latter derive from a legacy of high public indebtedness and high interest rates.

After its crisis-driven peak in 2001, the fiscal imbalance somewhat receded through 2003. But there still remains considerable room for improvement. Despite its expansion in the same year, the current account shortfall has remained in relatively modest bounds. The quite low level of FDI inflows seems to be more problematic. It may reflect a less than satisfactory pace of privatization of state-owned enterprises as well as too much bureaucracy, an inefficient judicial system and limited hospitality toward foreign investors. While bank rehabilitation and resolution have made considerable progress and supervisory practices have been tightened, further work needs to be done, particularly with respect to bank privatization and legal reform.

One of the main factors that contributed to the swift stabilization and the restoration of confidence was the impressive adjustment of inflation and the reestablishment of trust in the lira. CPI inflation descended to 9% in June 2004 before slightly increasing to 10% in August 2004 (year on year), the latter uptick being triggered by oil price rises. Still, this is the lowest inflation level Turkey has seen since the early 1970s. Inflationary expectations have been reduced, money demand has recovered and remonetization has gained momentum. This was achieved while at the same time large fiscal costs were incurred and total financial means of around USD 30 billion (i.e. 15% of GNP) were earmarked for the banking sector cleanup. The Turkish central bank adhered to restrictive base money targets while intensively engaging in open market operations to absorb excess liquidity injected to stabilize the sector.

After rising sharply in late 2001, interest rates have steadily come down. Given the encouraging inflation environment, the central bank twice cut its intervention rate (overnight deposit rate) by 200 basis points to 22% in March 2004 and then again by the same amount to 20% in September 2004. The decline of interest rates and payments decisively assisted in the decrease of fiscal deficits. But inflation might not have come down as much as it did had the lira not substantially appreciated against the U.S. dollar in the final months of 2003 and in early 2004 (or vice versa, had the U.S. dollar not declined). In the meantime, banking activities have been recovering and the expansion of credit to the private sector accelerated from 10% in December 2002 (year on year) to 45% in December 2003. However, the rapid growth of credit and domestic demand appear to have made monetary targets somewhat more difficult to reach.

Although the central bank plans to move to inflation targeting, for the time being it appears reluctant to initiate such a shift, at least until the government has established a longer track record of fiscal discipline and until a more supportive environment is in place (lower volatility of the exchange rate, further reduction of inflationary expectations, stronger banking system). Still, the central bank is making some technical preparations in the area of inflation research, information and communication.

6 Comparative Overview and Conclusions

In the admittedly short time span observed (2001–04) most of the analyzed countries and territories exhibit some remarkable similarities, at least in the macroeconomic sphere. Notwithstanding weaknesses in data measurement, economic expansion has been relatively strong (GDP growth on average over 4% per annum) in most countries and seems likely to gain further strength in 2004. It has been less dynamic in the Former Yugoslav Republic of Macedonia (FYROM) and Montenegro. On the whole, the Southeastern European economic expansion outstrips that of Central Europe, not to speak of that of the western part of our continent. Southeastern Europe, of course, has the most catching-up to do. While first relying on export-led growth, economic expansion in many countries of the region has been driven by private demand in recent years. Rising capital formation has contributed to some (initial) retooling or restructuring of industries.

All analyzed countries/territories except Bulgaria, Kosovo, Macedonia and Romania have high budget deficits (over 3% of GDP, before grants). Although it has improved, Turkey's budget remains most deeply in the red. Turkey's current account shortfall, however, has been relatively modest – in contrast to substantial external imbalances in all other countries. Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia and Turkey are still dependent on foreign grants and financial assistance to cover or at least reduce budget and/or current account gaps. But this support is on a declining trend. On the whole, most countries remain saddled with twin deficits.

FDI is weak in most parts of the region, save Albania, Bulgaria, Croatia and Romania, where it covers more than half of current account shortfalls. It is surprisingly weak in Turkey. Gross foreign indebtedness is not generally high in Southeastern Europe and seems to be declining (as a percentage of GDP) in most countries. The most striking exception is Croatia, where foreign debt is high and rising. In Serbia it is high and subject to restructuring negotiations; in Bulgaria and Turkey it is high, but falling. Except in Romania, joblessness is in double digits all over region. It appears to be particularly high (above 30%) in Bosnia and Herzegovina, Kosovo, and Macedonia. On top of that, a turnaround, unfortunately, does not yet appear to be in sight in most countries. Serious restructuring still has a considerable way to go before a breakthrough may be reached on the labor market.

In contrast, inflation has been on a falling trend across the region, although a slight uptick is being registered in some countries for 2004. In 2003 single digits were reached everywhere, except in Romania and Turkey. Falling inflation appears to be linked to an overall reduction or slowdown of money growth, which enabled interest rates to be cut or to decline. Money supply has been controlled by foreign exchange and open market interventions, interest rate changes and/or by adjusting reserve requirements. In a number of cases, inflation performance can be explained by the stabilizing influence of the exchange rate as an external nominal anchor (whether referring to a currency board, a peg or a tightly managed float). Indeed, all countries with hard pegs have witnessed single digits lately. In Serbia, the loosening of the tightly managed float in 2003 contributed to interrupting the downward tendency of dinar inflation in 2004.

On the other hand, Albania, a country with a loosely managed float, has also boasted low price increases. Turkey as well has been successful in bringing down high inflation in a short time with a similar regime. Therefore, the confidence- and stability-enhancing effect of hard pegs appears to have been confirmed in most analyzed countries, but this does not exclude other monetary strategies (notably money growth targeting and a loose float) applied in a minority of countries from also being effective. Overall, monetary and economic policy credibility and perseverance may be the key to success here. Some countries are planning to move to formal inflation targeting soon; however, this requires a reasonably stable macroeconomic environment and a strong institutional framework.

Owing to the progress and track record on the route to price stability, confidence in domestic currencies and monetary policies – despite occasional setbacks – has been on the rise and is reflected in expanding monetization in most economies, which facilitates monetary policy. At the same time, unofficial euroization and the attachment of the population to foreign currencies, particularly the euro, remains high and is boosted by the increasing density of trade and economic relations of the region with the euro area and the EU. Foreign investment, notably from the euro area and EU countries, has contributed to structural change and modernizing Southeastern European banking sectors and financial intermediation, although from quite humble points of departure.

Banking activities have also benefited from the improving macroeconomic environment and from the euro changeover of 2001–02, which provided a sizeable net injection of liquidity into the sector and thus reflected increased confidence of the public in credit institutions. Given a hitherto untapped catching-up potential in investment and consumption, the sharp rise in deposits and the improvement of the overall situation contributed to credit booms in all countries of the region, without exception, even if it is appropriate to speak of "mini-booms" in some cases. Reflecting the prudence of monetary authorities, the booms were often accompanied by steps to enhance banking supervision. Credit expansion pushed up imports and put pressure on current accounts. Central banks reacted with monetary tightening, which was in most cases duly followed by a slowdown of credit growth.

Let us finally attempt a brief look into the future: Barring any major political setback, it is highly probable that the bonds of economic and institutional integration between the Southeastern European countries and the European Union will further strengthen. Romania and Bulgaria are already accession countries, Croatia's application has been accepted and accession negotiations are to commence in early 2005, Macedonia's application is being processed and Turkey is a candidate. Stabilisation and Association Agreements (SAA) have been signed with Croatia and Macedonia. Such a treaty is currently under negotiation with Albania, and Feasibility Studies on the opening of SAA negotiations with Bosnia and Herzegovina and with Serbia and Montenegro have been or are being drawn up by the European Commission. All countries have expressed their willingness to join the EU sooner or later. This certainly constitutes a major, if not the principal, external political anchor or lever for reforms in the region.

Upon joining the EU, new Member States commit themselves to adopting the euro after all the preconditions, in particular the Maastricht criteria, have been met. There are a number of exchange rate and monetary policy strategies that are compatible with the "Maastricht route." Even currency boards, judged on a case-by-case basis, may be compatible (see the Estonian and Bulgarian examples). But formal or de facto euroizations are considered inconsistent with the Maastricht Treaty. What would happen to the monetary regimes in Kosovo and Montenegro if these territories joined the European Union and were still euroized remains to be seen and decided. Taking into account the very small economic size of both territories and the fact that euroization took place in exceptional historical situations (aftermath of the Kosovo war, conflict with the Milosevic regime and its inflationary policies), perhaps pragmatic solutions could be found – without setting a precedent.

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