55th East Jour Fixe

Monetary and Exchange Rate Policy in South-Eastern Europe

The East Jour Fixe of the Oesterreichische Nationalbank (OeNB), 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, looks back on a long tradition. The 55th East Jour Fixe on May 30, 2005, was a special event. It served to underline the OeNB's dedication to its newly added focus of research: Southeastern Europe. While not much research has been devoted to this region so far, Southeastern Europe is already among the fastest-growing regions on the continent, and has large potential to be tapped for further output expansion. Austria is tightly linked to Southeastern Europe by geography and by centuries of close historical connections. Today, economic links play a prime role, with trade on a dynamic trajectory and Austrian investors from the enterprise and banking sectors in the forefront of the region's process of microeconomic reintegration with the rest of Europe.

The 55th East Jour Fixe dealt with "Monetary and Exchange Rate Policy in South-Eastern Europe," a domain exhibiting a surprising variety of approaches and strategies. High-ranking central bank representatives from eight countries or territories exchanged views under the chairmanship of the OeNB. The event was organized in three sessions. In her introductory statement, Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division, stressed the important progress a number of countries in the region have achieved in their EU integration process. Although economic growth has been strong across Southeastern Europe in recent years (about 4% to 5% per annum on average), most countries remain burdened by external disequilibria, particularly current account deficits, and some strongly depend on workers' remittances and foreign financial assistance. Most countries have been remarkably successful in bringing down inflation, be it with the help of the euro as a nominal anchor (as in the majority of cases) or with other policies. Growing confidence has contributed to remonetization and credit booms, which, however, are not without risks.

The first session, presided by Doris Ritzberger-Grünwald, was entitled "Monetary Policy Frameworks: Experiences and Challenges." Aneta Krstevska, Director of the Research Department of the National Bank of the Republic of Macedonia, presented the case of the monetary policy strategy of her country, which is a small and open economy and thus a price taker. Output and exports are not much diversified. The share of foreign currency deposits in total deposits (unofficial euroization) is very high (around 65%). Therefore, Macedonia has been running a de facto peg first to the Deutsche mark and then to the euro (exchange rate targeting) for the last ten years, which has the advantage of constituting a clear commitment for the public. During this period, the Macedonian denar was devalued only once – in July 1997. Prices and the real effective exchange rate have been stable in recent years. Aneta Krstevska cited potential swings in market expectations, the necessity to main-

tain high foreign currency reserves to defend the denar, if needed, and possible effects of capital account liberalization (impossible trinity) as challenges to the strategy.

Amir Hadziomeragic, Head of Economic Research and Statistics Department of Centralna banka Bosne i Hercegovine, highlighted major traits of his country's currency board regime. In a post-war situation of fragile statehood like Bosnia's, the conduct of rule-based monetary policy is the only realistic option, he argued. The currency board and the new Bosnian currency, the Bosnian convertible mark, both established in 1997–98 in line with the Dayton agreement, turned out to be very successful in reducing inflation, replacing the previously existing multicurrency system and creating a stable pillar of Bosnian statehood and identity. The arrangement was so successful that, after the expiration of the initial period of six years, the authorities decided to extend it indefinitely (i.e. until the eventually expected adoption of the euro). The only major deviation from strict currency board rules and the only available monetary policy instrument are reserve requirements for commercial banks. According to Hadziomeragic, the country's persistent and very high current account deficits are the consequence of incomplete structural adjustment, but also of large international aid flows, remittances and growing FDI inflows in recent years.

The focus of Gramoz Kolasi's presentation was the evolution of the Bank of Albania's monetary policy. Kolasi, Head of the Monetary Policy Department of Banka e Shqipërisë (Bank of Albania), pointed out that his institution had already adopted a monetary targeting regime in 1992. Since 1998, the publicly stated monetary policy objective of Banka e Shqipërisë has been to keep the annual inflation rate within a band of between 2% and 4% at year-end. This is to be achieved by exercising monetary control. Most recently, inflation in Albania has declined to below the bottom limit of the band. Although the Albanian lek floats loosely, there is no doubt that the euro is the most important foreign currency for the country (80% of trade is conducted with the EU.) Even though the signaling power of monetary aggregates targeted by Banka e Shqipërisë may start to fade, Gramoz Kolasi cautioned that the central bank's goal of adopting an explicit inflation targeting regime in the medium term would require more macroeconomic stability, stronger economic growth, more new jobs, greater price stability, a speedier implementation of structural reforms, etc.

The next session dealt with implications of currency substitution for monetary policy and was chaired by Thomas Reininger, Senior Expert with the OeNB's Foreign Research Division, who gave a brief overview of the various types of currency substitution that can be observed in the region, ranging from the complementary (unofficial) use of a foreign currency (mostly the euro) to the official adoption of a foreign currency (the euro) as sole legal tender. Nicola Fabris, Chief Economist of Centralna banka Crne Gore, explained why and how the Montenegrin authorities decided to unilaterally introduce the Deutsche mark/the euro in the period from 1999 to 2001, and what the results were. Monetary policy misuse by the Milošević regime in Belgrade, a very high level of inflation and a dramatic decline of GDP compelled the authorities in Podgorica to euroize, Fabris argued. In a first step, the hitherto usual practice of using the Deutsche mark was legalized in November 1999, when the

Deutsche mark was given the status of legal tender in parallel to the Yugoslav dinar. In January 2001, the Deutsche mark became sole legal tender in the republic. In March 2001, Centralna banka Crne Gore, the central bank of Montenegro, was established. With the cash changeover in early 2002, euro cash was officially introduced. According to Nicola Fabris, euroization helped create stability in Montenegro, with inflation rates coming down swiftly, but it cannot be treated as a substitute for economic reform.

A case of very high – unofficial – euroization is Croatia, as emphasized by Ljubinko Jankov. In his presentation, the Executive Director of the Research and Statistics Area of Hrvatska narodna banka emphasized the low inflation rate and the stability of the exchange rate of the Croatian kuna to the Deutsche mark/euro (without commitment) since late 1993. Despite this record, the share of foreign currency deposits in total bank deposits continues to surpass 75%. Given this situation and the fact that Hrvatska narodna banka's foreign exchange reserves exceed base money by about 50%, the country's monetary policy has long been characterized by the authorities as that of a "quasi currency board." With this regime, as Jankov put it, the monetary authorities strive to get the best of both worlds: first, credibility associated with exchange rate stability and low inflation; and second, discouragement of speculative capital flows through upholding two-way residual risk. But, of course, under these circumstances freedom of monetary policy is severely circumscribed. To improve the country's competitiveness and reduce its external disequilibrium, Hrvatska narodna banka attempts to persuade the government to trim the fiscal deficit and step up structural reforms.

Real exchange rate dynamics in the run-up to EU accession was the topic of the third session, chaired by Peter Backé, Head of Unit – Central and Eastern European Analysis, Foreign Research Division (OeNB). Backé raised the question of what to think of real appreciation pressures, as witnessed in some Southeastern European countries, in the context of sizeable current account imbalances and possible future shifts in capital flow dynamics. Rossen Rozenov, Head of the Monetary and Financial Research Division in the Bulgarian National Bank's Economic Research and Projections Directorate, discussed Bulgaria's recent experience with real exchange rate developments. The Bulgarian National Bank has been running a currency board linked to the Deutsche mark (and later the euro) since mid-1997. In the period from 1998 to 2004, the weighted real exchange rate of the Bulgarian lev appreciated by about 20% (CPI-deflated) or by 7% (ULC-deflated), respectively. Given sizeble FDI and industrial restructuring, real exchange rate appreciation (so far) does not seem to have adversely impacted on Bulgarian export performance; as Rozenov stressed, Bulgarian firms have recently gained market shares in the EU.

Cezar Botel, Director of the Macroeconomic Modeling and Forecasting Department at Banca Națională a României, focused on real exchange rate dynamics in his country. The Romanian leu's exchange rate regime over the last decade has been a managed float, featuring the gradual removal of current and capital account restrictions and lately showing higher flexibility. The real exchange rate, based on the CPI as a deflator, has been relatively stable over the past five years; taking ULC in industry as a deflator, the real exchange rate has even decreased. Yet since 2004, there has been a substantial real apprecia-

tion. According to Botel, this most recent turnaround is attributable to strong capital inflows that were triggered by a high interest rate differential to the euro area, by the rising attractiveness of the Romanian economy owing to the country's good macroeconomic performance and improved prospects for joining the EU in 2007, and by anticipated capital account liberalization. Moreover, in preparation for the planned switch to inflation targeting in 2005, Banca Naţională a României decided in November 2004 to allow more exchange rate flexibility and, if applicable, some appreciation of the leu.

An overview analysis of real exchange rate dynamics in Southeastern Europe was offered by Gunther Schnabl, Adviser with the Division EU Neighbouring Regions, DG International and European Relations at the ECB. Despite quite heterogeneous exchange rate regimes in the region, most countries – except Serbia, Bosnia and Herzegovina, and the FYR of Macedonia – witness real appreciation pressures. Schnabl reviewed the determinants of real exchange rate dynamics, arguing that in this context factors other than the standard Balassa-Samuelson framework can be important for the Southeastern European region. Finally, Darko Bohnec, Vice Governor of Banka Slovenije, shared his country's experience with real exchange rate developments prior to EU accession and ERM II entry. Based on the case of Slovenia, he aptly illustrated his main proposition, namely that exchange rate dynamics are shaped by the dual nature of the exchange rate, which constitutes an asset price while also reflecting macroeconomic fundamentals.

Summing up, while real appreciation tendencies have been rather limited in most Southeastern European countries in recent years, a number of factors – including growing capital flows – indicate mounting appreciation pressures in the future. Given the traditionally large external imbalances in the region, this fact promises to become a major challenge for economic policies in Southeastern Europe.

In all three sessions, the discussion was very lively and focused on a number of issues, ranging from statistics to the design of economic policy, including possible equilibrium exchange rates, which are gaining interest.

Please note that all speakers' presentations can be downloaded from the OeNB's Central and Eastern Europe Research Platform at *ceec.oenb.at*.