OVERVIEW OF EXCHANGE RATE ARRANGEMENTS AND MONETARY POLICY IN SOUTH EASTERN EUROPE AND TURKEY

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ABSTRACT

The paper offers an analytical overview over exchange rate regimes and monetary policy frameworks in the countries of South Eastern Europe and Turkey. The following ten countries/non-sovereign territories are analyzed here: Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Kosovo, FYR Macedonia, Montenegro, Romania, Serbia, 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 institutional importance as well as the unofficial role of the euro in South Eastern Europe are dealt with. Next, individual countries'/territories' economic developments in recent years (2001 - early 2005) and current monetary and exchange rate policies, instruments, issues and outcomes are focused on 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 dominated by the euro as a stable anchor and point of convergence.

1 INTRODUCTION

The following article attempts to give an analytical overview over exchange rate regimes and monetary policy frameworks in the countries of South Eastern Europe and Turkey. Given this topic and the fact that Serbia and Montenegro (as a subject of international law) comprises three separately managed currency areas, namely the republics of Serbia, Montenegro and the province of Kosovo, in the following these three political entities will be dealt with separately, notwithstanding the fact that none of the three constitute a fully sovereign country.

Accordingly, the following ten countries/non-sovereign territories are analyzed here: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, FYR Macedonia, Montenegro, Romania, Serbia, Turkey.

To start with, Chapter 2 provides a general overview of the demographic and economic sizes and per capita incomes of the ten quite heterogenous countries/territories of the region. Chapter 3 presents a global descriptive outline of the topic which also sketches the institutional importance of the euro as economic factor/anchor for these countries. Chapter 4 focuses more on the unofficial role of the euro in South Eastern Europe, on euro legacy currencies circulating in and outside banking sectors (up to end-2001), the effect of the euro cash changeover (of end-2001) and on euro-denominated deposits (up to end-2003). Individual countries'/territories' economic developments in recent years (2001 to early 2005) and current monetary and exchange rate policies, instruments, issues and outcomes are dealt with in somewhat more detail in Chapter 5. Chapter 6 gives a summarizing comparison of major results of the preceding chapter and draws some overall conclusions.

2 BASIC TRAITS OF THE REGION'S COUNTRIES/ TERRITORIES

Compared to the European Union, the South Eastern European countries are economically small to miniscule players. As can be seen from Table 1, South Eastern 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[1] of the EU 25. The largest former socialist country of the region, Romania, commands an economic size of half a percent of that of the EU 25. The smallest (non-sovereign) republic, Montenegro, accounts for 0.012% of the EU 25's GDP. Average per capita GDP in South Eastern Europe without Turkey comes to about a tenth of the average level of the 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 South Eastern European countries taken together. Turkey's GDP per capita is somewhat higher than South Eastern 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.[2]

Table 1: South Eastern European countries'/territories' basic characteristics

Country	Territory (km²)	Population (2002 million)	GDP (2002, EUR billion)	GDP per capita (2002, EUR)
Albania	28700	3.15	5.13	1630
Bosnia and Herzegovina	51100	4.11	5.94	1445
Bulgaria	111000	7.97	16.43	2060
Croatia	56500	4.47	23.80	5325
Kosovo (Serbia)	10900	1.96	1.40*	715*
FYR Macedonia	25700	2.02	4.02	2000
Montenegro	13800	0.65	1.20*	1850*
Romania	238400	21.75	48.52	2230
Serbia (without Kosovo)	77500	7.52	14.00*	1860*
South Eastern Europe w ithout Turkey	613600	53.60	120.44*	2245*
Turkey	779500	69.63	194.87	2800
South Eastern Europe with Turkey	1393100	123.2	315.3*	2560*
EU 15	3234500	379.7	9234.3	24320
New Member countries	738600	74.5	438.1	5880
EU 25**	3973100	454.2	9672.4	21295

* estimate
** EU 25 refers to all old and new EU member states after the enlargement round of May 1, 2004.
Source: Fischer Weltalmanach 2005, IMF, own estimates

3 OUTLINE OF EXCHANGE RATE REGIMES AND MONETARY POLICY FRAMEWORKS IN THE REGION

The euro plays an important official and/or unofficial[3] role for the economies and economic policies of South Eastern European countries. Five of the ten analyzed countries – namely successor countries/territories to the former Socialist Federative Republic of Yugoslavia – changed their currencies in the 1990s. Seven of the ten countries have geared their monetary policy to an external anchor. This external anchor is - without exception - the euro, as shown in Table 2. Two of these seven (Bosnia and Herzegovina, Bulgaria) run currency boards, two (non-sovereign) territories (Montenegro, 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 reference). In early 2003 Serbia somewhat loosened its stance and can now be characterized as pursuing a real exchange rate anchor.[4]

Three countries (Albania, Romania, Turkey) have practiced managed or loosely managed floats, coupled with money growth targeting (Table 2). In early 2005, Romania switched from a reference basket for its float, in which the euro had the largest weight, to the euro as sole reference currency. The three countries are aiming for inflation targeting in the near-term future. 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, p. 24-28).

Table 2: South East European countries'/territories' monetary characteristics

Country	Currency (since); previous	Exchange rate regime (s ince); previous	Convertibility	Monetary policy framework (since); previous
Albania	Albanian lek (ALL)	Loosely managed float (early 1990s), major reference currencies: EUR (up to 1/1/1999: DEM), USD	Not yet unrestricted current account convertibility (IMF Art. XIV status)	Informal inflation targeting through money growth targeting (1998)
Bosnia and Herzegovina	Konvertibilna marka (BAM, June 1998); YUD and HRK (used regionally), DEM (country-wide) (until Dec. 1999); YUD (until early 1990s)	Currency board, peg to EUR (up to 1/1/1999: DEM) (formally introduced: August 1997, de facto since mid-1998); multiple currencies	Full (or almost full) convertibility	Nominal exchange rate anchor EUR (DEM) (August 1997)
Bulgaria	Bulgarian lev (BGN)	Currency board, peg to EUR (up to 1/1/1999: DEM) (since July 1997); managed float	Full (or almost full) convertibility (IMF Art. VIII acceptance Sept. 1998)	Nominal exchange rate anchor EUR (DEM) (July 1997); money growth targeting
Croatia	Croatian kuna (HRK) (May 1994); Croatian dinar (transitional); YUD	Tightly managed float, reference currency: EUR (up to 1/1/1999: DEM) (since Oct. 1993)	Almost full convertibility (IMF Art. VIII acceptance May 1995)	Nominal exchange rate anchor EUR (DEM) (Oct. 1993)
Kosovo/ Kosova (Serbia)	All foreign currencies legalized for transactions, EUR (DEM) predominant, YUD used regionally (Sept. 1999); YUD		Full convertibility	EUR legal tender (September 1999)
FYR Macedonia	Macedonian denar (MKD, April 1992); YUD	De facto peg to EUR (exchange rate target, up to 1/1/1999: DEM) (since early 1990s)	Current account convertibility (IMF Art. VIII acceptance: June 1998)	Nominal exchange rate anchor EUR (early 1990s)
Montenegro	Unilaterally euroized/EUR (November 2000); November 1999-2000 EUR (DEM) parallel currency to YUD; before that YUD		Full convertibility	EUR legal tender (November 1999/2000)
Romania	Romanian leu (ROL)	Managed float (1991), reference currency: EUR (since early 2005); previously: reference basket: EUR (75%), USD (25%) (early 2004), EUR (60%), USD (40%) (early 2002); before that: reference currency: USD	Current account convertibility (IMF Art. VIII acceptance: March 1998)	Money growth targeting (early 1990s)
Serbia (without Kosovo/ Kosova)	(Yugoslav) dinar (YUD)	Managed float (January 2003), previously tightly managed float, reference currency: EUR (Dec. 2000); peg to EUR (DEM)	Current account convertibility (IMF Art. VIII acceptance: May 2002)	Real exchange rate anchor (January 2003), previously nominal anchor EUR (DEM) (1994)
Turkey	New Turkish lira (TRY, January 2005, based on re-denomination); Turkish lira (TRL)	Loosely managed float (Feb. 2001); crawling peg, reference basket: USD (56%), EUR (44%) (Dec. 1999); managed float (early 1998)	Full (or almost full) convertibility (IMF Art. VIII acceptance: March 1990)	Money growth targeting, informal inflation targeting (Feb. 2001); exchange rate anchor (USD/EUR basket); monetary targeting

4 UNOFFICIAL EUROIZATION IN SOUTH EASTERN EUROPE

South East 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. Holdings of foreign exchange in the region are primarily of euros and to a smaller extent of US dollars, Swiss francs etc. In this sense one can also speak of euroization, more precisely unofficial euroization – as opposed to official or unilateral euroization, which is reality in the Republic of Montenegro, or as opposed to the official introduction of the euro as dominant legal tender in the Province of Kosovo. The latter can be regarded as a defacto unilateral euroization, even if the decision-making body in this case was the UN provisional administration.

In the mid-1990s the Bundesbank, using various methods, estimated the amount of D-Mark cash held outside Germany to come to 30-40% of total German currency in circulation, corresponding to EUR 32-45 billion (Seitz, 1995). This has often been quoted as the main estimate of euro/D-Mark holdings abroad. Most of the money was deemed to circulate in EU neighboring regions, including Central and South Eastern Europe and the Mediterranean. In the course of the 12 months preceding the euro cash changeover at end-2001, foreign exchange bank deposits in euro legacy currencies (i.e. D-Mark, Austrian Schilling, French Franc etc.) in 20 reporting countries neighboring the EU, including South Eastern Europe and Turkey, increased by EUR 9.2 billion to EUR 41.7 billion. In order to strengthen their respective banking systems, many countries promoted euro conversion by paying into bank accounts instead of exchanging cash over the counter. And in the months following the cash changeover, banks did not generally experience large withdrawals.

The EUR 46 billion of euro banknotes shipped by banks to destinations outside the euro area from December 2001 to June 2004 provide another approximate indicator of the amount of euro banknotes circulating abroad. This accounts for around 10-12% of

the total volume of euros in circulation. To give some details on the implications and effects of the cash changeover: Turkey and Croatia led (in absolute terms) all the EU's 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. The share of euro-denominated deposits in total deposits rose in Croatia from 56% in December 2000 to 62% in December 2001, then expanded further – to 76% at end-2003. In Bosnia the respective share expanded from 38% to 50%, then receded to 41%, in Bulgaria the evolution was from 12% via 18% to 19% and in Turkey from 12% via 15% down to 10%. In Kosovo and Montenegro, the share was, of course, (almost) 100% and in Serbia it was also very high (83% at end-2003) (ECB, 2004, p. 66).

This change implies that the sum of cash euros in circulation in the region decreased; on the other hand, banks benefited from the surge of euro deposits, which also bears witness to the enhanced trust the public of various countries has harbored in the banking sector. Given that the banking sectors of most South East European countries are in majority ownership of financial institutions of euro area countries, it is also likely that financial links between banks of EU 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. On the other hand, up to EUR 10 billion of legacy currencies may have been exchanged for other international currencies, mainly the US 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 with respect to the US 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 since late 2002, the euro has been perceived as more stable than the American currency. This view is also likely to be held in other parts of South Eastern Europe and Turkey. Authorities assess 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'/TERRITORIES' ECONOMIC DEVELOPMENTS AND CURRENT MONETARY POLICY ISSUES

5.1 Albania

Table 3 Albania: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	7.2	3.4	6.0	6.0
General government budget balance (% of GDP): before grants	-8.2	-6.7	-4.5	-6.0
- after grants	-7.6	-6.1	-4.1	-5.4
Trade balance (% of GDP)	-23.2	-25.8	-24.8	-22.9
Current account balance (% of GDP): before grants	-6.2	-9.5	-8.1	-7.2
- after grants	-3.2	-6.8	-5.5	-5.2
Net FDI inflows (% of GDP)	4.8	2.6	2.7	5.0
Gross foreign debt (end-year, % of GDP)	26.8	23.3	20.2	21.0
Gross reserves of central bank (excl. gold, end-year, % of GDP)	13.9	17.3	16.5	16.2
Repo rate (end-year, %)	7.0	8.5	6.5	5.5
Broad money growth (nominal, end-year over preceding end-year, %)	20,2	5.7	8.7	12.5
CPI-inflation (end-year, %)	3.4	1.7	3.3	2.2
Average exchange rate: ALL/EUR	128.5	132.4	137.5	127.6
Average exchange rate: ALL/USD	143.5	140.2	121.9	102.8
Unemployment rate (registered, end-year, %)	16.4	15.8	15.2	14.5

* preliminary data or estimates
Source: national statistics, Banka Shqipëriut, IMF, WIIW, EC, EBRD, BIS

Albania has witnessed robust growth in recent years, although the country remains saddled with serious structural shortcomings, particularly in the area of governance, transparency, rule of law, and infrastructure. Administrative barriers to investment and business creation remain high 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 less than half of the current account shortfall. But in 2004, this ratio was much higher. Foreign liabilities are relatively low. Privatization gathered some momentum recently.

The central bank's cautious monetary policy has succeeded in keeping inflation at low one digit levels in recent years. The central bank has conducted a policy of informal inflation targeting and in 2001 through 2004 has successfully committed to holding CPI end-year inflation within a band of 2 to 4%. In order to achieve this, money supply (M3) and interest rates have been targeted. The monetary authorities intervene by varying their net domestic assets and net international reserves and by changing repo (repurchase

agreement) rates, reverse repo rates and by conducting open market operations. The complement to money growth targeting is Albania's 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 US dollar). However, the exchange rate can also become a (secondary) policy objective, but only if inflation remains comfortably within the band. Most recently, currency appreciation has assisted in achieving the inflation objective.

The fragility of Albania's banking system was exposed by the bank runs and massive deposit withdrawals in the spring of 2002. These runs had been triggered by the failed privatization attempt of the largest Albanian credit institution, the state-owned Savings Bank and 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 collapse of 1997. The 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, in 2003 and early 2004 the lek came 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 recovering money demand. Still, by end-2004, the real-effective exchange rate of the lek was substantially higher than a year earlier, putting 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 to a foreign strategic investor, Raiffeisen Zentralbank (of Austria). This should contribute to improving confidence. Although Albania is still underbanked - even compared to other South Eastern European countries - lending is now in a process of dynamic expansion, and the banking sector is enlarging the range of its products.

5.2 Bosnia and Herzegovina

Table 4 Bosnia and Herzegovina: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	4.5	5.5	3.5	5.5
General government budget balance (% of GDP): before grants	-10.5	-7.3	-3.0	-3.2
- after grants	-3.3	-2.2	0.4	-0.1
Trade balance (% of GDP)	-36.4	-37.0	-35.0	-35.0
Current account balance (% of GDP): before grants	-16.7	-20.3	-18.2	-18.7
- after grants	-16.2	-20.0	-18.0	-18.5
Net FDI inflows (% of GDP)	2.6	4.1	4.5	5.2
Gross foreign debt (end-year, % of GDP)	48,2	42,2	34.0	33.0
Gross reserves of central bank (excl. gold, end-year, % of GDP)	24.6	21.7	25.4	26.9
Broad money growth (nominal, end-year over preceding end-year, %)	89.3	8.6	8.3	.
CPI-inflation (end-year, %)	0.9	0.3	0.6	0.0
- Federation of BiH	0.3	-0.7	0.3	-1.0
- Republika Srpska	2.2	2.4	1.3	2.3
Average exchange rate: BAM/EUR	1.96	1.96	1.96	1.96
Average exchange rate: BAM/USD	2.19	2.08	1.73	1.56
Unemployment rate (registered, end-year, %)	40.3	40.9	42.0	42.0

* preliminary data or estimates
Source: national statistics, Centralna banka Bosne i Hercegovine, IMF, WIIW, EC, EBRD, BIS

Following the war of 1992-95, Bosnia and Herzegovina have received considerable, if declining, international reconstruction assistance (roughly EUR 6 billion so far). Despite this assistance, the country has not yet been able to put in place 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 and the Republika Srpska as well as Brcko District. However, initiatives at selective centralization have been successful in some areas recently, incl. military control, customs administration, indirect taxation and in January 2005, banking supervision. The gradual reduction of external assistance has been accompanied by lower economic growth in recent years.

Attempts to dismantle bureaucratic barriers and improve the business environment have contributed to a doubling of FDI inflows in 2002 and to further expansion thereafter, but FDI remains far from matching the huge and persistent current account shortfalls. On the other hand, fiscal as well as monetary policies have been prudent in recent years, 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.

The central bank has functioned as a currency board since 1998, irrevocably fixing the exchange rate of the konvertibilna marka to the D-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. Neither can the monetary authorities 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 has hardly budged since 2001 – which has even implied slight deflation in the Federation.

In recent years, price level changes have also been on an overall converging tendency between the two Entities 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", bringing pressure to bear on the corporate sector to shape up.

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 slightly reduced the external disequilibrium in 2003. New more restrictive bank capital requirements were pre-announced taking effect at end-2003.

Meanwhile, credit growth continued in 2004. The banking sector is one of the few areas where substantial progress in structural reform has been achieved. The official unemployment rate amounted to above 40% in 2002 through 2004; 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

Table 5 Bulgaria: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	4.1	4.9	4.3	5.5
General government budget balance (% of GDP)	-0.9	-0.6	-0.3	0.7
Trade balance (% of GDP)	-11.7	-10.3	-12.4	-12.2
Current account balance (% of GDP)	-7.3	-5.6	-8.5	-7.5
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 reserves of central bank (excl. gold, end-year, % of GDP)	26.8	27.7	30.2	28.6
Base rate (end-year, %)	4.7	3.4	2.9	2.4
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	4.5
Average exchange rate: BGL/EUR	1.96	1.96	1.96	1.96
Average exchange rate: BGL/USD	2.18	2.08	1.73	1.57
Unemployment rate (acc. to labor force survey, average, %)	19.7	17.8	13.7	12.1

* preliminary data or estimates
Source: national statistics, Balgarska narodna banka, WIIW, IMF, EBRD, BIS

Following a deep financial and economic crisis in 1996/97, Bulgaria has since July 1997 strictly adhered to a D-Mark/euro-based currency board regime. The Bulgarian economy has witnessed overall favorable macroeconomic developments in recent years. GDP has expanded on average by 4-5% annually. The current account deficit has consistently been high and further increased in 2003, but FDI inflows have also been substantial and covered most or all of the shortfall. 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. 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 amounted to less than half a percent of GDP and in 2004 a surplus of the same magnitude is expected. On the other hand, poverty and public dissatisfaction continue to be widespread.

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 have even witnessed a credit boom (growth in bank claims on enterprises and households accelerated 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 sucked in imports and contributed to the deterioration of the current account and to inflationary

pressures. 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 serious deterioration, they weakened in the fall of 2004, despite the fact that the monetary authorities had strengthened supervisory oversight and standards to encourage prudent lending. Given the currency board regime, the monetary authorities do not have many instruments 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 was the withdrawal of government funds (part of its fiscal reserve) deposited in credit institutions in order to reduce the level of liquidity in the banking system. In the summer and subsequently on repeated occasions, the central bank had broadened the coverage of reserve requirements and/or raised them. The authorities stand ready to resort to further liquidity tightening measures if necessary, including credit ceilings.

5.4 Croatia

Table 6 Croatia: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	4.4	5.2	4.3	3.8
General government budget balance (% of GDP)	-6.8	-5.0	-6.3	-4.6
Trade balance (% of GDP)	-20.9	-24.3	-27.4	-25.5
Current account balance (% of GDP)	-4.2	-8.5	-7.0	-5.4
Net FDI inflows (% of GDP)	7.2	4.4	5.3	3.5
Gross foreign debt (end-year, % of GDP)	57.9	60.9	74.3	76.5
Gross reserves of central bank (excl. gold, end-year, % of GDP)	24.1	23.3	25.5	22.9
Discount rate (end-year, %)	5.9	4.5	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	2.7
Average exchange rate: HRK/EUR	7.47	7.41	7.56	7.50
Average exchange rate: HRK/USD	8.54	7.86	6.70	6.04
Unemployment rate (acc. to labor force survey, average, %)	15.9	14.8	14.5	14.2

* preliminary data or estimates
Source: national statistics, Hrvatska narodna banka, WIIW, IMF, EC, EBRD, BIS

The Croatian economy has steadily grown since the turn of the century. Inflation has almost without exception been in 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, giving rise to concern. The largest part of the recent debt expansion stems from credit institutions borrowing from parent banks abroad, followed 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 degrees of freedom for an independent monetary policy. Since the lion's share of Croatian banks' liabilities are 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 (mostly euro) indexed kuna loans. In this way, however, they transfer most of the foreign exchange risk to their often unhedged clients. Thus, the exchange rate risk becomes part of the 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 eleven and a half years (since October 1993) the exchange rate of the kuna has been fluctuating in a corridor of approx. ±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 approx. twice the value of base money and one and a half times M1 money supply. But the central bank has not fixed the exchange rate. Thus, a limited degree of exchange rate flexibility is retained, also with a view 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 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 in 2002-2003, 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. Until December 2003, this ratio was successively ratcheted up to 42%. An administrative measure introduced in early 2003 pertained to the compulsory purchase of central bank bills if a credit institution's loans expanded at a rate higher than 16% p.a. In the fourth quarter of 2003 the monetary authorities also intervened repeatedly on the forex market to support the kuna. As a consequence, nominal credit growth as well as banks' profitability declined. The administrative measure was repealed in early 2004. 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 re-emerged, 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)

Table 7 Kosovo/Kosova: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004
GDP growth (real, %)	11.0	1.2	3.1	3.2
Consolidated government** budget balance (% of GDP): before grants	4.7	5.6	2.5	-2.4
- after grants	7.2	6.2	2.5	-2.4
Balance of goods and services (% of GDP)	-103.7	-86.0	-76.8	-68.5
Current account balance (% of GDP): before grants	-78.9	-63.5	-56.6	-50.0
- after grants	-8.6	-11.6	-15.8	-17.1
Net FDI inflows (% of GDP)	0.3	0.6	.	.
Gross reserves of central bank (excl. gold, end-year, % of GDP)	18.7	20.5	.	.
CPI-inflation (end-year, %)	11.7	3.6	1.0	1.7
Unemployment rate (%, after factoring in formal employment)		35-40*		

* preliminary data or estimates

Source: Banking and Payments Authority of Kosovo (BPK), EC, IMF

Kosovo's economic recovery from the war of 1999 was almost totally driven by foreign financial aid and private inflows, particularly

remittances from the Kosovar diaspora. A sharp decline of external donor assistance and the end of the post-conflict construction boom contributed to GDP growth almost grinding to a halt in 2002. Foreign grants have shrunk from around 100% to less than 40% of GDP. Workers' remittances equal around 20% of the size of the economy and have been essential to the survival of many Kosovar families. Since 2003, a degree of fiscal loosening has supported a weak recovery. 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, shaky security, insufficient rule of law, sluggish privatization and structural reforms, in particular unsettled Serbian property claims, a failing education system and uncertainty about the province's future status, foreign investors have been extremely reticent so far. Overall investment in productive structures has remained feeble. Unemployment is very high, including probably the majority of people aged 16-24.

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, at least up to 2003. The UN administration of Kosovo, more precisely the EU-led "Pillar IV: Reconstruction and Economic Development"[5], 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 reflected applying customs duties to aid-financed imports and taxing "exports" created by the donor sector.

Another bright spot is Kosovo's inflation performance, boasting low single digits recently. The province was de facto euroized by the permission given in September 1999 by the UN administration, respectively the EU-led Pillar IV, to freely use foreign currencies beside the Yugoslav dinar. The administration pays its employees solely in euros, levies taxes and carries out its transactions in euros. Transactions in other currencies are subject to a processing fee. The euro has thus become the dominant legal tender, imposing financial discipline and securing a degree of stability. 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 license and supervise credit institutions. Private banking has developed quickly, confidence in local banks has grown as witnessed by the swift expansion of deposits and loan portfolios, albeit from a tiny base. Most loans remain short-term.

5.6 FYR Macedonia

Table 8 FYR Macedonia: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	-4.5	0.9	3.3	1.8
General government budget balance (% of GDP)	-7.2	-5.7	-1.6	-1.4
Trade balance (% of GDP)	-15.2	-20.5	-18.4	-17.6
Current account balance (% of GDP): before grants	-8.2	-11.3	-8.2	-8.9
- after grants	-6.9	-9.5	-3.5	-6.3
Net FDI inflows (% of GDP)	12.8	2.1	2.0	2.2
Gross foreign debt (end-year, % of GDP)	42.0	41.1	38.8	37.9
Gross reserves of central bank (incl. gold, end-year, % of GDP)	21.9	19.2	19.3	19.1
Basic interest rate of NBRM (end-year, %)	10.7	10.7	6.5	10.0
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	1.0
Average exchange rate: MKD/EUR	60.91	60.98	61.36	61.54
Average exchange rate: MKD/USD	68.04	64.75	54.30	49.41
Unemployment rate (average, % of labor force)	30.5	31.9	36.7	37.0

* preliminary data or estimates

Source: national statistics, Narodna banka na Republika Makedonija, IMF, EC, WIIW, EBRD

The Macedonian economy has so far witnessed a quite hesitant recovery in the wake of the economic destabilization triggered by the ethnic and security crisis of 2001. Ethnic tensions have not yet been entirely overcome. 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 telecoms operator in 2001, FDI has featured disappointingly low levels. This reflects continued high political risk, weak governance, a feeble judiciary, slow structural adjustment and a difficult business climate. On the other hand, macroeconomic policies have been prudent in recent years: The budget deficit has been considerably reduced and a generally tight monetary stance has kept inflation under control.

The monetary authorities pegged the Macedonian denar to the D-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 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 re-emerged in late 2003, triggering renewed central bank forex market interventions. In early 2004, policy rates were raised again. Liquidity was withdrawn through auctions of central bank bills and through augmenting the government's denar deposits with the monetary authorities. Also in early 2004, treasury bills were introduced to the Macedonian financial market. Later on, in August and September, policy rates were increased once again. 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, reflecting re-intermediation gathering momentum and confidence in credit institutions growing. But there is a mismatch between predominantly (almost 2/3) foreign currency-denominated deposits and mostly (about 85%) denar-denominated loans. The Macedonian jobless rate is one of the highest in the region and is continuing to increase.

5.7 Montenegro

Table 9 Montenegro: Key macroeconomic and monetary policy indicators

	2001	2002	2003*	2004*
GDP growth (real, %)	1.0	0.8	2.5	5.8
Consolidated government budget balance (% of GDP): before grants	-4.7	-4.0	-5.2	-4.0
- after grants	-1.6	-1.8	-4.2	-3.5
Trade balance (% of GDP)	-46.5	-34.9	-25.0	.
Current account balance (% of GDP): before transfers	-52.8	-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 reserves of central bank (incl. gold, end-year, % of GDP)	.	4.7	.	.
CPI-inflation (end-year, %)	28.0	9.4	6.7	5.0
Unemployment rate (average, %)	24.8	23.5	21.0	.

* preliminary data or estimates
Source: national statistics, Centralna banka Crne Gore, WIIW, IMF

Montenegro's recovery following the Kosovo war of 1999 has been feeble and may be somewhat underestimated by official statistics,

since the gray economy is estimated to come to about a third of economic activities. In 2003 and 2004, 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 (Kombinat Aluminijuma Podgorica, 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.

In order to escape the inflationary policies of Belgrade and become more independent of the then Milosevic regime, Podgorica introduced the D-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 between Serbia and Montenegro.

The Central Bank of Montenegro started to function in early 2001. Its gross reserves are (still) 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 tendencies in banking sector development, incl. 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 may give rise to concern for a euroized economy and jeopardize Montenegro's modest competitiveness. Inflation is partly fueled by the high level of public expenditures with 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

Table 10 Romania: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	5.6	5.0	4.9	7.8
General government budget balance (% of GDP)	-3.3	-2.9	-2.2	-1.0
Trade balance (% of GDP)	-7.4	-5.7	-7.9	-8.0
Current account balance (% of GDP)	-5.5	-3.4	-6.0	-6.6
Net FDI inflows (% of GDP)	2.9	2.4	3.0	4.5
Gross foreign debt (end-year, % of GDP)	31.2	30.8	30.9	29.4
Gross reserves of central bank (excl. gold, end-year, % of GDP)	9.9	12.3	12.7	13.5
Reference rate (end-year, %)	35.0	22.0	20.4	18.0
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	9.3
Average exchange rate: ROL/EUR	26027	31255	37556	40532
Average exchange rate: ROL/USD	29061	35056	33200	32637
Unemployment rate (acc. to labor force survey, average, %)	6.6	8.4	7.0	7.5

* preliminary data or estimates

Source: national statistics, Banca Nationala a Romaniei, WIIW, IMF, EBRD, BIS

After a protracted period of sluggish reforms and stagnation, followed by an economic and financial crisis (1997-99), Romania has since 2001 experienced some robust GDP growth, which accelerated to around 8% in 2004. However, the country has so far been saddled with its twin deficit problem. While budget shortfalls have been on a clear-cut downward path recently, the current account gap sharply widened in 2003 and reportedly further widened somewhat in 2004. This deterioration was driven by an acceleration of domestic consumption and investment, stemming from rapid wage growth and swift expansion of credit to the private sector. FDI, which in some years covered over two thirds of the external disequilibrium and has brought about some important gains in structural adjustment, productivity and competitiveness, in 2003 and 2004 made up for somewhat more than half of the imbalance. Administration and courts still suffer from serious transparency and enforcement problems and payments discipline remains unsatisfactory in a number of areas.

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 degree of stability of the real effective exchange rate. In the past the 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 has been and 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-US dollar currency basket, since early 2005, the reference unit has solely been the euro. The 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 build-up 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. This stance, supported by a coherent policy mix, led inflation to decline from 41% in 2000 to 14% in 2003 (end-year). In response to the downward trend of inflation the central bank lowered its interest rates substantially.

2003 featured a sharp rise of the minimum wage 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 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 credit growth 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 appreciation pressures re-emerged. In June 2004 the reference rate was lowered by half a percentage point, followed by further cuts in August. Inflation reportedly declined to slightly below double digits by year-end 2004, which is a novelty since the collapse of communism. By mid-2005 the authorities intend to change their official policy from monetary to inflation targeting.

5.9 Serbia (without Kosovo)

Table 11 Serbia: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GDP growth (real, %)	5.5	4.1	3.1	6.7
Consolidated government budget balance (% of GDP): before grants	-1.2	-4.5	-4.2	-3.3
- after grants	-0.8	-3.4	-3.8	-2.9
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	-13.5
- after grants	-6.1	-12.1	-10.2	-13.0
Net FDI inflows (% of GDP)	1.4	3.5	6.0	3.2
Gross foreign debt (end-year, % of GDP)	104.0	74.0	70.5	59.0
Gross reserves of central bank (incl. gold, end-year, % of GDP)	9.4	15.2	18.7	16.0
Discount rate (end-year, %)	16.4	9.5	9.0	8.5
Broad money growth (M2, nominal, end-year over preceding end-year, %)	106.7	63.0	12.9	20.0
CPI inflation (end-year, %)	40.7	14.8	8.1	12.5
Average exchange rate: YUD/EUR	59.44	60.79	65.36	73.00
Average exchange rate: YUD/USD	66.84	64.19	57.44	58.59
Unemployment rate (average, % of labor force)*	12.2	13.3	15.2	15.5

* preliminary data or estimates

Source: national statistics, Narodna banka Srbije, WIIW, IMF, OECD, EC, EBRD

Serbia's economic recovery from the 1999 war was stronger than Montenegro's, but at least until 2004 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 had only started after 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 as of lately with respect to the fiscal and banking spheres.

Tax reforms strengthened fiscal administration and FDI gathered some momentum in 2003, driven by a few large successful

privatizations. Numerous small firms were also sold in 2003. Although privatization and FDI slowed down the following year, output gains in recently privatized enterprises contributed to the acceleration of growth. The enhancement of the supervisory and regulatory frameworks improved the financial performance of credit institutions. Given the country's still very high foreign debt and its debt service obligations, which are scheduled to rise in the coming years, the decade-long neglect of its industries and concomitant huge structural catching up needs, it appears most important that Serbia regain the above-mentioned momentum in attracting FDI. Given 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 D-Mark/euro as external nominal anchor. This sharply reduced inflationary expectations and engendered growing money demand and a remonetization of the economy. Although inflation has been brought down, in the two years until end-2002 the dinar appreciated by about 50% in real-effective terms (if from an undervalued base).

In order to better tackle the Serbian economy's external constraints and forestall a further deterioration of its price competitiveness, the central bank chose to loosen somewhat 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 US dollar), but the dinar's real effective exchange rate remained broadly unchanged. This development largely continued in 2004. Thus, in striking a balance between inflation and external competitiveness, the monetary authorities have recently assigned somewhat more weight to the external objective.

The authorities now consider the exchange rate a real rather than a nominal anchor. When the loose union of Serbia and Montenegro replaced the Federal Republic of Yugoslavia (FRY) in February 2003, the National Bank of Yugoslavia (NBY, which had already lost

control of euroized Montenegro in 2000) was renamed National Bank of Serbia (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 have 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 on the forex market and to raise NBS bill rates in order to support the domestic currency. Although forex reserves have remained on a relatively high level, the overall external position continues to be fragile. After declining to 8% in 2003, inflation rose again to about 13 % in 2004, pushed up by strong real wage adjustments in the public sector, oil price increases and the currency depreciation. In the fall of 2004, the NBS raised reserve requirements and stepped up open market operations. IMF and international donor support remain essential for Serbia.

5.10 Turkey

Table 12 Turkey: Key macroeconomic and monetary policy indicators

	2001	2002	2003	2004*
GNP growth (real, %)	-7.5	7.9	5.9	7.9
Consolidated budget balance (% of GNP)	-15.8	-14.2	-11.5	-8.5
- primary balance	5.5	4.1	6.3	6.0
Trade balance (incl. shuttle trade, % of GNP)	-5.2	-4.6	-5.7	-7.5
Current account balance (incl. shuttle trade, % of GNP)	2.4	-0.8	-3.2	-4.9
Net FDI inflows (% of GNP)	1.9	0.5	0.4	0.5
Gross foreign debt (end-year, % of GDP)	81.5	72.1	60.3	53.0
Net public sector debt (end-year, % of GDP)	94.0	78.8	70.5	70.4
Gross reserves of central bank (incl. gold, end-year, % of GDP)	13.4	13.4	12.4	12.0
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	26.9
CPI-inflation (end-year, %)	68.5	29.7	18.4	9.4
End-year exchange rate TRL/EUR	1290	1756	1763	1850
End-year exchange rate TRL/USD	1450	1655	1353	1491
Unemployment rate (acc. to labor force survey, %)	8.4	10.3	10.7	10.8

* preliminary data or estimates
Source: national statistics, Türkiye Cumhuriyet Merkez Bankasi, IMF, OECD

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 instable developments in preceding years were followed by the launching of a disinflation program 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.

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 US 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, triggering 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 US 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 Fund has remained financially committed to Turkey so far (January 2005). The new program has focused more deeply than previous ones on public sector, fiscal and tax reforms, on shaping up the banking sector and on product and labor market reforms. Monetary policy reverted to money growth targeting, while maintaining a loosely managed float of the lira.

Quite a degree of success has already been achieved. The macroeconomic situation stabilized more quickly than expected. In 2002 the economy all but fully made up for the sharp slump it had suffered in 2001 and continued its brisk expansion in 2003, even accelerating in 2004. The main driving forces were private sector consumption and investment. Capital formation gained further

momentum in the first half of 2004, contributing 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 15-20% of annual GNP in recent years). The latter derive from a legacy of huge public indebtedness and high interest rates.

After its crisis-driven peak in 2001, the fiscal imbalance somewhat receded through 2003 and 2004. Notwithstanding impressive fiscal consolidation efforts, there still remains considerable room for improvement. Given the accelerating economic growth in 2004, the current account shortfall is on the rise. Although FDI has stirred somewhat recently, its overall low level seems to be problematic. This may reflect a less than satisfactory pace of privatization of state-owned enterprises as well as too much bureaucracy, an inefficient judicial system, corruption 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 re-establishment of trust in the lira. CPI inflation descended to below 9% in early 2005. This is the lowest inflation level Turkey has seen since the early 1970s. Inflationary expectations were reduced, money demand recovered and remonetization 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 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 steadily came down. Given the encouraging inflation environment, the central bank cut its intervention rate (overnight deposit rate) twice 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 US dollar in the final months of 2003 and in 2004. In the meantime, banking activities have been recovering and the expansion rate of credit to the private sector accelerated from 10% in December 2002 (year-on-year) to 45% in December 2003. Buoyed by portfolio capital inflows, most recently the lira has also appreciated against the euro, giving rise to concerns about Turkey's competitiveness.

Although the central bank plans to move to inflation targeting soon, for the time being it appears reluctant to make the shift, at least until the government has established a longer track record of fiscal discipline and until a more sustained stable environment (lower volatility of exchange rate, stronger banking system) is in place. 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 (2001-2004) 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 > 4% p.a.) in most countries and has gained further strength in 2004. It has been less dynamic in FYR Macedonia, in Montenegro and in Kosovo. South Eastern European economic expansion on the whole outstrips that of Central Europe, not to speak of the Western part of our continent. South Eastern Europe, of course, has 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 retooling/restructuring of industries.

All analyzed countries/territories except Bulgaria, Kosovo, Macedonia and Romania witness high budget deficits (> 3% of GDP, before grants). Although it improved, Turkey's budget has remained

most deeply in the red. Practically all countries of the region are saddled with high or very high current account shortfalls. Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia and Turkey remained 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 remained 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 South Eastern 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, although a large part of it is private. In Serbia it is high and subject to restructuring negotiations, in Bulgaria and Turkey it is high, but falling. Except for 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, unfortunately in most countries a turnaround does not yet appear to be in sight. 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 has been registered in some countries in 2003, in others in 2004. In 2003 single digits were reached everywhere, except in Romania and Turkey. In 2004 Serbia was the sole exception. Falling inflation appears to be linked to an overall reduction/slowdown of money growth, which enabled interest rates to be cut/to decline. Money supply has been controled by forex 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, but it was not the major cause for the interruption.

On the other hand, Albania, a country with a loosely managed float, has also boasted low price increases. And Turkey has been successful in bringing down stubbornly high inflation in short time with a similar regime. Therefore, the confidence and stability-enhancing effect of hard pegs appears to have borne out success in most analyzed countries; but this doesn't 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. Due to the progress and track record on the route to price stability, despite occasional setbacks, confidence in domestic currencies/ monetary policies 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, remain high and are boosted by the increasing density of trade and economic relations of the region with the euro area and the EU. Foreign investment, notably from euro area and EU countries, has contributed to changing the structure and modernizing South Eastern 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 2001/2002, which provided a sizable 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 of 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 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 prudential and monetary tightening, which was in some – but not yet all - cases followed by a slowdown of credit growth.

Finally, attempting 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 South Eastern European countries and the European Union will further strengthen. Romania and Bulgaria are already acceding countries, Croatia's application has been accepted, even if there is still no firm date for launching accession negotiations. FYR Macedonia's application is being processed, Turkey is a candidate. Stabilization 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 Serbia and Montenegro have been/are being drawn up by the 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/lever for reforms in the region.

Upon joining the Union, new member states commit themselves to adopting the euro after all the pre-conditions, 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 treaty. What would happen to the monetary regimes in Kosovo and Montenegro in the event that these territories joined the 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 Kosovo war, conflict with Milosevic regime and its inflationary policies), perhaps pragmatic solutions – without setting a precedent – could be found.

Cut-off date: January 31, 2005

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ENDNOTES

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[1] The GDP ratio is calculated on the basis of exchange rates. If purchasing power parities were used, the ratio might be about three times as large. – See also Gligorov, 2004, p. 52.

[2] The size would likely exceed 7% if purchasing power parities were taken into account.

[3] See next chapter.

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

[5] UNMIK (the United Nations Interim Administration Mission in Kosovo), created in June 1999 by Security Council resolution 1244, consists of four «pillars»: 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.