

# Exchange Rate Regimes and the Transition Process in the Western Balkans

## A Comparative Analysis\*

by  
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### Extended abstract

In the academic literature some criteria have been identified which could have an impact on the success of the transition process, such as macroeconomic stability, microeconomic restructuring and implementation of legal and institutional reforms. The role of the exchange rate system in general is to foster the stability of the monetary environment characterized by low inflation rates and a stable domestic currency. Although the importance of a sustainable price-level oriented monetary policy for the transition-success has been stressed in the academic literature, there are still further questions to be answered related to the choice of the exchange rate system throughout the different phases of the transition process. This paper intends to contribute to close this gap in the literature. The guiding research question is how the choice of an exchange rate system influences the economic success of a country in transition and its gradual integration within the European Union (EU) and the European Monetary Union (EMU). For this purpose, the study focuses on the transition process of South-eastern Europe (SEE). In particular and for the first time in a joint study, we will take a look at the following South-eastern European Countries (SEECs), often referred to as the “West Balkans”: Bosnia and Herzegovina (BiH), Croatia, Former Yugoslav Republic of Macedonia (FYRM) and Serbia and Montenegro (S&M), as these four countries share certain common characteristics: they were part of the Former Yugoslav Republic (FYR); they are countries in transition; they are members of the Stability Pact for South-eastern Europe and they are all potential EU-accession candidates.

**JEL-codes:** E44, F33, P21

**Keywords:** Balkans, exchange rate mechanism, optimum currency areas, economic transition, trade integration.

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## 1. Introduction

Many studies nowadays conclude that transition as a problem on its own is over now in Central Europe. However, this does not mean, as Gros and Steinherr (2004, p. 134) put it that “all transition economies are in a state of bliss”. Instead, transition is a still unfinished business for regions like the Balkans.

In the academic literature, some criteria have been identified which could have an impact on the success of the transition process<sup>1</sup>, such as macroeconomic stability, microeconomic restructuring and implementation of legal and institutional reforms (Havrylyshyn 2001, Hillman 2003, Roland 2001). The role of the exchange rate system, as it is generally seen, is to foster the stability of the monetary environment which is characterized by low inflation rates and a stable domestic currency (Domaç, Peters & Yuzefovich 2001, p.5). Although the importance of a sustainable price-level stability oriented monetary policy for the transition-success has often been stressed in the academic literature up to now, there is still ample room for further questions to be discussed and answered related to the choice of the exchange rate system throughout the different phases of the transition process.

This paper intends to contribute to close this gap in the literature. The guiding research question is how the choice of a specific exchange rate system influences the economic success of a country in transition and, above all, its gradual integration within the European Union (EU) and European Monetary Union (EMU). For this purpose, the study will focus on the transition process of South-eastern Europe (SEE). In particular we will take a look at the following South-eastern European Countries (SEECs), often referred to as the “Western Balkans”: Bosnia and Herzegovina (BiH), Croatia, Former Yugoslav Republic of Macedonia (FYRM) and Serbia and Montenegro (SCG), as these four countries share certain common characteristics: they were part of the Former Yugoslav Republic (FYR); they are countries in transition; they are members of the Stability Pact for South-eastern Europe and they are all potential EU-accession candidates. Referring to standard Optimal Currency Area (OCA) theory, we will try to identify whether and when the four Western Balkan countries are ready to join the Exchange Rate Mechanism (ERM) and the EMU and which monetary-transitional regime should be chosen.

The paper proceeds as follows. After the introduction the paper will focus on the following issues: a) introduction of the basis political and institutional settings of the four Western Balkan countries and their macroeconomic development in the recent years, b) the actual, as opposed to the optimal choice of the exchange rate regime and the main objectives of monetary policy, and c) a

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<sup>1</sup> The transition process is inducing - amongst other things - transformation of a centrally planned economic system into an advanced free market economy (Havrylyshyn 2001, p.54).

normative judgment on the choice of the optimal transitional exchange rate regime in the Western Balkan countries with respect to the integration within the EU and EMU.

## 2. The economic transition process in the Western Balkans

The approach to transform centrally planned economies into market economies, undertaken in parallel with the establishment of democratic political regimes, has been the largest social project of the last century. It was (and still is) necessary to reestablish and modernize the infrastructure of the market economies (legal, informational, attitudinal, relationship). In the monetary area, the intermediate goals of the transition strategy are to free prices, stabilize the price level, liberalize trade, unify markets (in particular, the foreign exchange and money markets) and thus prices (exchange and interest rates), and to reduce and make transparent the political (government) allocation of resources (Coats et al 2002, p.1).

The SEECs went through major political and economic changes during the 1990s, leaving them with a persisting reputation for instability. In the meantime, the situation of the four Western Balkan countries has changed for the better and there are some reasons for optimism about their medium- to long-term future development. The fall of the Milosevic regime in October 2000 allowed the FRY (formerly known as Federal Republic of Yugoslavia and renamed by the State Union of Serbia and Montenegro in February 2003) to rejoin the international community. All countries in the Western Balkan region are cooperating both bilaterally and in regional forums to an extent that was unimaginable five years earlier.

Though many problems, risks and challenges still remain, the likelihood of overcoming most of these obstacles is getting higher as the region is starting to catch up with the other transition countries in Central Eastern Europe (CEE) and the Baltic states (see Table 1).

| Country                          | Per capita GDP (in US-\$) | Real GDP growth rate (% change) | Consumer prices (end year, % change) | unemployment (% of labor force) | current account / GDP (in %) |
|----------------------------------|---------------------------|---------------------------------|--------------------------------------|---------------------------------|------------------------------|
| Bosnia and Herzegovina           | 1857.3                    | 3.5                             | 0.1                                  | 40.6                            | -17.8                        |
| Croatia                          | 6408.6                    | 4.5                             | 1.8                                  | 14.8                            | -6.8                         |
| FYRM                             | 2357.3                    | 2.8                             | 2.5                                  | 31.9                            | -6.3                         |
| Serbia and Montenegro            | 2506.6                    | 2                               | 7.7                                  | 28.9                            | -11.6                        |
| <b>CEECs &amp; Baltic states</b> | <b>7157.3</b>             | <b>3.6</b>                      | <b>3.2</b>                           | <b>12</b>                       | <b>-5.7</b>                  |

**Table 1: Selected macroeconomic indicators 2004**

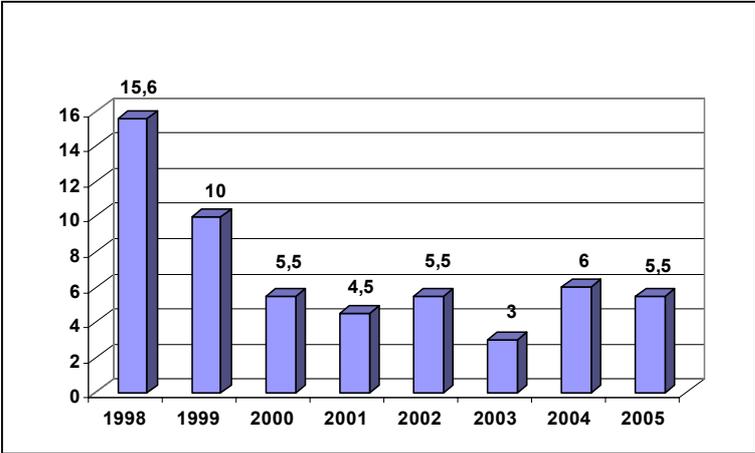
Source: Data taken from the EBRD.

The process of integration of the four Western Balkan countries within the EU influences the transition success and paves the way towards democracy and a free market economy. The often

claimed objective of the EU is to promote stability, security and prosperity in the Western Balkans through the integration of the region into the “European mainstream” (European Commission 2006, p. 2). Therefore, important steps have been taken in recent months such as the opening of accession negotiations with Croatia, granting candidate status to the Former Yugoslav Republic of Macedonia, opening-up of the Stabilization and Association Agreement (SAA)<sup>2</sup> negotiations with Serbia and Montenegro and Bosnia and Herzegovina. In the next section we will take a closer look at each of the four selected Western Balkan countries and their economic development during the recent year as well as at the overall present and future economic trends in the region.

**2.1. Country analysis: Bosnia and Herzegovina**

During the first years after the civil war (1996 - 1999) **BiH** has experienced high **GDP growth rates** but the annual growth rates slowed down to an average of 5% between 2000 and 2002. The main reason for the slowdown has been the limited capacity of BiH to substitute the aid driven growth with mobilization of domestic sources of growth. Although the slowdown of the growth rates continued in 2003 (3%), the economic rebound initiated the increase of the GDP growth rates in 2004 (6%) and 2005 (5.5%), particularly due to an increase of the industrial and agricultural production. In the Federation, the increase was mainly attributed to growth in the processing industry as well as in the utilities, while the rise in industrial production in the RS mainly came from mining (European Commission 2004, p.46).



**Figure 1: Real GDP growth rates BiH**

Source: Data source is the BiH Central Bank.

According to official figures, the **unemployment rate** at the end of the year 2003 was at an – at least to OECD standards – incredibly high value of 42%, with an unemployment rate of 44% in the Federation and 37% in RS. However, estimates including employment in the grey economy

<sup>2</sup> SAAs are already in place with Croatia and FYRM. SAAs are powerful engines for trade integration, domestic reform and rapprochement to the EU, not least through their clauses which encourage legislative approximation and the building up of administrative capacity.

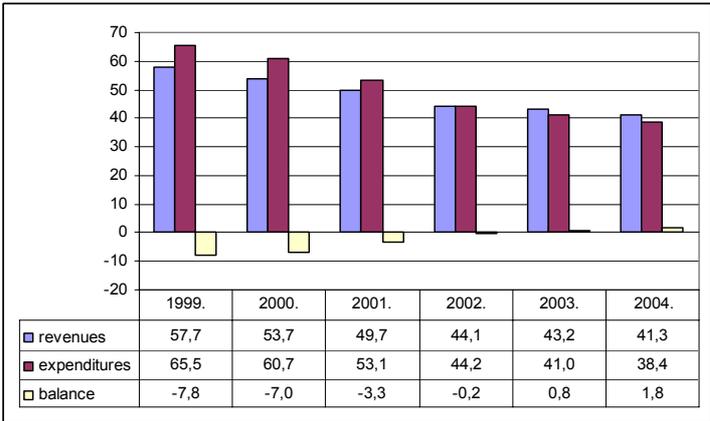
point to an actually lower unemployment rate of around 20% in 2003 which came down from 23% in 2001. New estimates of the size of the grey economy, made by the Central Bank, suggest that the grey economy roughly corresponds to 40% of official GDP figures.

|      | Unemployment rates % |                 |       |
|------|----------------------|-----------------|-------|
|      | Federation BiH       | Republic Srpska | BiH   |
| 1998 | 38.7                 | 36.8            | 38.0  |
| 1999 | 39.0                 | 37.6            | 38.5  |
| 2000 | 38.8                 | 40.2            | 39.3  |
| 2001 | 39.9                 | 40.2            | 40.0  |
| 2002 | 42.7                 | 38.2            | 41.1  |
| 2003 | 44.0                 | 37.0            | 42.05 |
| 2004 | 44.9                 | 47.2            | 43.2  |

**Table 2: Unemployment rates in BiH and the two entities**

Source: Data gained from the OHR and national agencies.

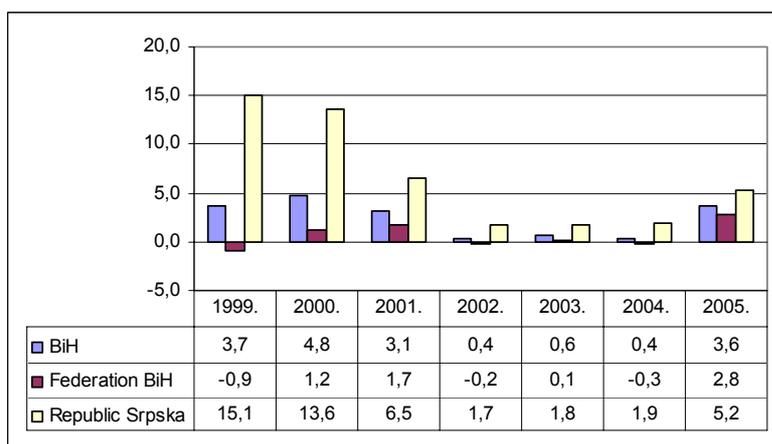
Following several years of progressive fiscal consolidation, a further significant adjustment took place in 2004. The **consolidated budget** moved from a deficit of 3.3% of GDP in 2001 to a surplus of 1.8% in 2004.



**Figure 2: Budget General Government BiH (in % of GDP)**

Source: Data were received from the BiH Central Bank.

**Inflation** remains low and was on average 3.6 % in 2005. It has to be noted that the inflation rates in the two entities have been converging over the last years, but inflation still remains higher in the RS, where the retail price index grew by 5.2 % in 2005 versus 2.8 % in the Federation.



**Figure 3: Retail price growth rates BiH**

Source: Data collected from the BiH Central Bank.

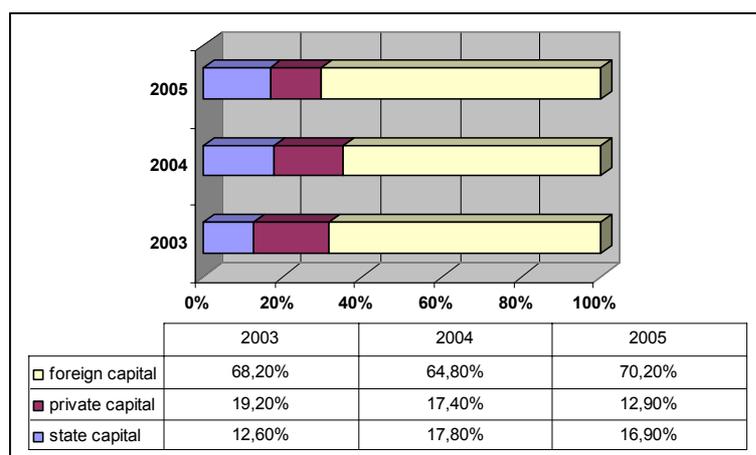
**Structural reforms** are proceeding, although progress has been unevenly distributed among different areas of potential reforms. Major achievements have been reached with respect to the establishment of the Indirect Tax Authority, which will unify indirect taxation across the entities, as well as reforms improving the business environment and budget control. Although a large number of laws have been adopted, the fast implementation of enacted laws is certainly necessary in order to achieve concrete improvements.

**Privatization** has in general progressed slowly, in spite of a legislative framework in place for already a number of years. Some of the most important factors hampering the privatization process have been: lack of political will and the potential investors' hesitations.<sup>3</sup> The privatization of small-scale publicly owned enterprises which have been sold to local buyers is the most advanced one. However, recent progress related to the privatization of larger and strategically more important enterprises has been made. About 20 strategically important companies are privatized in the Federation and the sale of several companies in the Republic of Srpska is either ongoing or has already been finalized. Because of the size of these companies and their strategic importance the generated sales are expected to have a positive impact on the BiH economy in general (European Commission 2004, p. 63).

The **banking system** is one of the sectors in BiH where the most rapid reforms and structural transformation have been taking place. State ownership declined between 2000 and 2005 as a result of privatizations. By end 2005, 90% of total capital in the banking sector was in private hands and the sector is at present dominated by the foreign-owned banks (Federal Banking Agency 2006 p.4; Banking Agency of Republic Srpska 2005 p.4). The banking sector in the Federation is considerably larger than the one in the RS, hosting 27 out of the 37 banks and accounting for over 80% of total banking sector capital.

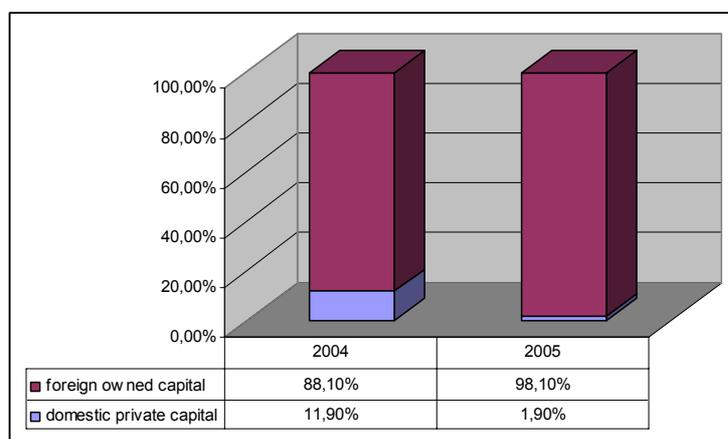
<sup>3</sup> For the political economy of privatization in general see Belke and Schneider (2006).

Overall, banking system restructuring has progressed at a much faster pace than corporate reforms. Therefore, a relatively modern and dynamic banking sector coexists with a weak corporate sector.



**Figure 4:** Ownership structure banking sector Federation BiH

Source: Data taken from the Federal Banking Agency.



**Figure 5:** Ownership structure banking sector Republic Srpska

Source: Data taken from the Banking Agency, Republic Srpska.

BiH benefits from the autonomous trade measures of the European Community, introduced in September 2000, which allows more than 95% of all imports to enter the EU duty- and quota free. Major trading partners are the countries of the European Union as well as the Western Balkan neighbouring countries Croatia and Serbia and Montenegro.

| EU           | EXP in %    | IMP in %    |
|--------------|-------------|-------------|
| Austria      | 4,5         | 4,1         |
| Italy        | 18,6        | 9           |
| Germany      | 13,5        | 14,1        |
| Hungary      | 3,8         | 4,1         |
| Slovenia     | 6,4         | 9,3         |
| <b>Total</b> | <b>46,8</b> | <b>40,6</b> |

**Table 3:** Exports and Imports with the EU major trading partner 2004

Source: Data delivered by the BiH Statistical Agency.

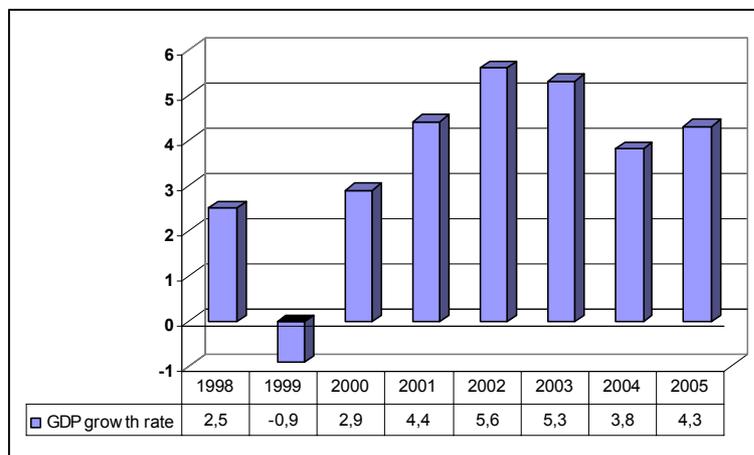
| Western Balkan        | EXP in %    | IMP in %    |
|-----------------------|-------------|-------------|
| Croatia               | 19,9        | 16,2        |
| Serbia and Montenegro | 12,5        | 3,1         |
| <b>Total</b>          | <b>32,9</b> | <b>19,3</b> |

**Table 4: Exports and Imports with Western Balkan major trading partner 2004**

Source: Data delivered by the BiH Statistical Agency.

## 2.2. Country analysis: Croatia

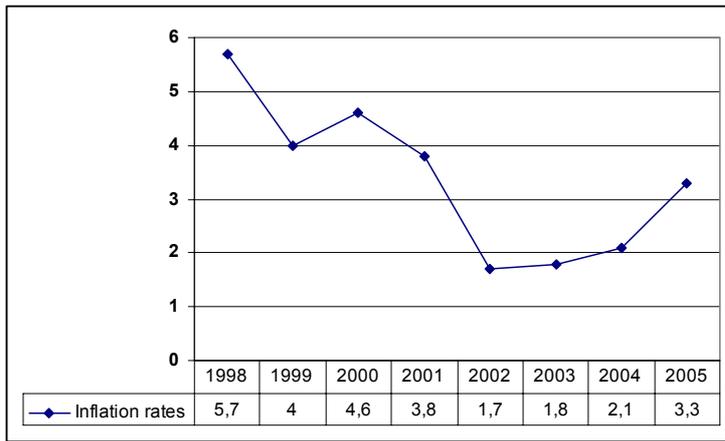
In 2004, growth of real GDP in **Croatia** decelerated to 3.8%, after 5.3% in 2003 and 5.6% in 2002. This downward trend continued in the first quarter of 2005, before economic activity started to pick up during the second quarter so that the GDP has risen by 1.5% to 4.3% in 2005 (Croatian National Bank).



**Figure 6:** Croatia development of the GDP year-on-year growth rate

Source: Data collected from the Croatian Central Bank,

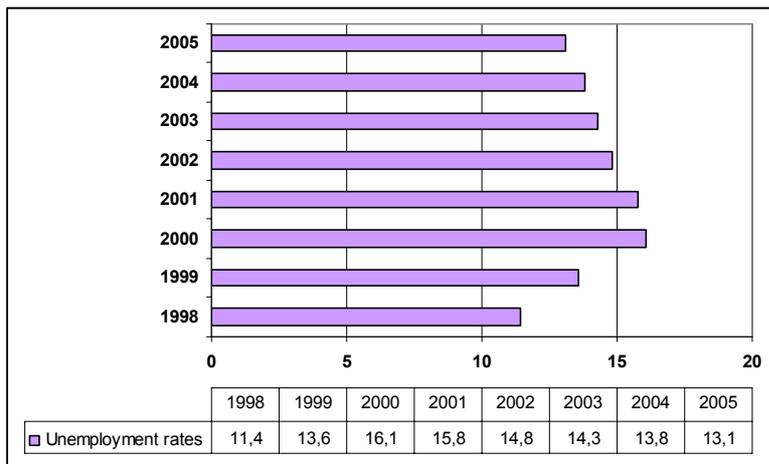
**Inflation** remained relatively low, although there has been some upward pressure on prices in the second half of 2004 and in early 2005, mainly due to higher energy and food prices. This led to a slight increase in annual average inflation from 1.8% in 2003 to 2.1% in 2004 and 3.3% in 2005 (Croatian National Bank).



**Figure 7:** Croatia average year-on-year inflation rates

Source: Data collected from the Croatian Central Bank.

High **unemployment** remains one of the most pressing problems of the Croatian economy, although the situation on the labor market improved slightly in 2004. The officially registered unemployment rate fell from 14.3% in 2003 to 13.8% in 2004 and 13.1% in 2005 (Croatian National Bank).



**Figure 8:** Croatia development of the unemployment rates

Source: Data collected from the Croatian Central Bank.

The Croatian **budget deficit** was reduced in 2004, but higher than targeted, and further fiscal consolidation remains an important challenge. The 2004 general government deficit declined to 4.9% of GDP, down from 6.3% a year earlier (European Commission 2005, p.40). Progress with **privatization** has been slow, but gained some new momentum since early 2005. A total of 25 privatization tenders were launched in 2004 and 14 companies were sold, whereas in the first five months of 2005, 14 companies were tendered and 10 were sold. As a result, the total value of state-owned assets under the responsibility of the Privatization Fund declined by 3% in 2004, while it shrank by 13% in the first half of 2005 (European Commission 2005, p. 41).

The privatization and consolidation of the Croatian **banking sector** is very well advanced as the banking sector has traditionally played the most important role in financing the economy. Its assets accounted at the end of 2004 for 83.4% of the entire financial system, or around 111% of GDP, slightly up from the 2003 share. Only two banks (postal bank, Croatia Banka), accounting together for 3.1% of commercial banks assets in 2004, have remained state-owned and are expected to be merged and privatized. More than 90% of the total assets of the banking sector are foreign-owned. For the size of the market, the number of banks remains rather high at 38 in 2005, which has however declined from 41 banks in 2004 (European Commission 2005, p.42).<sup>4</sup>

Croatia is an **open economy** and its trade has been liberalized to a large extent, the country being a member of the WTO and having signed a number of bilateral Free Trade Agreements, notably with neighboring countries. The EU accounts for more than half (!) of both exports and imports, whereby Italy, Germany and Austria are the most important trading partners for Croatia. In 2004, the EU was Croatia's main trading partner accounting for 70% of external trade<sup>5</sup>. Furthermore Croatia is the EU's leading trading partner in the Western Balkans.

### **2.3. Country analysis: Former Yugoslav Republic of Macedonia**

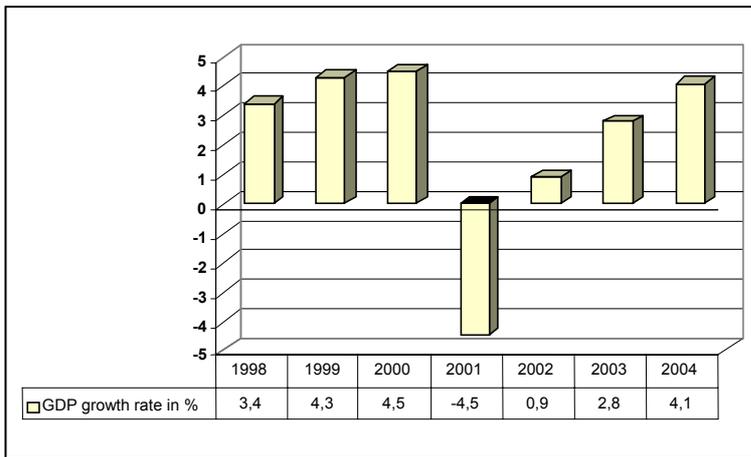
**The Former Yugoslav Republic of Macedonia** is a small country with a population of around 2 million people according to the latest census (2002). After a sharp recession during 1991-1993, which led to a fall in production levels to about three-quarters of pre-independence levels, the economy started to recover during 1996-2000. The crisis in 2001 resulted in a sharp decline in output by 4.5%. Since then **economic growth** has been positive, but rather low. Over the whole period of 1996-2004, average annual growth reached only 1.8%. As a result, by 2004 economic output stood at only about 90% of pre-independence levels. During this period, economic growth was mainly driven by private consumption and exports, while the contributions made to growth by investment and public consumption remained low (FYRM State Statistical Office; European Commission 2005, p.41).

During the early years of independence (1991- 1995) **inflation** averaged around values of 400% per year, with a clear peak of some 1700% in 1992. However, a stabilization program adopted in 1994 with a strong focus on maintaining strict fiscal and monetary discipline, controlling wage developments and pegging the exchange rate to an external anchor significantly contributed to bring down inflationary pressures quite rapidly. During the period 1996-2004, consumer price inflation amounted to 2.3% on average, with peak values of 5.8% and 5.5% in 2000 and 2001 (FYRM State Statistical Office; European Commission 2005, p.42).

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<sup>4</sup> For more details on the privatization process in the banking sectors of the Eastern and South-eastern European transition countries see Belke and Schaal (2005).

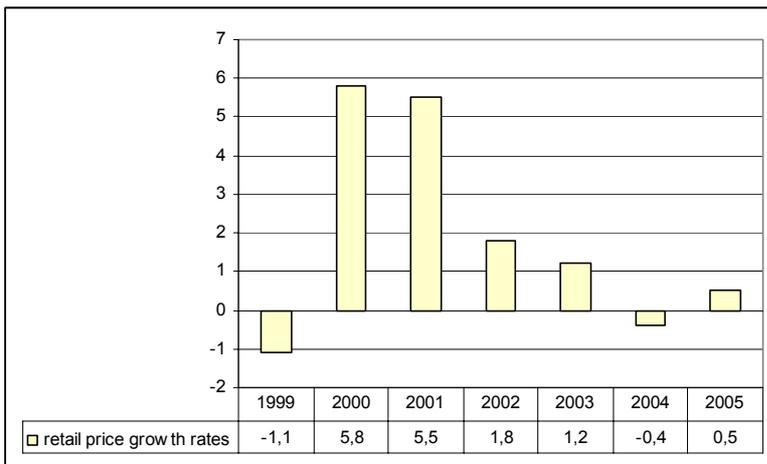
<sup>5</sup> Second came Bosnia-Herzegovina with 6.2% in 2004 (European Commission).



**Figure 9:** FYRM real GDP growth rates 1998 - 2004

Source: Data taken from the FYRM State Statistical Office 2005.

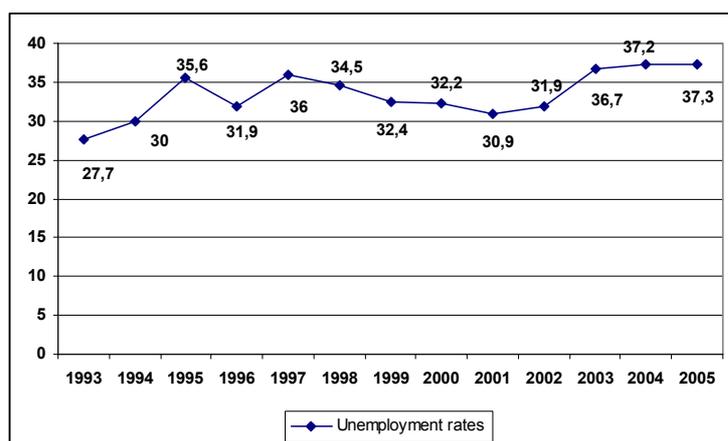
According to our point of view, the current main inflation indicator appears outdated with food items accounting for some 50% of the basket weighting. However, note that the FYRM State Statistical Office and Eurostat are currently working on the introduction of an updated inflation indicator.



**Figure 10:** FYRM Inflation average rates 1999 - 2005

Source: Data collected from FYRM State Statistical Office and FYRM Central Bank.

Despite stronger economic growth, the labor market performance in the Former Yugoslav Republic of Macedonia deteriorated during the years 2003 and 2004. In the year 2003, the number of employed persons declined by 3% (16 thousand persons) leading to an increase in the **unemployment rate** from around 32% in 2002 to 36.7% in 2003 and 37.2% in 2004 (FYRM State Statistical Office). However, when assessing the unemployment figures, the large size of the grey economy should be considered. Most important, note that people use to register as unemployed in order to access health insurance or social assistance, while working at the same time in the grey sector.



**Figure 11:** FYRM Development of unemployment rates 1993 - 2005

Source: Data collected from FYRM Central Bank.

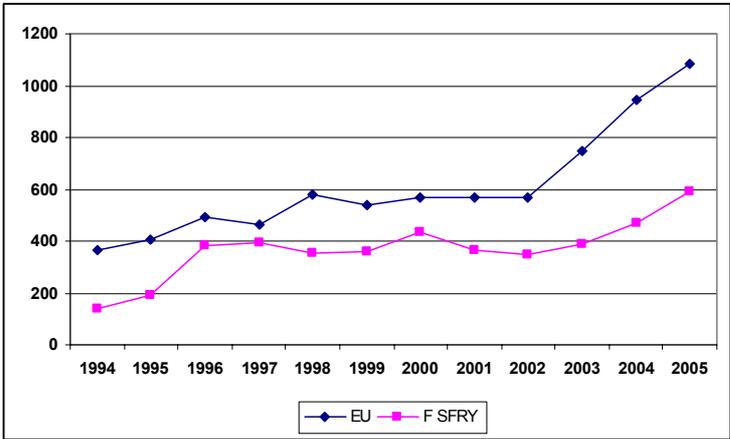
In the year 2003, the **fiscal performance** of the FYRM improved substantially. General government expenditures declined by almost 6% of GDP (from 40.5% in 2002 to 34.7% in 2003), whereas total revenues declined by around 2% of GDP (from 34.9% in 2002 to 33.1% in 2003) owing mainly to a lower than projected VAT collection, the abolition of the financial transaction tax and declining custom duties, reflecting the ongoing trade liberalization (FYRM State Statistical Office; European Commission 2004, p.61).

The **privatization process** of small- and medium-sized enterprises is almost complete. As of end December 2003, 1687 enterprises have been privatized, while 79 state companies out of those included in the privatization program that began in 1993 remained for sale. The action plan for the restructuring, liquidation or privatization of 40 large loss-making enterprises, which was launched in 2000, was finally completed in 2003. However, the main method of privatization, which favored insiders, and the lack of a market for corporate control, did not lead to improvements in corporate governance and gains in efficiency (European Commission 2004, p.63).

The **financial sector** of FYRM is characterized by the predominance of the banking sector and a limited role of non-bank financial institutions. The total assets of the banking sector account for some 41% of GDP and are fairly concentrated, with the two largest banks having a combined market share of 55% of total assets. The sector is largely in private hands, with only 13% of total capital still owned by the public sector, and characterized by a substantial degree of foreign participation – 40% of total banking capital is in foreign hands (European Commission 2004, p.65).

In contrast to some other transition economies, **trade integration** with Western Europe was already relatively high when the country was part of the Former Yugoslav Republic, while trade with other Western Balkan neighboring countries was rather low. Bilateral relations with the EU on trade and trade-related matters are regulated by the SAA which entered into force in April

2004. The Agreement foresees a gradual and asymmetric liberalization of trade with the EU. The importance of the trade with the EU-25, as a market with high purchasing power has increased significantly. The share of exports to the EU increased from 45.3% in 1999 to 57.1% in 2005 while the share of imports from the EU rose from 40.7% in 1999 to 47.5% in 2005 (FYRM State Statistical Office 2005c, p.3; European Commission 2005, p.50).



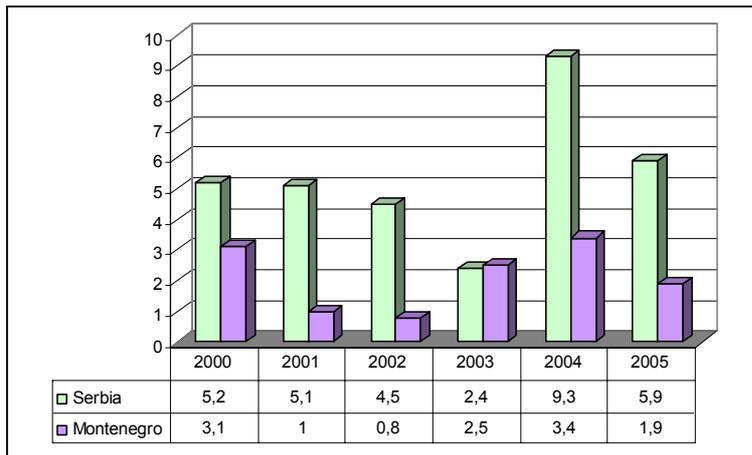
**Figure 12:** Exports to EU and Former Yugoslav Republic<sup>6</sup> in Mio. US-\$  
 Source: Data taken from FYRM Central Bank.

**2.4. Country analysis: Serbia and Montenegro**

According to available population figures, Serbia and Montenegro is the largest country in the Western Balkans - excluding Kosovo about 8.3 million. SCG started its transition to a market economy in late-2000, beginning from a relatively low starting point which reflected a decade of isolation, conflicts, and poor economic management.

The real **GDP** growth rate in **Serbia** reached an estimated 7.5%, mainly supported by services, in particular retail trade (17.9%), as well as agricultural production (19.8%) and industrial output (7.1%). In 2005, GDP grew by 5.9 %, driven by a large expansion of services, more than compensating a decline in manufacturing output (European Commission 2005, p.27). The real **GDP** in **Montenegro** rose by 3% in 2004, largely due to increased industrial production. Electricity and gas production rose by 21%, and the production of main export-oriented metal products steel and aluminum, which represented 45% of total production, grew by 13.4% (European Commission 2005, p.31).

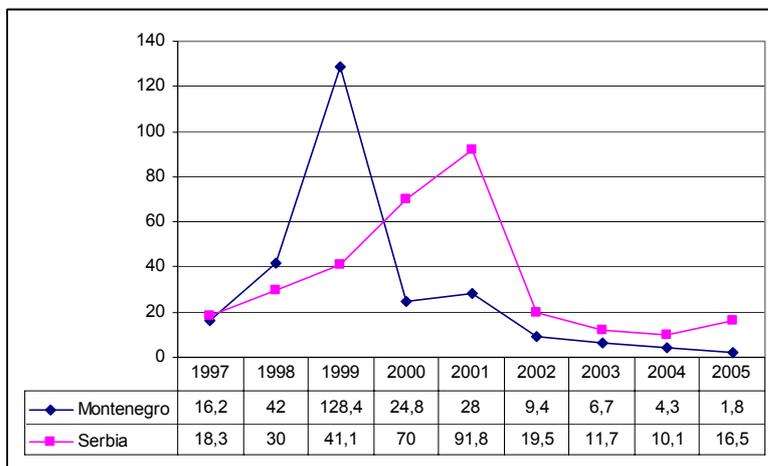
<sup>6</sup> Countries of Former Yugoslav Republic: BiH, Serbia and Montenegro, Croatia and Slovenia.



**Figure 13:** SCG development of the GDP growth rates 2000-2005

Source: Data collected from the Central Bank of the Republic of Serbia and European Commission 2005.

Year-on-year **inflation** (retail price index) in Serbia accelerated to 13.8% in December 2004 and to 16.5% in September 2005. This pattern was driven by a significant increase of domestic demand, increases in administered prices, rising cost of fuel imports, strong wage growth and the one-off effect of the VAT introduced in January (Republic of Serbia Central Bank; European Commission 2005, p.28). In Montenegro, which had unilaterally introduced the euro as legal tender already in 1999, annual inflation reached 6.6% in 2003, implying a substantial real appreciation. In contrast to Serbia, however, Montenegro retail-price inflation declined to a remarkable 4.3% in 2004 and to 3.5% in August 2005 (European Commission 2005, p.32).



**Figure 14:** SCG development of the average annual inflation rates.

Source: Data received from the Central Bank of Republic of Serbia and Central Bank of Montenegro.

Official figures of registered unemployed in Serbia come up with an **unemployment rate** of 31.7% at end-2004, as compared to 26.8% three years earlier (Republic of Serbia Central Bank). Adjusted for those who are registered as unemployed but pursue activities in the informal sector of the economy, the unemployment stands at below 20% (European Commission 2005, p.28).

Unemployment in Montenegro in 2004 was 14% lower than in December of the previous year but still high at a 22% rate. At the same time, employment also decreased by 1.3%.

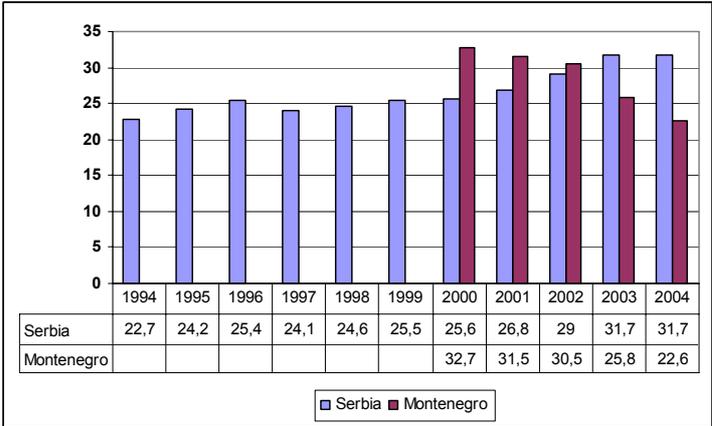


Figure 15: SCG Development of unemployment rates

Source: Data from the Republic of Serbia Central Bank and European Commission.

The consolidated **general budget deficit** of Serbia for 2004 was reduced to 0.3% of GDP from 2.3% in 2003. Fiscal revenues grew to 45.2% of GDP from 42.7% in 2003 because of strong domestic demand and improved tax enforcement efforts (European Commission 2005, p.28). The introduction of the VAT in January 2005 helped to boost revenues, but expenditure remained high, although they remained under tight control. In Montenegro the government deficit declined to 2.2% of GDP in 2004 from 3.3% in 2003. In this period, revenues increased by 6.4% and expenditures rose by only 3.3% over 2003.

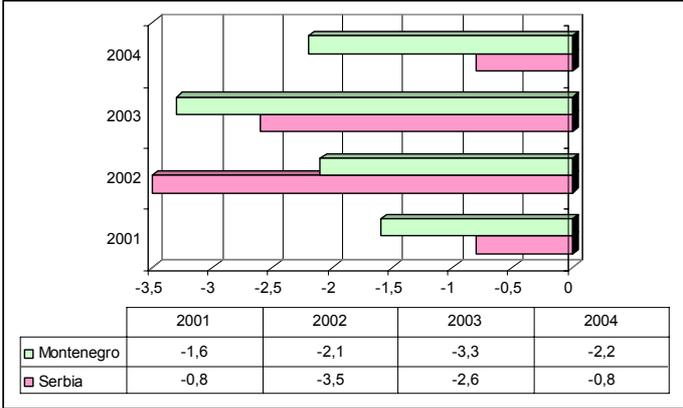


Figure 16: SCG Government expenditures 2001-2004

Source: Data from the European Commission.

The total number of **privatized** companies in Serbia reached 1524 by end-May 2005. The process of restructuring some 76 large and insolvent companies, which were selected by the Privatization Agency for restructuring, progressed slowly. However, the adoption of amendments to several important laws (such as the laws on privatization, share fund and financial markets) in May 2005 might help to accelerate the privatization process (European Commission 2005, p.29). However,

in the Serbian economy, highly indebted socially-owned companies that need to be closed or restructured and privatized and state-owned companies with a high number of surplus work-force still play a predominant role and therefore hinder the development of a dynamic private sector. In Montenegro 70% of the state-owned capital has been privatized until June 2005.

At end 2004, 46 **banks** operated in the Serbian market. This number has further declined to 40 at end-September 2005 and included 14 majority foreign banks which are among the largest in terms of financial strength (European Commission 2004, p.69). The Serbian authorities have taken necessary steps to modernize the regulatory and institutional framework for financial sector operations. However, despite the recent initiatives and improvements of the banking supervision in Serbia, it remains plagued by questionable quality of off-site data. These factors undermine the ability of the Serbian Central Bank to properly identify risks in the banking sector because of the poor data quality. In Montenegro, all but one last bank with majority state-ownership have already been privatized. Risk control is largely in compliance with the basic “Basle principles”, but banks face high risks in Montenegro as the institutional arrangements for creditors’ rights are underdeveloped. Thus, reliable data on the creditworthiness of potential borrowers or customers are not available. The right of establishment of foreign banks, including subsidiaries, is still not fully granted (Belke and Schaal 2005, and European Commission 2005, p.34).

Exports of goods and services in Serbia increased to 24% of GDP from 20% in 2003 while imports surged to 54% of GDP from 43%, respectively. The **degree of openness in Serbia**, defined as the sum of export and import volumes in percentage of GDP, has been rising to 78% in 2004 compared to 63% in 2003. Trade integration with EU has been rising since 2000 and the EU share of total imports reached 49% in 2005, whereas the EU share of total exports reached 55% (Serbian Central Bank; European Commission 2005, p.31).

Export of goods and services in **Montenegro** rose in 2004 by 2% totaling 42% of GDP, and the **degree of openness** attained 81%. The level and change of trade integration with the EU 25 increased from 14% in 2003 to 47.7% of total value of exports in 2004, while imports from the EU 25 also increased from 39.8% in 2003 to 42.6% in 2004. The trade integration with Serbia still remains high. Serbia is, after the EU, the main trade partner of Montenegro, with a share of 31.5% of Montenegrin total exports and 30.3% of its imports (European Commission 2005, p.34).

### **3. The exchange rate regimes of the West Balkan countries**

#### **3.1. The role of monetary policy at the beginning of the transition process**

All the West Balkans transitional economies inherited only a few of the important financial institutions such as banks, insurance companies, funds and capital markets. As is well-known, centrally planned economies implied that money was only passively adapting central planning

goals in the real sector. The financial sector in general did not serve as the intermediary, and prices neither reflected relative scarcities of goods nor were used as a target of macroeconomic policy. Thus, at the beginning of transition the SEECs faced the tremendous challenge of transforming their financial systems from passive residuals (i.e., the mono-banking system and administered prices) to a system with the task of increasing economic efficiency and with an active role in the macroeconomic transmission process and management (i.e., a two-tier banking system, indirect instruments of monetary policy, etc.). Furthermore it is obvious that such a setting could not serve as a proper foundation for either an efficient macroeconomic tool in combating inflation (which became a problem in most transition economies as a consequence, among other factors, of rapid price liberalization and the abolishment of hefty subsidies) or the development of the proper allocative role of commercial banks in decentralized market economies (Coats et al 2002, p.5).

The newly established independent central banks in the SEECs faced several difficulties at the beginning of the transitional process. They lacked experience with their new powers and instruments and thus the technical ability to implement their policy objectives effectively. The environment in which they had to operate (weak tax systems and fiscal controls, weak banking systems, weak market discipline over the allocation of resources and behavior of firms, and weak legal systems and enforcement of property rights and contracts) was not conducive to an efficient transmission of policy. In addition, the central banks of the SEECs lacked a track record that might help establish public confidence in the credibility of their policies. The underdeveloped market infrastructure tends to eliminate the link between monetary policy and prices, distorts relative prices and resource allocation, and weakens the financial discipline required to enjoy the full economic benefits of stable prices. The third difficulty, i.e. the lack of CB credibility, results in a slower adjustment of public expectations of inflation, with the result that real interest rates rise or remain high longer (see, e.g., Belke and Hebler 2002).

In addition to these difficulties, there was a lack of support for reform from some still in positions of political power (i.e., a lack of enthusiasm for surrendering power or privilege). These initial conditions and institutional path-dependencies clearly require a simple and transparent monetary policy. The simplest to implement and most transparent monetary policy is a fixed exchange rate, which can be particularly attractive for new central banks with no track record, poor market data and little technical experience. In addition, the institutional changes that characterize transition economies also make money demand less stable and more difficult to empirically estimate (short time series under new regime, etc.), and such estimates are not needed for implementing an exchange rate anchor in emerging markets like those under investigation in this paper (Belke and Hebler, 2002, and Coats et al 2004, p.6).

### 3.2. Exchange rate regimes in the selected Western Balkans countries

With the exception of Serbia<sup>7</sup>, the four Western Balkan countries have chosen a more or less fixed exchange rate system with the euro as the anchor currency: a currency board system is established in BiH; Montenegro is euroized, whereas managed respectively free floating regimes can be found in Croatia, FYRM and Serbia (Table 2).

| Country                      | Exchange Rate System  |
|------------------------------|---|
| <b>Bosnia Herzegovina</b>    | Since 1997 Currency Board System with euro as anchor currency   |
| <b>Croatia</b>               | Managed floating within a narrow band of +/- 2% around the euro |
| <b>FYRM</b>                  | Managed floating within a narrow band of +/- 2% around the euro |
| <b>Serbia and Montenegro</b> | Montenegro euroization; free floating in Serbia                 |

**Table 5: Exchange rate systems BiH, Croatia, FYRM and Serbia and Montenegro**

Source: Fritz & Wagener 2003, p.613; Reinhart & Rogoff 2002, p.54; Klyuev 2001, p.36.

#### 3.2.1. Bosnia and Herzegovina

Following the 1992-95 civil war, there were a number of currencies circulating in BiH, including the Bosnian and Yugoslav Dinar, Croatian Kuna, and the Deutsche Mark (DM). The independent Central Bank of Bosnia and Herzegovina (CBBH) was established after the end of the civil war in 1997. As stated in the CBBH Law and in the Dayton Peace Agreement the CBBH conducts monetary policy through a currency board arrangement. The choice of a currency board basically had two main motivations. First, it provides a firm nominal anchor in the form of a fixed exchange rate. This was considered critical for the very uncertain postwar economic situation in BiH. Second, it is a rule-based approach to monetary policy that took into account the difficulty there would be in establishing institutions and making political decisions in the complex political environment that existed in BiH after the war (Belke and Hebler, 2002, Gros, 1999, 1999a, 2000). In this sense, exchange rate stabilization in weak emerging markets leads to discipline in economic policy making and, hence, to a better employment performance (Belke and Setzer, 2004).

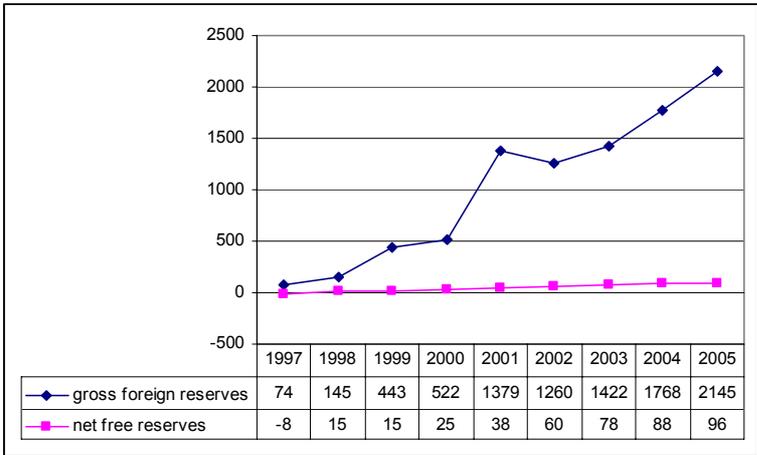
There are three essential features of the currency board, all of which are specified in the CBBH Law:

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<sup>7</sup> S&M are still politically united, but with regard to the monetary policy they have selected different exchange rate systems. However according to the memorandum, held in May 2006 the people in Montenegro have voted for a detachment from Serbia and an independent state.

- a) A fixed exchange rate: the BiH currency, the convertible mark (KM), was introduced in 1997 and it was tied to the Deutsche mark (DEM) at a fixed exchange rate of 1:1. This exchange rate allowed the two currencies to be used together during the period in which citizens were building up their trust in the new currency. It has been tied to the euro at the same rate as the Deutsche mark (1.95583 per euro) since the euro was introduced in January 1999.
- b) A full foreign exchange backing: the domestic currency liabilities of the CBBH have to be fully backed with convertible foreign assets.
- c) Full convertibility: the CBBH had to be prepared to exchange KM for Euro at any time for any amount.

Since its introduction, the KM has largely displaced the other currencies<sup>8</sup> and the currency board has delivered Euro area levels of inflation (Figure 3). Gross international reserves and net free reserves (net reserves minus reserve money) have risen steadily to 2145 million Euro and 96 million Euro, respectively, at the end-of-year 2005. The confidence in the KM was strengthened by the smooth transfer to a new CBBH-board in August 2003, and a transition from an expatriate to a Bosnian governor at end-2004. If citizens continue to shift out of Euro currency in circulation into KM currency in circulation as a means of settlement and store of value, the KM currency will rise and this will be reflected in further increased international reserves of the CBBH.

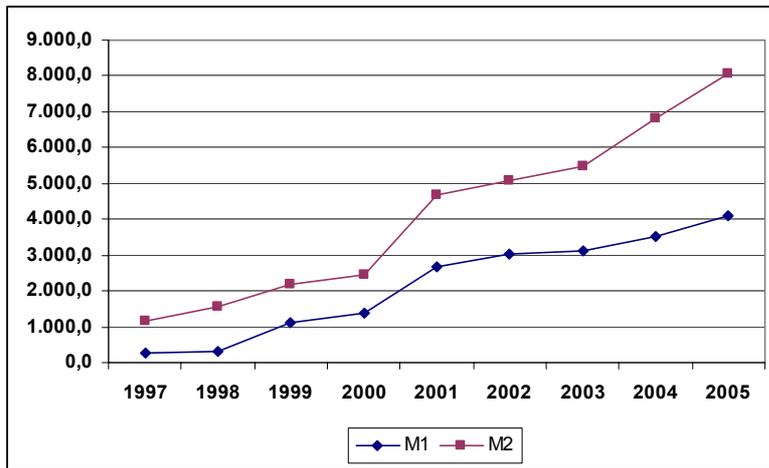


**Figure 17:** BiH Development of gross foreign and net free reserves

Source: Data collected from the CBBH and own calculations.

However, domestic banks do not appear to have such a confidence in KM as the Bosnian private households as banks have often required that their KM loans are indexed to foreign currencies, typically the Euro. Therefore, this kind of behavior of banks suggests some caution on their part about the exchange rate risk.

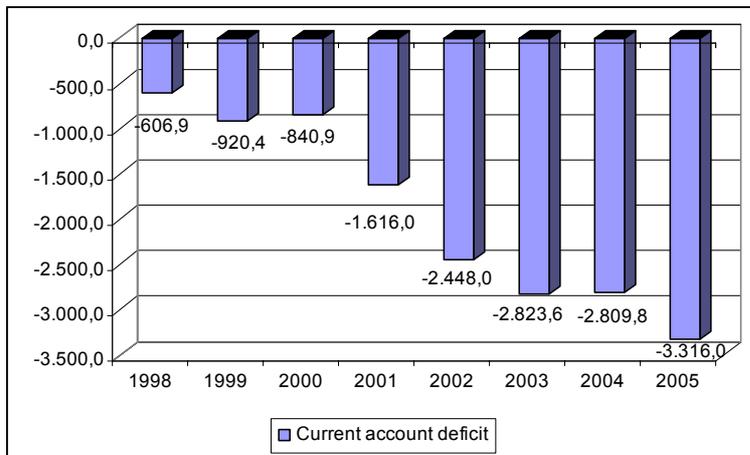
<sup>8</sup> There is also recent anecdotal evidence available that some merchants are beginning to be less willing to accept Euro notes and coins for small transactions. This is in contrast with previous years when the KM was not accepted for these purposes.



**Figure 18:** BiH Development of monetary aggregates (end of period, in millions of KM)

Source: Data taken from the CBBH and own calculations.

Currently, BiH faces at least two phenomena which may well imply exchange rate instabilities: a huge current account deficit and a credit boom in the private sector. The Bosnian current account deficit has remained well above 10 percent of GDP since 2000, peaking at almost 22 percent in 2002 (CBBH, IMF estimates). The large current account deficit can also be seen as a result of strong import growth since 2001.<sup>9</sup>



**Figure 19:** BiH Development of the current account deficit

Source: Data taken from the BiH Statistical Agency.

Furthermore, bank credit to non-government, relative to GDP, has increased by over 20 percentage points in 2001–05. Most of the new loans have gone to private households for reconstruction and consumption purposes—with the ratio of bank credit to households rising by 14 percentage points of GDP since 2001 (IMF 2005, p.32). If we compare the current situation in BiH (large current account deficit and credit boom) with other active currency board countries, only Bulgaria has, like BiH, experienced rapid credit growth alongside an external deficit, but

<sup>9</sup> BiH's external deficit is unique in this respect. Only Nicaragua is reporting a similar external deficit in 2003 and 2004 (IMF 2005, p.33).

before it introduced the currency board. Hong Kong also experienced rapid credit growth from 1993–97, but alongside current account surpluses (IMF 2005, p.32).

3.2.2. Croatia

The general framework of the monetary policy in Croatia can be described as a “managed float”, whereby the primary policy objective is the price stability (Croatian National Bank). The exchange rate has traditionally been used as a stabilization anchor, following periods of high and hyperinflation in the early 1990ies. The scope for larger exchange rate flexibility is constrained against the background of a highly euroized economy with a significant share of bank loans and deposits denominated in foreign exchange.

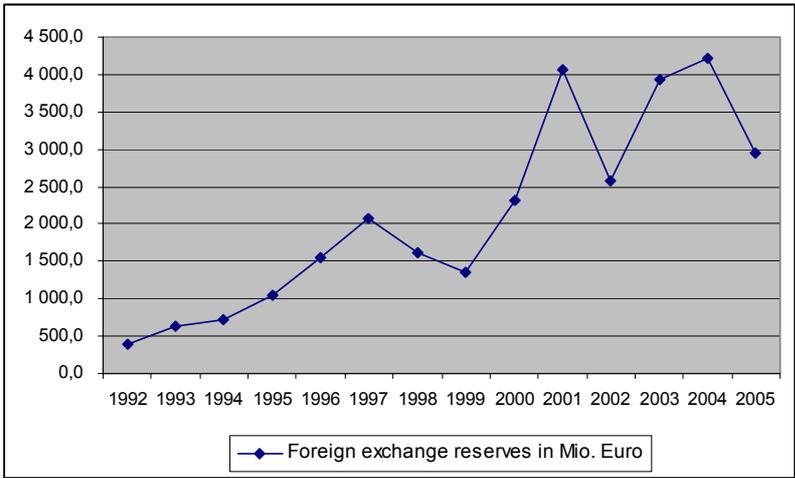
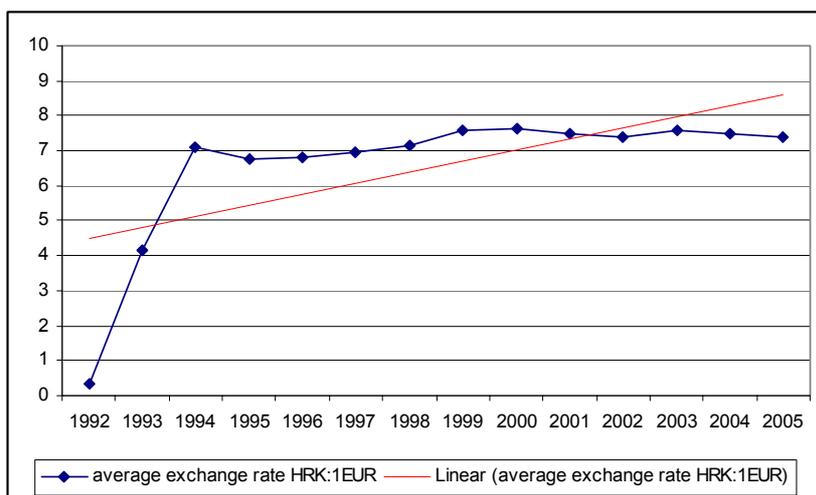


Figure 20: Croatia development of the foreign exchange reserves

Source: Data delivered by the Croatian Central Bank.

The main instrument of monetary policy continued to consist of interventions in the foreign exchange market through auctions. Interventions have not been carried out to defend a pre-announced exchange rate or exchange rate band, but in order to smooth short-term exchange rate fluctuations. During the four quarters starting in the second quarter of 2004, the average monthly Kuna exchange rate to the EUR fluctuated within a margin of 1.4% of the average rate (Croatian Central Bank).



**Figure 21:** Croatia average exchange rate of the Croatian Kuna vis-à-vis the Euro (HRK : 1EUR)

Source: Data delivered by the Croatian Central Bank.

Towards the end of 2004, the central bank repeatedly bought foreign exchange to alleviate appreciation pressures resulting from capital inflows. In the context of a continued and strong increase of foreign debt, the Central Bank took also administrative measures aimed at discouraging commercial banks from foreign borrowing. In July 2004, it introduced marginal reserve requirements on commercial banks' foreign liabilities, which were increased in February and May 2005. In order to absorb domestic currency liquidity, the central bank increased the share of obligatory reserve requirements to be held in Kuna from 42% to 50% in May 2005 (Croatian National Bank). Since April 2005, the central bank became active in open market operations, including repurchase agreements, reverse repos, and direct purchase and sale of securities with a view to fine-tuning liquidity and smoothing short term interest rate fluctuation (European Commission 2005, p.39). In early 2005, the central bank reduced the share of liquid foreign exchange assets that commercial banks need to hold as a percentage of their foreign exchange liabilities (from 35 to 32%).

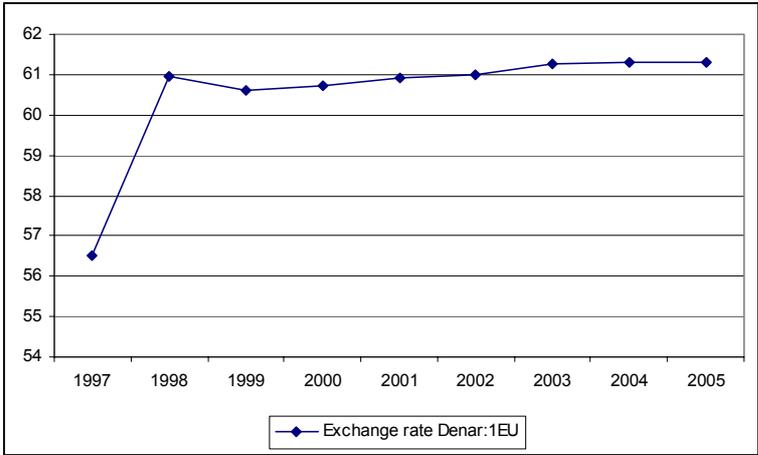
### 3.2.3. Former Yugoslav Republic of Macedonia

The Macedonian National Bank, established in 1992, is largely independent. In 2002 the Law on the National Bank was brought further into line with the EU *acquis*, leading to a significant strengthening of the independence of the National Bank. Under the current law the main objective is to maintain price stability (FYRM National Bank).

With a view to maintaining price stability, the National Bank has pursued a policy of targeting a stable exchange rate against the euro since 1995. In order to withdraw excess liquidity from money markets, twice a week the National Bank organizes auctions for National Bank bills with maturities of 7 and 28 days. So far, the National Bank's interest rate policy has had only limited

influence on lending and deposit rates of the banking sector, although some impact on the foreign exchange holdings of the sector is noticeable. At the end of 2004 the Bank’s foreign exchange reserves amounted to approximately 2.9 months of projected imports of goods and services.

The Former Yugoslav Republic of Macedonia introduced its own currency in April 1992 in the form of a coupon with an equivalent value as the Yugoslav dinar. On 5 May 1993 the official currency, the Macedonian denar (MKD), was introduced, replacing the coupons. The currency was de facto pegged to the German mark in 1994. In the year 1997, the authorities decided on a step devaluation by 15%. Since then the exchange rate has remained largely stable against the euro in a narrow band of 60.5-61.5 MKD to 1 euro (FYRM National Bank).



**Figure 22:** FYRM development of the exchange rate MKD:1EUR

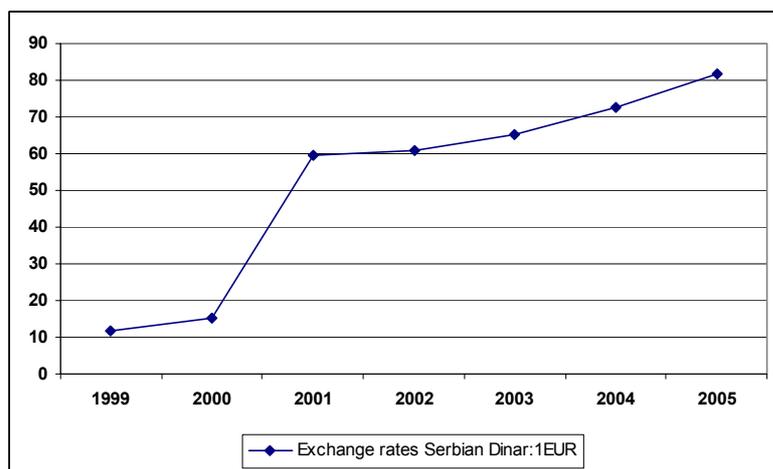
Source: Data taken from Eurostat.

Even during the events in Kosovo in 1999 and the subsequent crisis in 2001, the stability of the exchange rate was maintained. In order to keep the exchange rate stable, the National Bank still uses open market operations, foreign exchange interventions and changes in the interest rates.

*3.2.4. Serbia and Montenegro*

The independence of the National Bank of Serbia (NBS) is ensured by the Law on the National Bank of Serbia. As other central banks in Western Balkan the NBS focuses on the price stability. NBS attempts to follow a policy of balancing the objective of maintaining price stability with external competitiveness. Hereby the NBS follows a flexible “managed float” exchange rate regime.<sup>10</sup>

<sup>10</sup> Managed floating exchange rate regimes in other Western Balkan countries (e.g. Croatia) are less flexible. Hence, the exchange rate regime in Serbia could even be considered as a free float.



**Figure 23:** Serbia development of the exchange rate Serbian Dinar : 1 EUR

Source: Data from Eurostat.

The Serbian dinar depreciated against the euro by 13.4% in 2004 and 5.7% during the first seven months of 2005. In 2005, authorities re-focused their priorities on keeping inflation in check and aimed for a slower depreciation (European Commission 2005, p.28). In Serbia broad money increased from about 20% of GDP at end-July 2004 to 26% at end-July 2005. Euroization - measured as the share of foreign-currency deposits in total deposits - rose by 3.3 percentage points in one year, reaching 69% at the end of June 2005 (European Commission 2005, p.30).<sup>11</sup>

The Government of Montenegro introduced a dual currency system (dinar/ German mark) in 1999 and in 2000 the German mark became the only means of payment in Montenegro. In 2002 the Euro became the official mean of payment in Montenegro and it was introduced on the basis of the Law on the Central Bank - as the replacement for the German mark. Thus, Montenegro is the only Western Balkan county so far that has been fully euroized. According to the Central Bank of Montenegro Euro one of the most important reasons for the unilateral euroization was to facilitate the turnover of goods and services as well as the international communication of Montenegro.

#### **4. The exchange rate regimes in Western Balkan and the European integration**

##### **4.1. Methodological approach – the theory of optimal currency areas**

By applying the theory of optimal currency areas (OCA) on the detailed evidence brought forward in the preceding sections of the paper, it can be assessed whether the integration of the four Western Balkan countries into the ERM II and later on into EMU makes sense (Emerson / Gros 1999). There are six popular criteria available for assessing the relative suitability of specific economies for an EMU-membership from the perspective of a small country. These indicators are

<sup>11</sup> For the pros and cons of early euroization see Belke and Setzer (2003).

founded on the OCA theory and they all concern the structure of the real economy. We refer to the following:

- *similarity of trade structures;*
- *intra-industry trade intensity;*
- *exports to EU as % of GDP;*
- *correlation of GDP growth rate;*
- *correlation of industrial production growth;* and the
- *correlation of the unemployment rate.*

The first three indicators refer to the structure of trade, whereas the second group focus on the degree to which the national macroeconomic variables have tended to evolve in step with the EU.

In general, a country can profit from an EMU-accession:

- 1) if it is smaller than the current EMU;
- 2) if the degree of political and economic integration between the considered candidate country and the EMU is very high;
- 3) if the similarity of the economic structure between the EMU and the candidate country is high and/or
- 4) if the public debt of the candidate country is high.

The criteria 1 - 3 reduce the probability of asymmetric shocks in an enlarged EMU and the criterion 4 refers to the reduction of the interest rate premia within a monetary union. Because of the poor data availability and quality, we were not able to deliver a profound and complete textbook-style OCA analysis as is usually done in the literature for industrialized countries. Instead, the following section of our paper should be considered in the light of this severe restriction and as the first effort in the literature to systematically collect and evaluate the data in a comparative and joint analysis of the four South-eastern European Countries (SEECs), often referred to as the “Western Balkans”. Based on this preliminary evaluation, future research could follow when the data basis is long and reliable enough to allow for a sound statistical and econometric evaluation.

#### **4.2. A first and still preliminary application of the OCA-criteria to the Western Balkans**

In the academic literature it is quite popular to maintain that the very weak countries<sup>12</sup>, such as some of the considered Western Balkan states, would gain from entering EMU as soon as possible, because that would be a way to import sensible macroeconomic policies and decisively gain the confidence of financial markets. Since the alternatives to this step could be hyperinflation

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<sup>12</sup> These are the ones which are very far from fulfilling the requirements for EU membership in general and the Maastricht fiscal criteria in particular. As an early source, see, for instance, Gros (1999, 1999a, 2000). For a systematic overview of the issue see Belke and Hebler (2002).

and/or enormous risk premia on foreign debt, the benefits of this confidence effect and the benefit of a stable currency can far outweigh any potential costs of not being able to react to asymmetric shocks with exchange rate changes.

If we take a look at the above stated OCA-criteria and our extensive country analysis of section 2 related to the macroeconomic development of the Western Balkan countries, the following conclusions can be made. All four Western Balkan countries are very small and open economies. The population ranges from 2 Mio in FYRM up to 8.1 Mio in Serbia and Montenegro. The countries of the EU are the most important trading partners for the selected Western Balkan states (Table 6, see also our country analysis in section 2) with an EU-export ratio between approximately 76% in SCG and 52% in FYRM of all exports in 2004. Therefore the degree of the economic integration between the Western Balkan state and the EU is already very high.

|                | Population in Mio.                            | GDP per capita (in euro)           | GDP growth rate (2004) | Exports to EU (as % of total) | Inflation rate                    | Unemployment rate                |
|----------------|---|------------------------------------|------------------------|-------------------------------|-----------------------------------|----------------------------------|
| <b>Croatia</b> | 4,4   | 6200                               | 3,8                    | 70                            | 2,1                               | 13,8                             |
| <b>FYRM</b>    | 2   | 2170                               | 4,1                    | 52,3                          | -0,4                              | 37,2                             |
| <b>BiH</b>     | 4,5   | 1654                               | 6                      | 60                            | 0,4                               | 43,2                             |
| <b>SCG</b>     | 8,1 (SCG)<br>7,5 (Serbia)<br>0,6 (Montenegro) | 2506 (Serbia)<br>2648 (Montenegro) | 8,8 (SCG)              | 76 (SCG)                      | 17,5 (Serbia)<br>1,8 (Montenegro) | 31,7 (Serbia)<br>22 (Montenegro) |

Table 6: Key data for the Western Balkan Countries 2004.

Source: Data from the European Commission, national agencies and own calculations.

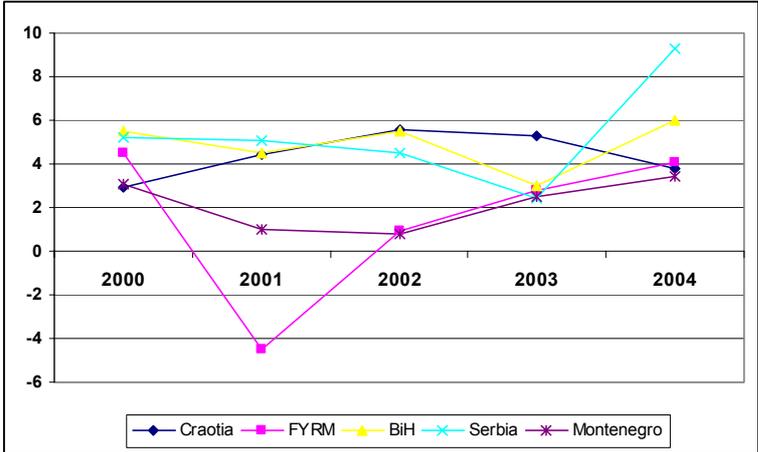
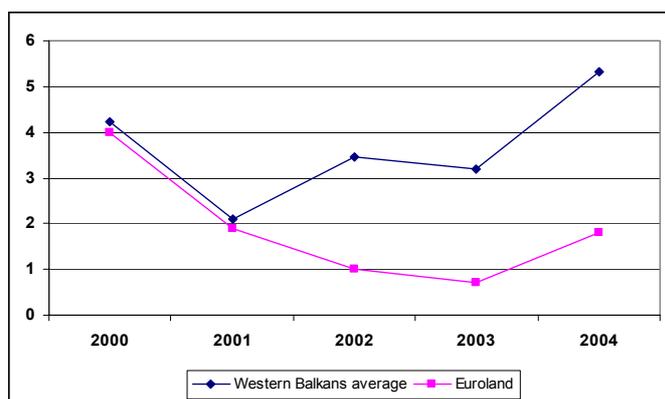


Figure 24: Development of the GDP growth rates in Western Balkan

Source: Data collected from national agencies.



**Figure 25:** GDP growth rates Euroland and Western Balkan countries in average

Source: Data collected from national agencies and DB research.

However, if we take a look at the development of the GDP growth rates in Western Balkans and the Euro area (Figure 25), it becomes obvious that these countries are still caught in the process of transition, having a great catching up capability. That is why the Western Balkan economies are still going through some important political, economic and social changes, which will significantly influence and modify their future economic structure. However, the fact that the significance of the industrial sector in Western Balkan is steadily declining, whereas the service sector<sup>13</sup> gains even more importance is a development which can be already observed.<sup>14</sup>

The prospect of a potential membership in the EU is also an important factor which influences the future economic development of the Western Balkan countries and increases the probability of meeting the OCA-criteria. Croatia and FYRM have started their negotiations with the EU not earlier than last year (2005) and they already obtain the status of a candidate country, whereas BiH and SCG are politically treated as potential candidate countries by the EU. Although these countries will still have a long way to go before they will become official members of the EU, the accession process with the requirements that have to be fulfilled is even more significant and has (and will have) a huge impact on the economic and political future of the Western Balkans as well as its integration within the EU.

Generally, we can state that the degree of the economic integration with the EU is relatively high if we take into account the history of the four Western Balkan countries (the communist era<sup>15</sup> until the 1990s and the Eastern Bloc membership) as well as the political unrests in this region which have occurred since the 1990s. With an eye on the ongoing transition and the EU-accession negotiations it can be expected that the degree of the European integration will rise further. That is why the question should not be whether the Western Balkans will become the members of the

<sup>13</sup> Especially the banking sector as already described in section 2 of this paper immediately comes into mind here.

<sup>14</sup> Similar developments also occurred in the CEECs.

<sup>15</sup> However, note that during the Tito-era the former Yugoslav Republic already was a relatively open and western-oriented country if compared to other countries which belonged to the former Eastern-Bloc.

EMU and adopt the Euro as an official currency, but rather when the Western Balkan countries will become the part of the Euro area and how this process should look like.<sup>16</sup> Hereby, alongside the economic and political integration, the choice of the monetary transitional exchange rate regime will play an important role.

#### **4.3. Optimal monetary-transitional exchange rate regimes for the Western Balkan countries**

The conventional view of the euro area enlargement process is: converge first, and durably, and then join. But this conventional view, while probably appropriate for the current EMU-members may not be adapted to the situation faced by some of the Western Balkan countries (Gros, 1999). Already two potential EU-candidate countries have virtually become the members of the euro area: BiH, which has implemented a euro-denominated currency board and Montenegro that is already fully euroized. The two candidate countries Croatia and FYRM are targeting a stable exchange rate against Euro by pursuing a managed floating strategy as already described in the chapter three of this paper.

So what is actually the optimal monetary-transitional exchange rate regime for the Western Balkan countries during their integration within the EU? The hypothesis that the stronger economies may find it advantageous not to hurry in joining the EMU after their EU-accession is explained by the fact that these states would retain some flexibility for their real exchange rate - which could be necessary in order to neutralize the Balassa-Samuelson effect in the catching up economies-, if they can maintain the already established adequate credibility of their own currency which will avoid serious instability. On the other hand, countries with very weak monetary institutions may be driven more strongly and urgently into securing an anchor on the euro. For these cases, the option of adopting the euro unilaterally as the official national currency and using it in cash form (without of course seeking a place on the board of the European Central Bank) or implementing a euro-denominated currency board might be the appropriate solutions.

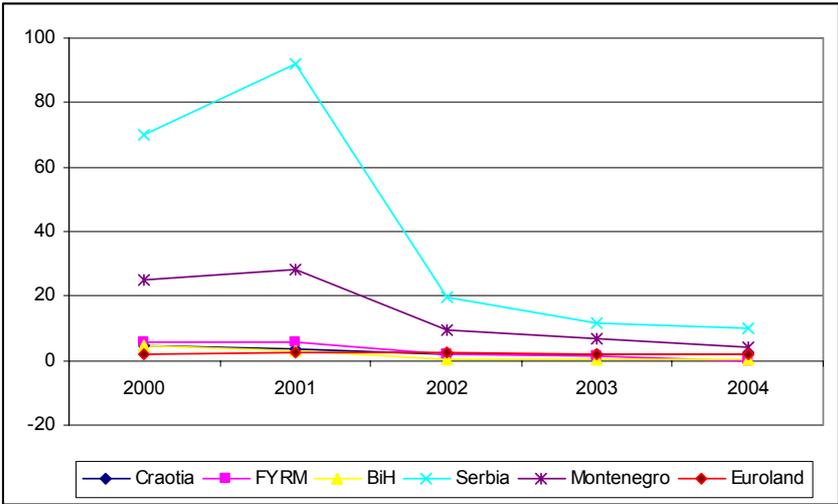
If we try to classify the four Western Balkan countries into strong and weak economies as suggested by the above stated hypothesis, then the following conclusions can be drawn based on our preceding analysis in this paper. Croatia clearly is economically the strongest country in the region with the highest GDP per capita (6200 Euro, see Table 6) and, hence, can be seen as a strong economy compared to other Western Balkan countries. If we take a look at the development of the exchange rate HRK: 1EUR (Figure 21), we observe that Croatia has been able to maintain a stable exchange rate towards the Euro within a narrow fluctuation band since 1993. Thus, from the current point of view, maintenance of the required ERM II fluctuation band of +/- 15% should not demonstrate a difficulty for Croatia. With respect to the optimal transitional

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<sup>16</sup> Additionally, as there is no opt-out clause for Western Balkan countries (as well as for the CEECs that have joined the EU) we expect them to join the EMU after their EMU-accession.

exchange rate regime and the above hypothesis that Croatia could find it advantageous to keep some exchange rate flexibility in order to neutralize a possible Balassa-Samuelson effect. However, it should be considered that in addition to the relatively stable exchange rates, the inflation rates in Croatia were very moderate since 2002 and in line with the average Euro area inflation rate of approximately 2.1% (Figure 26), which could possibly indicate an only very small Balassa-Samuelson effect so far.

Although a candidate country, FYRM cannot be seen as a strong economy according to the economic indicators (Table 6) and the country analysis which can be found in the chapter two of this paper. In fact, with respect to the degree of the economic development FYRM can be assigned to the group of the potential candidate countries such as BiH and SCG. The MKD:1EUR exchange rate has been stable since 1998 and moves within a relatively narrow fluctuation band of approximately +/-2% (Figure 22, 26). Since 2000 the inflation rates are very moderate, whereas in 2004 a slight deflation of -0.4% occurred. Despite the relative inflation and exchange rate stability in FYRM, the country has got still a long way to go in order to catch up with Croatia and other Eastern European Countries. However, from the current point of view FYRM should be able to meet the criteria of the ERM-II.



**Figure 26:** Development of the inflation rates Western Balkans and Euroland

Source: Data gained from national agencies and DB research.

With regard to BiH, the maintenance of the euro-denominated currency board regime should be the best monetary-transitional strategy towards the EU / EMU accession.<sup>17</sup> The currency board regime was very successful so far and it is the main reason for the high confidence of the BiH population in the Bosnian currency (KM). In order to overcome the current economic stagnation and fasten the transition process in BiH, significant structural changes are necessary, especially

<sup>17</sup> BiH can profit from the experience of the Estonian Currency Board Regime and its future experience related to the EMU accession. According to the statements of the ECB and the Eesti Pank, Estonia will be one of the first Eastern European EU-member states that will join the EMU in the near future.

with respect to the reduction of the very high current account deficit. Furthermore, smoothing of the ongoing credit boom initiated by the private households and supported by the banking sector in order to maintain and respectively increase the market shares, should be at top of the Bosnian agenda in order not to jeopardize the already gained monetary stability (IMF 2005, p.16).

As the only country in Europe that has been fully euroized, Montenegro has been able to significantly lower the inflation rates since 2001 (Figure 26). However, Montenegro is currently facing some serious political changes, as according to the results of the latest memorandum, held in May 2006, the Montenegrin people strive for an independent state and for the segregation of the state union with Serbia. In case that Montenegro becomes an independent state, it would be the smallest economy in Western Balkan region with a population of approximately 0.6 Mio. Facing these facts and the already high degree of trade integration with the EU-countries (see chapter two for further details) the euroization seems to be a good solution for Montenegro. In fact, it is the task of the ECB and the representatives of the EMU in order to find a way how to deal with fully euroized countries after they have become the members of the EU, regarding the ERM-II membership and the fulfilment of the Maastricht criteria.

Serbia is the only country which is still facing very high inflation rates and a relatively high degree of exchange rate instability (Figures 23 and 26). In fact, if we take a look at the current economic situation and the political changes that this country is facing with respect to the possible segregation of the state union with Montenegro, then according to our hypothesis which is saying that weak countries may find it advantageous to import monetary stability and confidence by fixing their currencies to a stable anchor, Serbia should reconsider the current approach of free floating. From the current point of view Serbia would also not be able to meet the criteria of the ERM-II. As potential alternatives, a managed floating strategy within narrow fluctuation bands (FYRM, Croatia) or the implementation of Currency Board Systems (BiH) can be considered as well.

## **5. Concluding remarks**

In our analysis we have investigated four Western Balkan countries that were part of the Former Yugoslav Republic: BiH, Croatia, FYRM and Serbia and Montenegro. These countries had to face (and are still facing) three major transition processes: the transition from war to peace, transition from a socialist command economy dominated by the state to a market-oriented private sector economy and the transition from being a part of a larger nation to being an independent country with its own democratic and administrative institutions.

Unlike the CEECs, the four Western Balkan countries have chosen relatively common approach regarding the choice of the exchange rate regime. Except for Serbia, the rest of the Western Balkan states have implemented more or less fixed exchange rates (Table 5). Our analysis, so far, has shown

that most of the Western Balkan economies have still a long way to go until they can become members of the EU and consequently the EMU. Hereby the choice of the monetary- transitional exchange rate regime plays an important role with regard to the fulfillment of the Maastricht criteria, especially the inflation and exchange rate conditions.

Also, with respect to the explicit wish and policy priority of the EU to foster intra-regional integration and cooperation in the Western Balkans (European Community 2006) exchange rate stability is one of the significant factors. Thus, if all the Western Balkan countries use the Euro as an anchor, the exchange rates between the single currencies should also be relatively stable and have a positive impact on the intra-regional economic activities. Furthermore the Western Balkan countries are in the good position of learning from the experiences made by the CEEs during their way to the EU- and future EMU-membership. Western Balkans is ready for Europe, so the question is whether the Europe is ready for the Western Balkans? We leave this task and a more formal application of the OCA analysis to the Western Balkans for further research.

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