THE RESULTS OF MACROECONOMIC STABILIZATION IN SOUTHEAST EUROPEAN COUNTRIES: SOME EMPIRICAL EVIDENCE


Nela Vlahinić-Dizdarević

SUMMARY
The paper analyses the results of the stabilization policies in the Southeast European countries in stabilizing the inflation and output and what is the price paid for the macroeconomic stability. SEECS had to adopt stabilization policies during the 90s that targeted aggregate demand and they chose two basic types of stabilization strategies: monetary targeting and exchange rate targeting. The analysis shows that those SEECS that have implemented monetary targeting accompanied by floating exchange rate regime, were not completely successful in inflation reduction. Furthermore, it seems that fighting inflation by reducing aggregate demand via a restrictive monetary policy may become extremely costly because these countries achieved slower GDP growth and did not succeed to reach the lasting economic recovery. On the other hand, another group of SEECS that have chosen exchange rate targeting, have maintained the one digit level inflation in most years and were more successful in creating a more stable environment for long-term recovery. It seems that stable nominal exchange rates as a nominal anchor, supported by the complimentary nominal wage anchor, relieved the monetary policy from fighting inflationary processes and therefore made the better support for growth.

1. INTRODUCTION
The starting point of economic and political transformation from the planned economy to the market economy has been relatively similar for both Central and East European countries (CEECs) and Southeast European countries (SEECs). Similar problems caused similar trends in the first two years of transformation: high inflation, the rapid reduction of industrial production and GDP, high current account deficits and an increase in external debt and unemployment. While the transitional depression in CEECs lasted only a few years, the situation in the SEECs was quite the opposite. In such a significantly different economic environment the SEECs had to adopt stabilization policies that targeted aggregate demand. These countries chose two basic

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1 Nela Vlahinić-Dizdarević, Ph.D., University of Rijeka, Faculty of Economics, I. Filipovića 4, Rijeka, Croatia, nela@efri.hr
types of stabilization strategies: monetary based stabilization program or monetary targeting and exchange rate based stabilization program or exchange rate targeting.

The aim of the paper is to analyze how successful have been the Southeast European economies in stabilizing the inflation and output and what is the price paid for the macroeconomic stability. Since the choice and implementation of stabilization policies is not the only factor that may explain the improvement in macroeconomic performance, the analysis takes into account the initial conditions, including initial level of development and the extent of inherited structural and macroeconomic distortions. Since different macroeconomic stabilization policies had different implications on the SEECs’ growth, the paper examines key macroeconomic indicators that indicate the possibilities of sustainable growth of the region.

2. SOUTHEAST EUROPE: A SHORT MACROECONOMIC OVERVIEW
Southeast European countries are economies that are structurally diverse, but they have faced similar macroeconomic disequilibria during the 90s, especially lack of GDP growth, large trade and current account deficits as well as high unemployment rates. For the first time in the past 10 years, in 2000 a positive GDP growth is recorded in all SEE countries. At the same time, in the period after 2000 the inflation in SEECs steadily declined. Generally, overall macroeconomic situation has improved, but the region has experienced strong external imbalances. (Table 1.)

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<th>Table 1. Western Balkans – Macroeconomic trends. 1998 - 2003</th>
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<td>-------------------------------------------------------------</td>
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<tr>
<td>Real GDP growth (1) %</td>
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<td>Inflation (average) (1) %</td>
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<td>General government balance (1)(2) % of GDP</td>
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<td>Exports (3)(4) billion EUR</td>
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<td>Imports (3)(4) billion EUR</td>
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<td>Trade balance with the EU (5) billion EUR</td>
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<td>Current account (1)(5) % of GDP</td>
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<td>Foreign Direct Investment (6) billion EUR</td>
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The growth in these countries has accelerated due to the improved political stability in the region and prospects for the EU accession countries Bulgaria, Romania and Croatia since June 2004. This growth has been particularly stimulated by credit expansion in all countries and especially in Croatia, Bosnia and Herzegovina, Bulgaria and Romania. Although the financial indicators do not indicate the tendencies of the increase in inflation rates, still some countries have decided to use certain monetary policy instruments, including reserve requirements and tightening the criteria for loans.

The growing demand in the SEECs has resulted in high increase in imports and current account deficit in all SEECs. Total exports grew faster than imports, though these countries have not been yet recovered from the breakdown of former Yugoslavia and loss of former market, wars and trade sanctions. The economists claim that the avoidance of a current account deficit and a high foreign debt is the best basis of development in a world with volatile international capital movements and an unstable global economy. Therefore these external imbalances in SEECs have become the main challenge to macroeconomic stabilization and sustainable growth in the region.

The strong GDP growth in the region after 2000 has been also driven by strong increase in FDI inflows in the region. These countries have started the privatization cycle more intensively in the late 90s and have become more attractive for foreign investors. While the Central and Eastern Europe\(^2\) has recorded the huge decline in FDI inflows from $23 billion in 2002 to $11 billion in 2003, mostly due to a fall in privatization flows, the FDI inflows in Southeast Europe have reached almost $7 billion in 2003.

Till now FDI inflows to the SEE region have been largely driven by big ticket sales of state assets. The volume and the composition of FDI inflows have been linked mostly to large-scale

\(^2\) The group of eight CEE countries that joined the EU in May 2004.
privatization transactions in telecommunications, banking and heavy industry. (Broadman et. al., 2004, p. 19) There is no doubt that the privatization process has so far attracted FDI, but in the medium-term there still remains the main problem – once all the “crown jewels” are sold, how can these countries and the region as a whole attract more greenfield FDI? Till now the greenfield investments have been very limited and directed primarily at servicing the domestic market.

3. STABILIZATION POLICIES IN SEECS

There is a broad consensus among economists that the choice and implementation of appropriate stabilization policies have had a very important impact on improvement in overall macroeconomic performance and reversing negative trends in output and GDP growth in all countries in transition during the 90s. Although the sound macroeconomic policy has not been the only factor of achieving economic growth sustainable in a long run, it is proven to be the one of most important. According to EBRD, (EBRD, 2004, pp. 11-15), there are three broad factors that may explain the improvement in macroeconomic performance and the fact that some countries are performing better than others: initial conditions, including initial level of development and the extent of inherited structural and macroeconomic distortions, the implementation of stabilization policies and progress in market-oriented reforms. Some studies (Fischer and Sahay, 2004 and Loungani and Sheets, 1997) have found that lower inflation rates and smaller budget deficits are strongly correlated with higher growth rates.

The stabilization policies in all transition countries have been based on two main elements: first, appropriate monetary policy that enables control over money supply and credit expansion and therefore results in lower inflation rate and second, sound fiscal policy that provides sustainable fiscal deficit. Still, the economic situation in Southeast European countries that has been considerably less favourable than the economic environment in advanced Central and East European countries, made the SEECS to rely upon stabilization policies for managing the aggregate demand. According to Bishev, Jovanovski and Naumovska (2001), the SEECS chose two basic types of stabilization strategies: monetary based stabilization program or monetary targeting and exchange rate based stabilization program or exchange rate targeting.
The first one uses the money supply and credits as nominal anchors in order to reduce inflation. It requires the ability of forecasting money velocity, real output and level of prices in order to set the appropriate target for money growth. Such a stabilization strategy is accompanied with flexible exchange rate because the exchange rate is not a goal of the monetary policy. On the other hand, the exchange rate targeting strategy is based on the exchange rate as a nominal anchor in the inflation reduction. The exchange rate of the domestic currency is linked with the exchange rate of the anchor country currency, usually the currency of its most important trade partner. In order to achieve macroeconomic stability and slowdown in the inflation, it is important to conduct sound fiscal policy and to have high foreign reserves. Fighting inflation by reducing aggregate demand via a restrictive monetary policy may become extremely costly in developing countries, although this is the standard recipe of the Washington Consensus. (Herr, Priewe, 2005)

Contrary to the monetary targeting, which results in gradual slowdown in the money growth and inflation, exchange rate targeting acts much faster in order to reduce inflation?

Southeast European countries could be divided regarding the different stabilization criteria. One criteria could be the choice of stabilization policy since these countries have opted for two different policies: monetary targeting and exchange rate targeting, and the results were different. Second criteria could be the time when the country has adopted stabilization programme. According to this criteria, transition countries could be divided into “early” and “late” stabilisers.

### 3.1. The SEECs’ choice and results of stabilization policies

Some of the SEECs like Albania, Serbia and Montenegro, Romania and Bulgaria until the mid 1997, have decided to choose monetary targeting accompanied by floating exchange rate regime. Their results were different, but generally they were not completely successful in inflation reduction. Table 2 shows the inflation rate as the main indicator of macroeconomic stability in all SEE countries.

**Table 2 Inflation in SEECs, 1992-2004**

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<tbody>
<tr>
<td>Albania</td>
<td>226.0</td>
<td>85.0</td>
<td>22.6</td>
<td>7.8</td>
<td>12.7</td>
<td>33.2</td>
<td>20.6</td>
<td>0.4</td>
<td>0.1</td>
<td>3.1</td>
<td>5.2</td>
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According to the presented data, Serbia and Montenegro and Romania obviously did not succeed to control inflation and both countries have never reached one digit level until 2004. An important reason is lack of discipline in managing stabilization policies with high impact of discretionary measures, often of political nature, to finance government deficits. (Bishev et.al., 2001, p. 9) Bulgaria had also experienced high inflation until 1997, when this country adopted currency board. Albania had lower inflation rates, mostly due to the implementation of financial arrangement with the IMF in 1998, which had introduced strong discipline in managing macroeconomic policies. It is well documented that high inflation has high costs: permanent depreciation, a lower reputation for the domestic currency, capital outflows, higher interest rates and weakening of the domestic financial sector. But, on the other hand, how much price stability do developing countries need? According to the World Bank (World Bank, 2003), less than 10 percent is considered to be sufficient. It seems that the fight against inflation in these SEECs and the need to reduce aggregate demand too much, leads to a situation of low growth and continuing inflationary problems (stagflation).

Second group of SEECs (Bosnia and Herzegovina, Croatia, Macedonia and Bulgaria after 1997) have chosen exchange rate targeting and the money supply growth was determined accordingly to the exchange rate objective. Their inflation rates were much lower and they have maintained the one digit level inflation in most years. Though these countries were much more successful in reaching macroeconomic stabilization, they are not in the same position because they have opted for different exchange rate regimes. Bosnia and Herzegovina and Bulgaria chose currency boards.
as irrevocably fixed exchange regime against the DEM, which took them a possibility to autonomously use the exchange rate in order to adjust their balance of payments. Croatia and Macedonia implemented flexible exchange rate regimes, though in very narrow zone, and therefore their exchange rate regimes are de facto more fixed than flexible.

The stabilization policies the SEE countries had adopted, had implications on their economic growth. Table 3 shows the real GDP growth in these countries.

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<tbody>
<tr>
<td>Albania</td>
<td>-7.2</td>
<td>9.6</td>
<td>8.3</td>
<td>13.3</td>
<td>9.1</td>
<td>-7.0</td>
<td>12.7</td>
<td>8.9</td>
<td>7.7</td>
<td>6.8</td>
<td>4.7</td>
<td>6.0</td>
<td>6.2</td>
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<tr>
<td>B&amp;H</td>
<td>-80.0</td>
<td>-10.0</td>
<td>0.0</td>
<td>20.8</td>
<td>86.0</td>
<td>37.0</td>
<td>15.6</td>
<td>9.6</td>
<td>5.5</td>
<td>5.5</td>
<td>3.5</td>
<td>4.0</td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-7.3</td>
<td>-1.5</td>
<td>1.8</td>
<td>2.9</td>
<td>-9.4</td>
<td>-5.6</td>
<td>4.0</td>
<td>2.3</td>
<td>5.4</td>
<td>4.0</td>
<td>4.8</td>
<td>4.3</td>
<td>5.5</td>
</tr>
<tr>
<td>Croatia</td>
<td>-11.7</td>
<td>-8.0</td>
<td>5.9</td>
<td>6.8</td>
<td>6.0</td>
<td>6.5</td>
<td>2.5</td>
<td>-0.9</td>
<td>2.9</td>
<td>4.4</td>
<td>5.2</td>
<td>4.3</td>
<td>3.7</td>
</tr>
<tr>
<td>FYRM</td>
<td>-8.0</td>
<td>-9.1</td>
<td>-1.8</td>
<td>-1.2</td>
<td>1.2</td>
<td>1.4</td>
<td>3.4</td>
<td>4.3</td>
<td>4.5</td>
<td>-4.5</td>
<td>0.9</td>
<td>3.1</td>
<td>2.5</td>
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<tr>
<td>Romania</td>
<td>-8.8</td>
<td>1.5</td>
<td>3.9</td>
<td>7.1</td>
<td>4.0</td>
<td>-6.1</td>
<td>-4.8</td>
<td>-1.2</td>
<td>1.8</td>
<td>5.3</td>
<td>4.9</td>
<td>4.9</td>
<td>5.8</td>
</tr>
<tr>
<td>S&amp;MN</td>
<td>-27.9</td>
<td>-30.8</td>
<td>2.5</td>
<td>6.1</td>
<td>7.8</td>
<td>10.1</td>
<td>1.9</td>
<td>-18.0</td>
<td>5.0</td>
<td>5.5</td>
<td>4.0</td>
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Note:  
1 Estimate  
2 Projection  
Source: EBRD, 2004

Countries with monetary targeting have again achieved slower GDP growth and it seems that they did not succeed to reach the lasting economic recovery. Another group of countries have been more successful in creating a more stable environment for long-term recovery. According to the Herr and Priewe (Herr and Priewe, 2005, p. 92), inflationary process has to be stopped by stable nominal exchange rates as a nominal anchor and a complimentary nominal wage anchor backing the exchange rate anchor. If these two anchors hold, monetary policy is relieved from fighting inflationary processes and can better support growth, as in the case of another group of SEECS.

3.2. Early” and “late” stabilizing countries and their macroeconomic performances

The results of macroeconomic stabilization in SEE countries could be also analysed regarding the time when they adopted stabilization policies. According to the EBRD (EBRD, 2004), transition countries could be divided into “early” and “late” stabilisers. The former group consists of
countries that had a comprehensive stabilisation programme in place before 1995 and had reduced annual inflation below 30 per cent by the end of 1995. This group includes Bulgaria, Croatia, Macedonia and Romania, while the group of “late” stabilisers includes remaining Albania, Bosnia and Herzegovina and Serbia and Montenegro.

The EBRD analyses shows that first group generally\(^3\) had shorter and less deep recessions and that they switched to positive growth earlier than the late stabilizing countries. The whole group typically reached the recession trough between 1991 and 1994, while the later stabilisers reached it on average much later. (EBRD, 2004, 11-12.) Of course, the whole group is not homogenous and the four SEECs have indeed been less successful in comparison to other countries of the group. These EBRD’s conclusions have not been so clear when analysing only SEECs because some of the late stabilisers in some years shown much higher growth rates than early stabilisers. The main reason is the catch-up phenomenon because the GDP in these countries have been very low before the transition period, for example in Albania, or they have experienced very sharp drop in GDP in the beginning of the transition. Figure 3 shows the level of real GDP in 2003 comparing with the pre-transition level.

Figure 1  Level of real GDP in 2003 compared to pre-transitional 1989

\(^3\) The group of early stabilisers includes all Central and East European countries, Baltic states, Croatia and Macedonia. Bulgaria and Romania have been covered as CEECs.
The early stabilisers Romania, Croatia, Bulgaria and Macedonia are the closest to the pre-transition GDP level with 92, 91, 84 and 78 per cent, while Serbia and Montenegro and Bosnia and Herzegovina have been on 52 and 57 per cent level. The only exception is Albania that has far exceeded 1989, due to the very low level of GDP before the beginning of transition.

4. CONCLUDING REMARKS

There is a broad consensus among economists that the choice and implementation of appropriate stabilization policies have a very important impact on improvement in overall macroeconomic performance in all transition countries. Since the economic situation in SEECs has been considerably less favourable than the economic environment in advanced CEECs, they rely upon stabilization policies for managing the aggregate demand. Basically, the SEECs chose two types of stabilization policies: monetary targeting and exchange rate targeting with considerably different macroeconomic results. Albania, Serbia and Montenegro, Romania and Bulgaria until the mid 1997, have decided to choose monetary targeting accompanied by floating exchange rate regime. Their results were different, but generally they were not completely successful in inflation reduction. It seems that the fight against inflation in these SEECs and the need to reduce aggregate demand too much, leads to a situation of low growth and continuing inflationary problems (stagflation). Data show that they have achieved slower GDP growth than other SEECs and they did not succeed to reach the lasting economic recovery.

On the other hand, Bosnia and Herzegovina, Croatia, Macedonia and Bulgaria after 1997 have chosen exchange rate targeting and they have maintained the one digit level inflation in most years. Though these countries were much more successful in reaching macroeconomic stabilization, they are not in the same position because they have opted for different exchange rate regimes: currency boards in B&H and Bulgaria, flexible exchange rate regimes (but in very narrow zone) in Croatia and Macedonia. This group of countries have been more successful in creating a more stabile environment for long-term recovery. It seems that stabile nominal exchange rates as a nominal anchor, supported by the complimentary nominal wage anchor,
relieved the monetary policy from fighting inflationary processes and therefore made the better support for growth.

Still, there should be pointed out that all SEE countries have failed to reach the GDP level in pre-transition 1989.

REFERENCES: