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Ansgar Belke\* and Albina Zenkić\*\*

# Exchange-rate Regimes and the Transition Process in the Western Balkans

## A Comparative Analysis

*Although the importance for successful transition of a monetary policy aiming at a sustainable price level has often been stressed in the academic literature, there is still ample room for further research into the choice of the exchange-rate system throughout the different phases of the transition process. This article deals with the question of how the choice of a specific exchange-rate system affects the economic success of a country in transition and, above all, its gradual integration into the European Union (EU) and European Monetary Union (EMU). It focuses on the transition process in five South-Eastern European countries (SEECs).*

Many studies nowadays conclude that transition as a problem on its own is over in Central Europe. This does not mean, however, as Gros and Steinherr put it, that “all transition economies are in a state of bliss”.<sup>1</sup> Instead, transition is a still unfinished business for regions like the Balkans. In the academic literature, several criteria have been identified which could have an impact on the success of the transition process,<sup>2</sup> such as macroeconomic stability, microeconomic restructuring and the implementation of legal and institutional reforms.<sup>3</sup> The role of the exchange-rate system is generally regarded as fostering the stability of the monetary environment, which is characterised by low inflation rates and a stable domestic currency.<sup>4</sup> Although the importance of a monetary policy aiming at a sustainable price for the success of transition has often been stressed in the academic literature up to now, there is still ample room for further questions to be discussed relating to the choice of exchange-rate system in the different phases of the transition process.

The purpose of this paper is to contribute to closing 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 into the European Union (EU) and European Monetary Union (EMU). For this purpose, the study will focus on the transition process in South-Eastern Europe (SEE). In

particular we shall take a look at the following South-Eastern European Countries (SEECs), often referred to as the “Western Balkans”: Bosnia and Herzegovina (BiH), Croatia, the Former Yugoslav Republic of Macedonia (FYRM), Serbia, and Montenegro, as these five 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 shall try to identify whether and when the Western Balkan countries will be ready to join the Exchange Rate Mechanism (ERM) and the EMU and which monetary transitional regime should be chosen.

The paper will focus on the following issues:

- the introduction of the basic political and institutional settings of the five Western Balkan countries and their macroeconomic development in recent years;

<sup>1</sup> D. Gros, A. Steinherr: Economic Transition in Central and Eastern Europe – Planting the Seeds, Cambridge 2004, Cambridge University Press, p. 134.

<sup>2</sup> The transition process is inducing – above all – the transformation of a centrally planned economic system into an advanced free market economy. Cf. O. Havrylyshyn: Recovery and Growth in Transition: A Decade of Evidence, in: IMF Staff Papers, Vol. 48, 2001, special issue, pp. 53–87, here p. 54.

<sup>3</sup> Ibid.; L. A. Hillman: Interpretations of Transition, in: F. N. Campos, J. Fidrmuc: Political Economy of Transition and Development, ZEI Studies in European Economics and Law, Vol. 5, 2003, pp. 23–40; G. Roland: Ten Years After ... Transition and Economics, in: IMF Staff Papers, Vol. 48, 2001, pp. 29–52.

<sup>4</sup> I. Domaç, K. Peters, Y. Yuzefovich: Does the Exchange Rate Regime Affect Macroeconomic Performance? Evidence from Transition Economies, World Bank Research Working Paper WPS 2642, 2001, p. 5.

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**Table 1**  
**Selected Macroeconomic Indicators 2005**

Country	Per capita GDP (in US \$)	Real GDP growth rate (% change in real terms)	Consumer prices (end year, % change)	Unemployment (% of labour force)	Current account / GDP (in %)
Bosnia and Herzegovina	2,425	5.8	2.4	44.5	-17.3
Croatia	8,674	4.3	3.3	12.3	-6.6
FYRM	2,850	4.0	0.1	36.5	-1.3
Montenegro	3,147	4.1	2.6	27.3	-8.6
Serbia	3,234	6.3	17.2	31.6	-10.0
Average Western Balkans	4,066	4.9	5.1	30.4	-8.8
Average CEECs & Baltic states	8,985	6.1	4.1	9.6	-7.2

Source: Data taken from the EBRD and own calculations.

- the actual, as opposed to the optimal, choice of exchange-rate regime and the main objectives of monetary policy;
- a normative judgment of the choice of the optimal transitional exchange-rate regime in the Western Balkan countries with respect to integration into the EU and EMU.

#### **The Economic Transition Process in the Western Balkans**

The transformation of centrally planned economies into market economies, undertaken parallel to the establishment of democratic political regimes, has been the largest social project of the last century. It was (and still is) necessary to re-establish and modernise the infrastructure of the market economies (legal, informational etc.) In the monetary sphere, the intermediate goals of the transition strategy are to free prices, stabilise the price level, liberalise 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.<sup>5</sup>

The SEECS went through major political and economic changes in the 1990s, leaving them with a persisting reputation for instability. In the meantime, the situation of the 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 the Federal Republic of Yugoslavia and reconstituted as the State Union of Serbia and Montenegro in February 2003) to rejoin the international community. All the countries in the Western Balkan region are cooperating both bilaterally

and in regional forums to an extent that was unimaginable five years ago.

Though many problems, risks and challenges still remain, the likelihood of overcoming most of these is increasing 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).

The process of integration of the Western Balkan countries into 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".<sup>6</sup> 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, the opening-up of Stabilisation and Association Agreement (SAA)<sup>7</sup> negotiations with Serbia, Montenegro, and Bosnia and Herzegovina. We shall take a closer look below at each of the Western Balkan countries and their economic development in recent years as well as at the general present and future economic trends in the region.

#### **Bosnia and Herzegovina**

During the first years after the civil war (1996-1999) BiH experienced high GDP growth rates but annual growth rates slowed to an average of 5% between 2000 and 2002. The main reason for the slowdown was the limited capacity of BiH to replace the aid-driven growth via the mobilisation of domestic sources of growth. Although the slowdown of the growth rates

<sup>5</sup> W. Coats, M. Skreb: Ten Years of Transition: Central Banking in the CEE and the Baltics, Surveys, Croatian National Bank, 2002, p. 1; <http://www.hnb.hr/publikac/pregledi/s-007.pdf>.

<sup>6</sup> European Commission: The Western Balkans on the Road to the EU: Consolidating Stability and Raising Prosperity, Brussels 2006, p. 2.

<sup>7</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 establishment of administrative capacity.

**Table 2**  
**Unemployment Rates in BiH and the two Entities**

	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

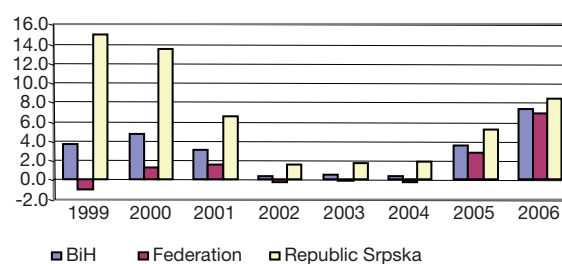
Source: Data gained from the OHR and national agencies.

continued in 2003 (3%), the economic rebound initiated the increase of the GDP growth rate in 2005 (5.5%) and 2006 (6.2%), particularly due to an increase in industrial and agricultural production. According to official figures, the unemployment rate of 42% at the end of 2003 was at an – at least by OECD standards – incredibly high level, with an unemployment rate of 44% in the Federation of Bosnia and Herzegovina and 37% in Republika Srpska (RS). However, estimates including employment in the grey economy indicate an actually lower unemployment rate of around 20% in 2003 which decreased from 23% in 2001. New estimates of the size of the grey economy, made by the Central Bank, suggest that it roughly corresponds to 40% of official GDP figures.

Following several years of progressive fiscal consolidation, a further significant adjustment took place in 2005. The consolidated budget moved from a deficit of 3.3% of GDP in 2001 to a surplus of 2.6% in 2005. During the period 1999 to 2005, inflation rates remained relatively low in BiH. Due to the introduction of VAT in 2006 there was an increase in inflation rates from 3.6% in 2005 to 7.4% in 2006. Furthermore 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 8.4% in 2006 versus 6.9% in the Federation.

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 rapid implementation of enacted laws is certainly necessary in order to achieve concrete improvements.

**Figure 1**  
**Retail Price Growth Rates BiH**



Source: Data gained from the BiH Central Bank.

Privatisation has in general progressed slowly, despite a legislative framework's having been in place for a number of years. Some of the most important factors hampering the privatisation process have been a lack of political will and hesitation by potential investors.<sup>8</sup> The privatisation of small-scale publicly owned enterprises which have been sold to local buyers is the most advanced. Recently, however, progress related to the privatisation of larger and strategically more important enterprises has been made. About 20 strategically important companies have been privatised in the Federation and the sale of several companies in RS is either ongoing or has already been finalised. 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.<sup>9</sup> The banking system is one of the sectors in BiH in which the most rapid reforms and structural transformation have been taking place. State ownership declined between 2000 and 2005 as a result of privatisation. By the end of 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.<sup>10</sup> The banking sector in the Federation is considerably larger than the one in the RS, hosting 27 of the 37 banks and accounting for over 80% of total banking sector capital. 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. BiH benefits from the autonomous trade measures of the European Community, introduced in September 2000, which

<sup>8</sup> For the political economy of privatisation in general cf. A. Belke, F. Schneider: Privatization in Austria: Some Theoretical Reasons and Performance Measures, in: H.-W. Sinn, J. Whalley (eds.): Privatisation Experiences in the EU, CESifo and MIT Press, Cambridge/MA 2006.

<sup>9</sup> European Commission: The Western Balkans in Transition – Enlargement Papers, Brussels 2004, p. 63.

<sup>10</sup> Federal Banking Agency 2006, p. 4; Banking Agency of Republic Srpska 2005, p. 4.

**Table 3**  
**BiH Exports and Imports from/to its EU Major Trading Partners 2005**

EU	EXP in %	IMP in %
Austria	4	4
Italy	13	9
Germany	11	14
Hungary	4	4
Slovenia	10	7
Total	42	38

Source: Data supplied by the BiH Statistical Agency.

allows more than 95% of all imports to enter the EU duty and quota free. The major trading partners are the countries of the European Union and the neighbouring Western Balkan countries of Croatia, and Serbia and Montenegro.

### Croatia

In 2004, the growth of real GDP in Croatia slowed 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, GDP rising to 4.8% in 2006.<sup>11</sup> Inflation remained relatively low, although there was 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.<sup>12</sup>

High unemployment remains one of the most pressing problems of the Croatian economy, although the situation on the labour market improved slightly in 2006. The officially registered unemployment rate fell from 14.3% in 2003 to 12.7% in 2005 and 11.8% in 2006.<sup>13</sup> The Croatian budget deficit was reduced in 2004, but higher than targeted, and further fiscal consolidation remains a major challenge. The 2004 general government deficit declined to 4.9% of GDP, down from 6.3% a year earlier.<sup>14</sup> Progress with privatisation has been slow, but has gained some new momentum since early 2005. A total of 25 privatisation tenders were launched in 2004 and 14 companies were sold, while 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 Privatisation Fund declined by 3% in 2004,

<sup>11</sup> Croatian National Bank.

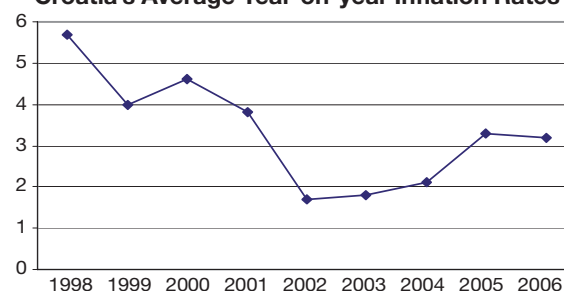
<sup>12</sup> Ibid.

<sup>13</sup> Ibid.

<sup>14</sup> European Commission: Feasibility Reports Serbia and Montenegro, FYRM and Croatia, Brussels 2005, p. 40.

**Figure 2**

**Croatia's Average Year-on-year Inflation Rates**



Source: Data collected from the Croatian Central Bank.

while it shrank by 13% in the first half of 2005.<sup>15</sup> The privatisation 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. At the end of 2004 its assets accounted 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 they are expected to be merged and privatised. 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, although it had declined from 41 banks in 2004.<sup>16</sup> Croatia is an open economy and its trade has been liberalised to a large extent, the country being a member of the WTO and having signed a number of bilateral Free Trade Agreements, notably with neighbouring 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. Furthermore, Croatia is the EU's leading trading partner in the Western Balkans.

### Former Yugoslav Republic of Macedonia

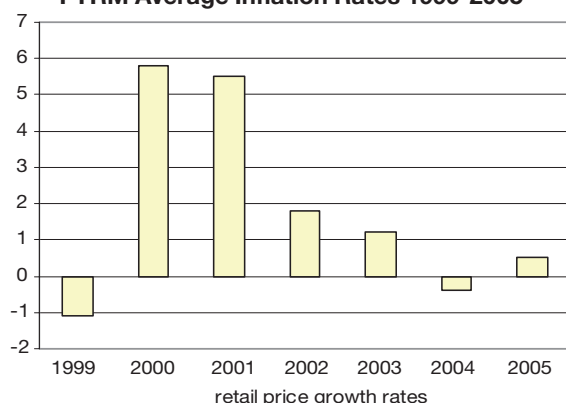
The Former Yugoslav Republic of Macedonia is a small country with a population of around 2 million people according to the latest census (2002). After a sharp recession in 1991-1993 which led to a fall in production levels to about three-quarters of pre-independence levels, the economy started to recover in 1996-2000. The crisis in 2001 resulted in a sharp de-

<sup>15</sup> Ibid., p. 41.

<sup>16</sup> Ibid., p. 42; for more details on the privatisation process in the banking sectors of the Eastern and South-eastern European transition countries cf. A. Belke, A. Schaal: Chance Osteuropa – Herausforderung für die Finanzdienstleistung, in: Europäische Finanzmarktarchitektur, DIW-Vierteljahreshefte zur Wirtschaftsforschung, Vol. 74, 2005, pp. 92-111.



**Figure 3**  
**FYRM Average Inflation Rates 1999-2005**



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

cline 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.<sup>17</sup> During the early years of independence (1991-1995) inflation averaged around values of 400% per annum, with a clear peak of some 1700% in 1992. However, a stabilisation programme 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 bringing 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.<sup>18</sup> In our opinion, the current main inflation indicator appears outdated, with food items accounting for some 50% of the basket weighting. The FYRM State Statistical Office and Eurostat are currently working on the introduction of an updated inflation indicator.

Despite stronger economic growth, labour market performance in the Former Yugoslav Republic of Macedonia deteriorated in 2003 and 2004. In 2003, the number of employed persons declined by 3% (16,000 persons) leading to an increase in the unemployment rate from around 32% in 2002 to 36.7% in 2003 and

37.2% in 2004.<sup>19</sup> However, when assessing the unemployment figures, the large size of the grey economy should be taken into account. Most important, people register themselves as unemployed in order to obtain access to health insurance or social assistance, while at the same time working in the grey sector. In the year 2003, the fiscal performance of the FYRM improved substantially. General government expenditure 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 liberalisation.<sup>20</sup>

The privatisation process of small and medium-sized enterprises is almost complete. As of end December 2003, 1687 enterprises have been privatised, while 79 state companies of those included in the privatisation programme that began in 1993 remained for sale. The action plan for the restructuring, liquidation or privatisation of 40 large loss-making enterprises, which was launched in 2000, was finally completed in 2003. However, the main method of privatisation, which favoured insiders, and the lack of a market for corporate control, did not lead to improvements in corporate governance and gains in efficiency.<sup>21</sup> The financial sector of FYRM is characterised by the predominance of the banking sector and the 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 characterised by a substantial degree of foreign participation – 40% of total banking capital is in foreign hands.<sup>22</sup> 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 neighbouring 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 liberalisation of trade with the EU. The importance of

<sup>19</sup> FYRM State Statistical Office.

<sup>20</sup> FYRM State Statistical Office; European Commission: *The Western Balkans in Transition – Enlargement Papers*, op. cit., p. 61.

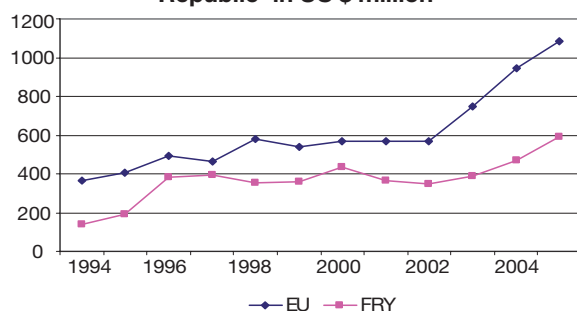
<sup>21</sup> European Commission, *ibid.*, p. 63.

<sup>22</sup> *Ibid.*, p. 65.

<sup>17</sup> FYRM State Statistical Office; European Commission: *Feasibility Reports Serbia and Montenegro ...*, op. cit., p. 41.

<sup>18</sup> FYRM State Statistical Office; European Commission, *ibid.*, p. 42.

**Figure 4**  
FYRM Exports to EU and Former Yugoslav Republic<sup>1</sup> in US \$ million



<sup>1</sup> BiH, Serbia and Montenegro, Croatia and Slovenia.

Source: Data taken from FYRM Central Bank.

the trade with the EU25, 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.<sup>23</sup>

### Serbia and Montenegro

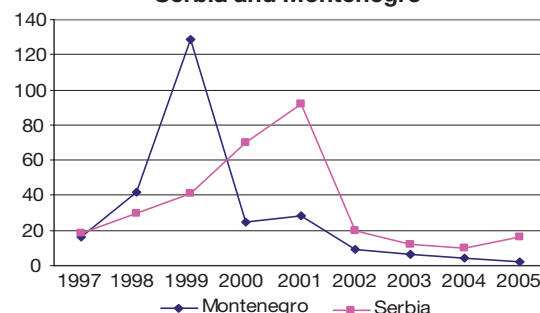
According to the available population figures, Serbia and Montenegro was the largest country in the Western Balkans – about 8.3 million excluding Kosovo. However, as a result of the referendum held on 21 May 2006 Montenegro dissolved the political union with Serbia. On 3 June 2006 Montenegro officially declared its independence. 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.<sup>24</sup> 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 the main export-oriented metal products, steel and aluminium, which represented 45% of total production, grew by 13.4%.<sup>25</sup> 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 in domestic demand, increases in administered prices, the rising cost of fuel imports, strong wage growth and the one-off effect of the VAT

<sup>23</sup> FYRM State Statistical Office; European Commission: Feasibility Reports Serbia and Montenegro ... , op. cit., p. 50.

<sup>24</sup> European Commission: Feasibility Reports Serbia and Montenegro ... , op. cit., p. 27.

<sup>25</sup> Ibid., p. 31.

**Figure 5**  
Development of Average Annual Inflation Rates in Serbia and Montenegro



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

introduced in January 2005.<sup>26</sup> In Montenegro, which had already unilaterally introduced the euro as legal tender in 1999, annual inflation reached 6.6% in 2003, implying a substantial real appreciation. In contrast to Serbia, however, in Montenegro retail price inflation declined to a remarkable 4.3% in 2004 and to 3.5% in August 2005.<sup>27</sup>

Official figures of registered unemployed in Serbia show an unemployment rate of 31.7% at the end of 2004, as compared to 26.8% three years earlier.<sup>28</sup> Adjusted for those who are registered as unemployed but pursue activities in the informal sector of the economy, unemployment stands at below 20%.<sup>29</sup> Unemployment in Montenegro in 2004 was 14% lower than in December of the previous year but still high at 22%. At the same time, employment also decreased by 1.3%. Serbia's consolidated general budget deficit 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.<sup>30</sup> The introduction of VAT in January 2005 helped to boost revenues, but expenditure remained high although 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 expenditure rose by only 3.3% over 2003.

The total number of privatised companies in Serbia reached 1524 by the end of May 2005. The process

<sup>26</sup> Republic of Serbia Central Bank; European Commission, *ibid.*, p. 28.

<sup>27</sup> European Commission, *ibid.*, p. 32.

<sup>28</sup> Republic of Serbia Central Bank.

<sup>29</sup> European Commission: Feasibility Reports Serbia and Montenegro ... , op. cit., p. 28.

<sup>30</sup> Ibid.

of restructuring some 76 large, insolvent companies, which were selected by the Privatisation Agency for restructuring, progressed slowly. However, the adoption of amendments to several important laws (such as the laws on privatisation, share fund and financial markets) in May 2005 might help to accelerate the privatisation process.<sup>31</sup> In the Serbian economy, however, highly indebted socially owned companies that need to be closed or restructured and privatised, and state-owned companies with a high number of surplus workers, still play a predominant role and therefore hinder the development of a dynamic private sector. In Montenegro 70% of state-owned capital had been privatised by June 2005. At the end of 2004, 46 banks operated in the Serbian market. This number had further declined to 40 at the end of September 2005 and included 14 majority foreign banks which are among the largest in terms of financial strength.<sup>32</sup> The Serbian authorities have taken necessary steps to modernise the regulatory and institutional framework for financial sector operations. However, despite the recent initiatives and improvements of banking supervision in Serbia, it remains plagued by the questionable quality of off-site data. These factors undermine the ability of the Serbian Central Bank to properly identify risks in the banking sector. In Montenegro, all but one last bank with majority state-ownership have already been privatised. 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 unavailable. The right of establishment of foreign banks, including subsidiaries, has not yet been fully granted.<sup>33</sup> Exports of goods and services by Serbia increased to 24% of GDP from 20% in 2003 while imports surged to 54% of GDP from 43%. The degree of openness in Serbia, defined as the sum of export and import volumes as a percentage of GDP, rose to 78% in 2004 compared to 63% in 2003. Trade integration with the EU has been rising since 2000 and the EU share of total imports reached 49% in 2005, while the EU share of total exports reached 55%.<sup>34</sup>

Exports of goods and services by Montenegro rose in 2004 by 2% totalling 42% of GDP, and the degree of openness attained 81%. The level and change of trade

integration with the EU25 increased from 14% in 2003 to 47.7% of the total value of exports in 2004, while imports from the EU25 also increased from 39.8% in 2003 to 42.6% in 2004. Trade integration with Serbia still remains high. Serbia is, after the EU, Montenegro's main trading partner, with a share of 31.5% of total Montenegrin exports and 30.3% of its imports.<sup>35</sup>

### Monetary Policy at the Beginning of Transition

All the West Balkan transitional economies inherited only a few of the major financial institutions such as banks, insurance companies, funds and capital markets. 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 they 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.) It is obvious that such a setting could not serve as a proper foundation for either an efficient macroeconomic tool for combating inflation (which became a problem in most transition economies as a consequence, among other things, of rapid price liberalisation and the abolishment of hefty subsidies) or the development of the proper allocative role of commercial banks in decentralised market economies.<sup>36</sup> The newly established independent central banks in the SEECs faced several difficulties at the beginning of the transition 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 behaviour 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,

<sup>31</sup> Ibid., p. 29.

<sup>32</sup> European Commission: The Western Balkans in Transition – Enlargement Papers, op. cit., p. 69.

<sup>33</sup> A. Belke, A. Schaal, op. cit.; European Commission: Feasibility Reports Serbia and Montenegro ..., op. cit., p. 34.

<sup>34</sup> Serbian Central Bank; European Commission: Feasibility Reports Serbia and Montenegro ..., op. cit., p. 31.

<sup>35</sup> European Commission, *ibid.*, p. 34.

<sup>36</sup> W. Coats, M. Skreb, op. cit., p. 5.



**Table 4**  
**Exchange-rate Systems BiH, Croatia, FYRM,**  
**Serbia and Montenegro**

Country	Exchange-rate System
Bosnia Herzegovina	Since 1997 currency board system with euro as anchor currency
Croatia	Managed floating within a narrow band of +/- 2% around the euro
FYRM	Managed floating within a narrow band of +/- 2% around the euro
Serbia	Free floating
Montenegro	Euroised

Sources: H. Fritz, H. J. Wagener: Währungspolitische Optionen für die ostmitteleuropäischen EU-Beitrittskandidaten, in: Vierteljahreshefte zur Wirtschaftsforschung, Vol. 72, 2003, pp. 611-623, here p. 613; M. C. Reinhart, S. K. Rogoff: The Modern History of Exchange Rate Arrangements: A Reinterpretation, National Bureau of Economic Research (NBER) Working Paper 8963, Cambridge/MA, 2002, p. 54; V. Klyuev: A Model of Exchange Rate Regime Choice in the Transitional Economies of Central and Eastern Europe, International Monetary Fund (IMF) Working Paper WP/01/140, 2001, p. 36.

and weakens the financial discipline required to enjoy the full economic benefits of stable prices. The third difficulty, the lack of Central Bank credibility, results in a slower adjustment of public expectations of inflation, with the result that real interest rates rise or remain high longer.<sup>37</sup>

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 the 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 characterise transition economies also make money demand less stable and more difficult to estimate empirically (short time-series under the 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.<sup>38</sup>

#### Exchange-rate Regimes

With the exception of Serbia, the five Western Balkan countries have chosen a more or less fixed exchange-rate system with the euro as the anchor currency: a currency board system has been established in BiH; Montenegro is euroised, whereas managed or

free floating regimes can be found in Croatia, FYRM and Serbia.

As already mentioned above, the credibility of the Central Bank plays an important role with regard to the monetary stability of the transition countries.<sup>39</sup> In order to gain the necessary credibility the institutional settings in the Western Balkan countries strengthen the central banks and enable them to act independently in order to conduct a policy which ensures monetary stability.

#### 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 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 post-war 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.<sup>40</sup> In this sense, exchange-rate stabilisation in weak emerging markets leads to discipline in economic policymaking and, hence, to a better employment performance.<sup>41</sup>

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

- *A fixed exchange rate*: the BiH currency, the convertible mark (KM), was introduced in 1997 and it was tied to the Deutsche Mark (DM) 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.

<sup>39</sup> W. Coats, M. Skreb, op. cit.

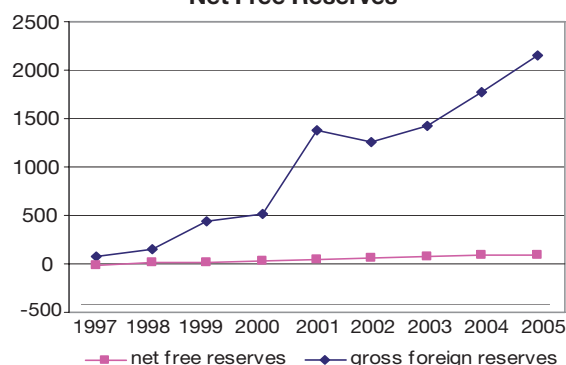
<sup>40</sup> A. Belke, M. Hebeler, op. cit.; D. Gros: An Economic System for Post-War South-East Europe, CEPS, Brussels 1999; D. Gros: Euro statt Rubel – Die Finanzkrise in Russland und anderen Krisenstaaten Osteuropas ist lösbar, in: Die Zeit, 27.5.99, p. 34; D. Gros: One Euro from the Atlantic to the Urals, in: CESifo-Forum, Vol. 1, No. 2, 2000, pp. 26-31.

<sup>41</sup> A. Belke, R. Setzer: Exchange Rate Stabilization in the CEECs – Discipline in Economic Policy Making and the Endogeneity Bias, in: Paul de Grauwe (ed.): Monetary Unions after EMU, CESifo, MIT Press, Cambridge/MA 2004.

<sup>37</sup> Cf. for example A. Belke, M. Hebeler: EU-Osterweiterung, Euro und Arbeitsmärkte, Munich and Vienna 2002.

<sup>38</sup> Ibid.; W. Coats, M. Skreb, op. cit., p. 6.

**Figure 6**  
**BiH Development of Gross Foreign and Net Free Reserves**



Sources: Data collected from the CBBH; own calculations.

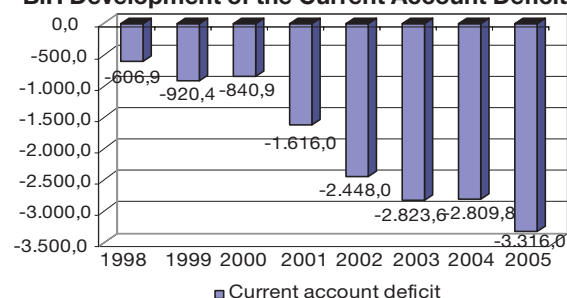
- *A full foreign exchange backing:* the domestic currency liabilities of the CBBH have to be fully backed with convertible foreign assets.
- *Full convertibility:* the CBBH had to be prepared to exchange KM for euro at any time and for any amount.

Since its introduction, the KM has largely displaced the other currencies and the currency board has delivered euro area levels of inflation. Gross international reserves and net free reserves (net reserves minus reserve money) had risen steadily to €2145 million and €96 million respectively at the end of 2005. 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 the end of 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.

However, domestic banks do not appear to have as much confidence in the KM as Bosnian private households since banks have often required that their KM loans are indexed to foreign currencies, typically the euro. Therefore, this kind of behaviour by banks suggests some caution on their part about the exchange-rate risk. 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 per cent of GDP since 2000, peaking at almost 22 per cent in 2002.<sup>42</sup> The large cur-

<sup>42</sup> CBBH; IMF estimates.

**Figure 7**  
**BiH Development of the Current Account Deficit**



Source: Data taken from the BiH Statistical Agency.

rent account deficit can also be seen as a result of strong import growth since 2001.

Furthermore, bank credit to non-government, relative to GDP, increased by over 20 percentage points in 2001-2005. 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.<sup>43</sup> If we compare the current situation in BiH (large current account deficit and credit boom) with other active currency board countries, only Bulgaria has also experienced rapid credit growth alongside an external deficit, but before it introduced the currency board. Hong Kong also experienced rapid credit growth from 1993-97, but alongside current account surpluses.<sup>44</sup>

### Croatia

The general framework of monetary policy in Croatia can be described as a “managed float”, whereby the primary policy objective is price stability.<sup>45</sup> The exchange rate has traditionally been used as a stabilisation anchor, following periods of high and hyperinflation in the early 1990s. The scope for greater exchange-rate flexibility is constrained against the background of a highly euroised economy with a significant share of bank loans and deposits denominated in foreign exchange.

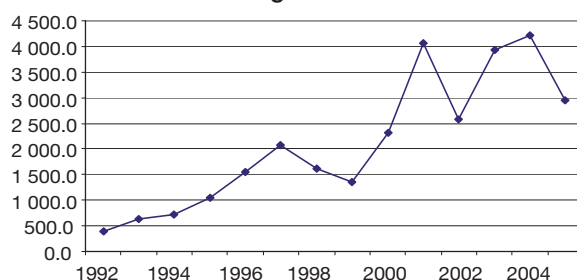
The main instrument of monetary policy continued to consist of interventions in the foreign exchange market through auctions. Interventions have not been carried out to defend a pre-announced exchange rate or exchange-rate band, but in order to smooth short-term exchange-rate fluctuations. During the four quarters starting in the second quarter of 2004, the average

<sup>43</sup> IMF: Bosnia and Herzegovina: Selected Economic Issues, 2005, p. 32.

<sup>44</sup> Ibid.

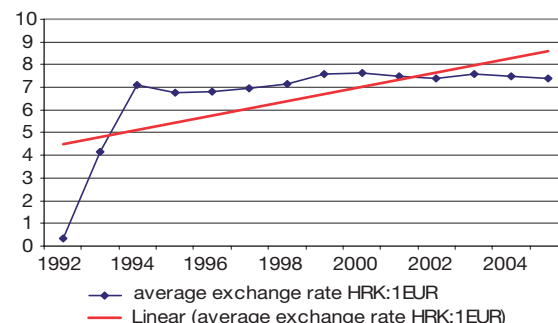
<sup>45</sup> Croatian National Bank.

**Figure 8**  
Development of Croatia's Foreign  
Exchange Reserves



Source: Data supplied by the Croatian Central Bank.

**Figure 9**  
Average Exchange Rate of the Croatian Kuna  
vis-à-vis the Euro



Source: Data supplied by the Croatian Central Bank.

monthly Kuna exchange rate to the euro fluctuated within a margin of 1.4% of the average rate.<sup>46</sup>

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 in foreign debt, the Central Bank also took 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.<sup>47</sup> 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.<sup>48</sup> 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%).

#### 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.<sup>49</sup> 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 organises 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 the 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 a value equivalent to 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 Deutsche Mark in 1994. In the year 1997, the authorities decided on a steep devaluation of 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.<sup>50</sup>

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.

#### Serbia and Montenegro

The Law on the National Bank of Serbia (NBS) ensures its independence. Like other central banks in the Western Balkans, the NBS focuses on price stability. It attempts to follow a policy of balancing the objective of maintaining price stability with external competitive-

<sup>46</sup> Ibid.

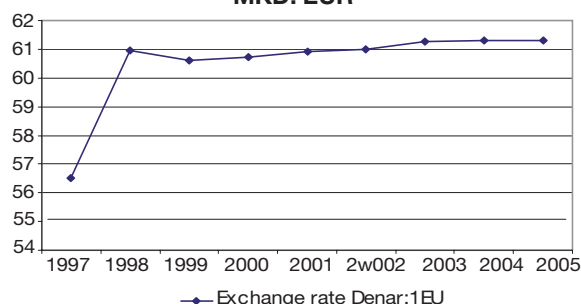
<sup>47</sup> Ibid.

<sup>48</sup> European Commission: Feasibility Reports Serbia and Montenegro ... , op. cit., p. 39.

<sup>49</sup> FYRM National Bank.

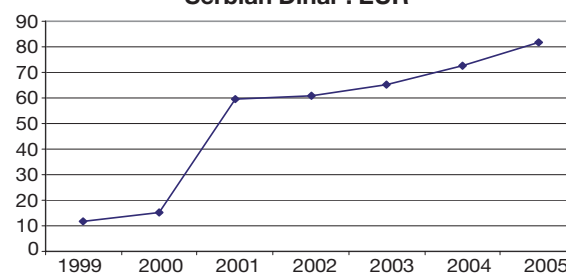
<sup>50</sup> Ibid.

**Figure 10**  
FYRM Development of the Exchange Rate  
MKD: EUR



Source: Data taken from Eurostat.

**Figure 11**  
Development of the Exchange Rate  
Serbian Dinar : EUR



Source: Data taken from Eurostat.

ness, using a flexible “managed float” exchange-rate regime.

The Serbian dinar depreciated against the euro by 13.4% in 2004 and 5.7% during the first seven months of 2005. In 2005, the authorities re-focused their priorities on keeping inflation in check and aimed for a slower depreciation.<sup>51</sup> In Serbia broad money increased from about 20% of GDP at the end of July 2004 to 26% at the end of July 2005. Euroisation – 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.<sup>52</sup>

The government of Montenegro introduced a dual currency system (dinar/Deutsche Mark) in 1999 and in 2000 the Deutsche Mark became the only means of payment in Montenegro. In 2002 the euro became the official means of payment in Montenegro and it was introduced on the basis of the Law on the Central Bank – as the replacement for the Deutsche Mark. Thus, Montenegro is the only Western Balkan country so far that has been fully euroised. According to the Central Bank of Montenegro, one of the most important reasons for the unilateral euroisation was to facilitate the turnover of goods and services as well as the international communication of Montenegro.

### The Theory of Optimal Currency Areas

By applying the theory of optimal currency areas (OCA) to the detailed evidence presented above, it can be assessed whether the integration of the Western Balkan countries into the ERM II and later on into EMU

would make sense.<sup>53</sup> There are six popular criteria available for assessing the relative suitability of specific economies for EMU membership from the perspective of a small country. These indicators are 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 concern the structure of trade, whereas the second group focuses 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 EMU accession if it is smaller than the current EMU, the degree of political and economic integration between the considered candidate country and the EMU is very high, the similarity of the economic structure between the EMU and the candidate country is high and/or if the public debt of the candidate country is high. The criteria 1 to 3 reduce the probability of asymmetric shocks in an enlarged EMU and 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 unable to deliver a profound and complete textbook-style OCA analysis as is usually done in the literature for industrialised countries. Instead, the following part 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 Western Balkan countries. 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.

<sup>51</sup> European Commission: Feasibility Reports Serbia and Montenegro ... , op. cit., p. 28.

<sup>52</sup> Ibid., p. 30; for the pros and cons of early euroisation cf. A. Belke, R. Setzer: Euroisierung der mittel- und osteuropäischen EU-Beitrittskandidaten – ein alternativer Weg in die Währungsunion?, in: Perspektiven der Wirtschaftspolitik, Vol. 4, 2003, pp. 425-436.

<sup>53</sup> M. Emerson, D. Gros: The CEPS Plan for the Balkans, Centre for European Policy Studies, Brussels 1999.

**Table 5**  
**Key Data for the Western Balkan Countries 2005**

	Population (million)	GDP per capita (US \$)	GDP growth rate (%)	Exports to EU (as % of total)	Inflation rate (%)	Unemployment rate (%)
Croatia	4.4	8,674	4.3	64.0	3.3	12.3
FYRM	2.0	2,850	4.0	52.3	0.1	36.5
BiH	4.5	2,425	5.8	53.3	2.4	44.5
Serbia	7.5	3,234	6.3	49.0	17.2	31.6
Montenegro	0.6	3,147	4.1	81.0	2.6	27.3

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

### Preliminary Application of OCA Criteria

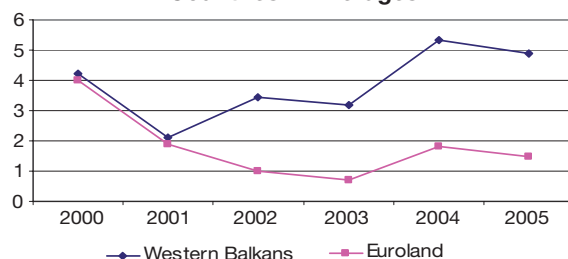
In the academic literature it is quite popular to maintain that the very weak countries,<sup>54</sup> such as some of the Western Balkan states considered here, would gain from entering EMU as soon as possible, because that would be a way to import sensible macroeconomic policies and decisively gain the confidence of financial markets. Since the alternatives to this step could be hyperinflation 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 being unable to react to asymmetric shocks with exchange-rate changes.

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

However, if we take a look at the development of the GDP growth rates in the Western Balkans and the euro area, it becomes obvious that these countries are still caught in the process of transition, with a lot of catching up still to be done. That is why the Western Balkan economies are still going through major 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 the Western Balkans is steadily declining, whereas the service sector<sup>55</sup> is gaining even more in importance, is a development which can already be observed.

Generally, we can state that the degree of economic integration with the EU is relatively high if we take into account the history of the five Western Balkan countries (the communist era<sup>56</sup> until the 1990s and the Eastern Bloc membership) as well as the political unrest in this region since the 1990s. With an eye on the ongoing transition and the EU accession negotiations it can be expected that the degree of European integration will increase further. That is why the question should not be *whether* the Western Balkans will become members of EMU and adopt the euro as an official currency, but rather *when* the Western Balkan countries will become part of the euro area and what this process should look like. In addition to economic and political integration, the choice of the monetary transitional exchange-rate regime will play an important role in this.

**Figure 12**  
**GDP Growth Rates Euroland and Western Balkan Countries in Averages**



Sources: Data collected from national agencies and DB research.

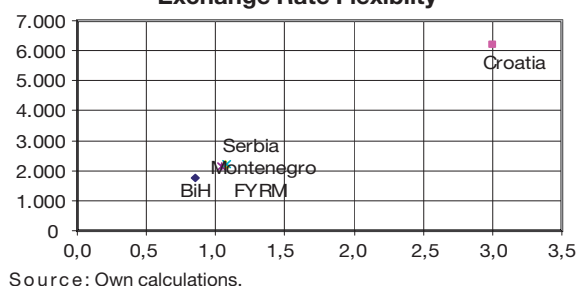
<sup>54</sup> These are the ones which are very far from fulfilling the requirements for EU membership in general and the Maastricht fiscal criteria in particular. For an early source, cf. for instance D. Gros: *An Economic System ...*, op. cit.; D. Gros: *Euro statt Rubel ...*, op. cit.; D. Gros: *One Euro from the Atlantic ...*, op. cit. For a systematic overview of the issue cf. A. Belke, M. Hebler, op. cit.

<sup>55</sup> Especially the banking sector as already described above in this paper immediately comes into mind here.

<sup>56</sup> However, note that during the Tito era the former Yugoslav Republic was already a relatively open and western-oriented country if compared to other countries which belonged to the former Eastern bloc.



**Figure 13**  
Average GDP Per Capita in US \$ and Degree of Exchange Rate Flexibility



### Optimal Transitional Exchange-rate Regimes

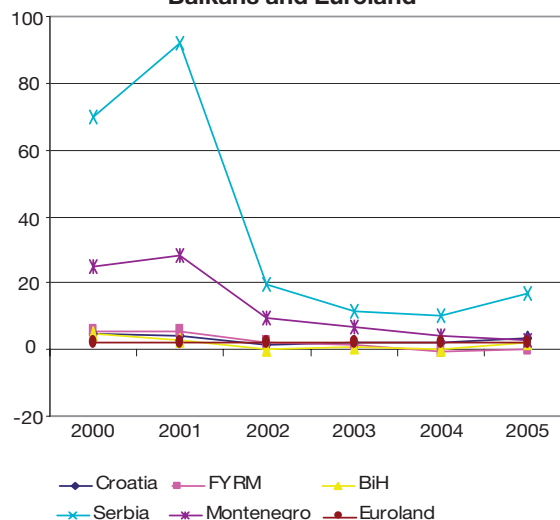
The conventional view of the euro area enlargement process is: converge first, and durably, and then join. But this conventional view, while probably appropriate for the current EMU members, may not be suited to the situation faced by some of the Western Balkan countries.<sup>57</sup> Already two potential EU candidate countries have virtually become members of the euro area: BiH, which has implemented a euro-denominated currency board, and Montenegro, which is already fully euroised. The two candidate countries Croatia and FYRM are targeting a stable exchange rate against the euro by pursuing a managed floating strategy as described above. So what is actually the optimal transitional exchange-rate regime for the Western Balkan countries during their integration into the EU? The hypothesis that the stronger economies may find it advantageous not to hurry to join 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 neutralise 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 to 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 solution.

If we classify the five Western Balkan countries into strong and weak economies according to their average per capita GDP,<sup>58</sup> Croatia is clearly the strongest country in the region. If we take a look at the develop-

<sup>57</sup> For an early source cf. D. Gros: *An Economic System ...*, op. cit.

<sup>58</sup> Average values for the time period 2000-2005.

**Figure 14**  
Development of Inflation Rates in the Western Balkans and Euroland



ment of the exchange rate HRK: EUR, 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  $\pm 15\%$  should not represent a serious difficulty for Croatia. With respect to the optimal transitional exchange-rate regime and the above hypothesis, Croatia could find it advantageous to keep some exchange-rate flexibility in order to neutralise a possible Balassa-Samuelson effect. However, it should be considered that in addition to the relatively stable exchange rates, the inflation rates in Croatia have proved to be very moderate since 2002 and to be in line with the average euro area inflation rate of approximately 2.1%, which could possibly indicate an only very small Balassa-Samuelson effect so far.

Although a candidate country, FYRM cannot be classified as a strong economy according to the average per capita GDP and other macroeconomic indicators. In fact, with respect to the degree of its economic development FYRM can be assigned to the group of the potential candidate countries such as BiH, and Serbia and Montenegro. The MKD:EUR exchange rate has been stable since 1998 and moves within a relatively narrow fluctuation band of approximately  $\pm 2\%$ . Since 2000 the inflation rates have been very moderate, whereas in 2004 a slight deflation of -0.4% occurred. Despite the relative inflation and exchange-rate stability in FYRM, the country still has a long way to go in order to catch up with Croatia and other CEECs.

However, from the current point of view FYRM should be able to meet the criteria of the ERM II.

With regard to BiH, the maintenance of the euro-denominated currency board regime should be the best monetary-transitional strategy towards EU/EMU accession.<sup>59</sup> The currency board regime has been 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 strengthen the transition process in BiH, significant structural changes are necessary, especially with respect to the reduction of the very high current account deficit. Furthermore, the smoothing of the ongoing credit boom initiated by private households and supported by the banking sector in order to maintain and increase market shares, should be at the top of the Bosnian agenda in order not to jeopardise the monetary stability already gained.<sup>60</sup>

As the only country in Europe that has been fully euroised, Montenegro has been able to lower its inflation rates significantly since 2001. After the break-up of its political union with Serbia, Montenegro became the smallest economy in the Western Balkan region with a population of approximately 600,000. In view of this fact and the already high degree of trade integration with the EU countries, euroisation seems to be a good solution for Montenegro. In fact, it is the task of the ECB and the representatives of EMU to find a way to deal with fully euroised countries after they have become members of the EU, both regarding their ERM II membership and their 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. 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 segregation of Montenegro from the state union, then according to our hypothesis that weak countries may find it advantageous to import monetary stability and confidence by fixing their currencies to a stable anchor, Serbia should reconsider its current approach of free floating. From the current point of view, Serbia would also be unable to meet the criteria of the ERM II. As potential alternatives, a managed floating strategy within narrow fluctuation bands (like FYRM and Croatia) or

the implementation of Currency Board Systems (BiH) should also be considered.

### Concluding Remarks

In our analysis we have investigated five Western Balkan countries that were part of the Former Yugoslav Republic: BiH, Croatia, FYRM, 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 five Western Balkan countries have chosen a relatively similar approach regarding the choice of exchange-rate regime. Except for Serbia, the rest of the Western Balkan states have implemented more or less fixed exchange rates (cf. Table 5). Our analysis so far has shown that most of the Western Balkan economies still have a long way to go before they will be able to become members of the EU and consequently also of EMU. In this context, the choice of the monetary transitional exchange-rate regime plays an important role with regard to the fulfilment of the Maastricht criteria, especially the inflation and exchange-rate conditions. With respect to the explicit wish and policy priority of the EU to foster intra-regional integration and cooperation in the Western Balkans,<sup>61</sup> 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, thus, should have a positive impact on intra-regional economic activities. Furthermore, the Western Balkan countries are in the good position of being able to learn from the experiences made by the CEECs during their path to EU and (future) EMU membership. However, in contrast to the economic development of the CEECs during their transition process and in contrast to the predictions of the Balassa-Samuelson effect, the five Western Balkan countries display – despite their very high catching-up potential – relatively low inflation rates linked with stable exchange rates. Therefore the questions are whether the Balassa-Samuelson effect can be detected in the Western Balkans, and which conditions in this region lead to the described deviations. We leave these tasks, as well as that of a more formal application of the OCA analysis to the Western Balkans, to further research.

<sup>59</sup> BiH can profit from the experience of the Estonian Currency Board Regime and its future experience related to Estonia's EMU accession. According to the statements by the ECB and the Eesti Pank, Estonia will be one of the first Eastern European EU member states to join the EMU in the near future.

<sup>60</sup> IMF: Bosnia and Herzegovina ... , op. cit., p. 16.

<sup>61</sup> European Community: Regional Cooperation in the Western Balkans – A Policy Priority for the European Union, Brussels 2006.