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Relevance of Low Inflation in the Southeastern European Countries

Abstract: The paper starts from the assumption that the significant reduction of the inflation problem is a result of the long-term dynamics of economic growth in countries with developing markets and, as a result, operational inability of multinational companies to increase accumulation through the policy of raising prices by creating space for their full expansion. We believe that in such circumstances civil theories on the causes of inflation are dominantly of class character. We check negative repercussions of low inflation on the examples of the countries of South-East Europe, in the regimes with fixed and flexible exchange rates, and with different strategies of monetary policy. We conclude that destructive implications of the financial crisis and psychological factors have a negative impact on a sustainable low-inflation environment, regardless of the monetary-exchange regime. We propose that low and stable inflation rates can be followed by a series of negative implications for the overall economic system, which our analysis of the observed countries proves.

Key words: inflation/deflation, aggregate demand, monetary and fiscal policy, exchange rate/inflation rate targeting

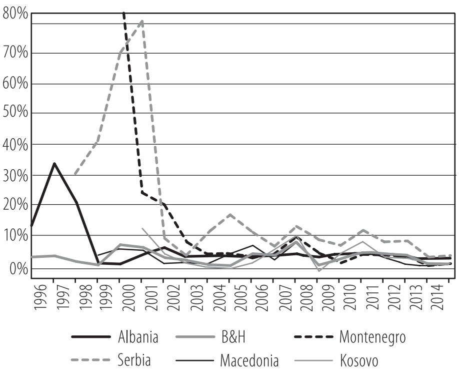
JEL classification: E52, E61 and E62

Introduction

The strategic choice of monetary policy implies an adequate selection of the nominal anchor, i.e. publicly presented nominal variable which serves as a target for monetary policy. Nominal anchor supports stability of prices by influencing the value of money, thus supressing inflationary expectations. A convincing strategy is of help in stabilizing inflationary expectations to the targeted low level. The selection of an optimal strategy, which can help in incorporating elements of different approaches, mainly depends on individual circumstances in each of the countries – their size, foreign trade links, financial structure (Lakić, 2006, p. 100). There is a consensus among economists and central bankers that the only long-term effect on economy that monetary authorities can achieve is determining sustainable or trend inflation rate. The National Bank of Serbia (NBS) (2015) believes that the programme of quantitative easing (expansive monetary policy) of the European Central Bank (ECB) may influence developing states, including Serbia, through: the expectations of lower interest rate, which, along with higher rates of return, encourages inflow of capital; increased demand for government securities, along with the lowering of the country risk premium, growth of asset prices, and lower interest rates; depreciation of the euro which reduced demand for import of goods in the euro area, i.e. lower import.

Montenegro opted for official dollarization as the monetary policy strategy, based on the regime of pegged (fixed) exchange rates. The strategy of targeting exchange rate implies the absence of monetary policy and exchange rate policy. Consequences of such a created monetary arrangement can be seen in Kosovo as well. The monetary regime in Bosnia and Herzegovina was completed with the currency board as the monetary-exchange institution, based on the super-fixed exchange rate and the absence of implementation of a monetary policy. Strategic choice of the monetary regime of Serbia is inflation targeting, with the possibility of flexible exchange rate. The National Bank of Serbia uses instruments of monetary management, including foreign exchange interventions. The strategy of the monetary policy in Macedonia varied from monetary targeting, over free floating, and managed floating of the exchange rate, whereby the last one is sometimes referred to as de facto fixed exchange rate. Strategic choice of the monetary policy in Albania is inflationary targeting in the conditions of free floating exchange rate regime, using repo and reverse repo agreements, central bank loans, minimal reserves and the like.

Figure 1: Inflation in SEE countries in the period 1996-2014



Source: IMF and Monstat

After high inflation rates recorded in the first years of the post-conflict period (with the exception of Serbia and Montenegro until disintegration of the Federal Republic of Yugoslavia), inflation in all the countries of the South-East Europe (SEE) constantly declined, and in the period 2002 – 2008 (except in Serbia) it ranged between 0% and 7%. Then the inflation rate in all the SEE countries was below 5%. Thus, in the period 2001 – 2007, the inflation rate in Serbia dropped from 91.8% (2001) to 10.1% (2007), and in Montenegro it fell from 28% to 3.1%.

The trends indicated in Figure 1 are approximately confirmed by data from other sources, presented in Table 1:

Table 1: Inflation rates in SEE countries in the period 1996-2014

Country	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Albania	12,7	33,2	20,6	0,4	0,1	3,1	7,8	0,5	2,3	2,4
B&H	-17,1	13,0	-1,6	8,4	28,8	3,1	4,5	0,7	0,3	3,8
Montenegro Serbia	94,1	18,3	30,0	40,1	70,0	80,6	8,9	2,9	10,6	17,2
Macedonia	2,5	1,3	0,5	-1,3	6,6	5,2	2,3	1,1	0,9	0,2
Kosovo	-	-	-	-	-	-	-	-1,1	-1,1	-1,4

Country	2006	2007	2008	2009	2010	2011	2012	2013	2014
Albania	2,4	2,9	3,4	2,3	3,6	3,5	2,0	1,9	1,6
B&H	7,2	4,8	7,4	- 0,4	2,2	3,7	2,1	-0,1	-0,9
Montenegro	2,9	4,3	8,8	3,5	0,7	3,5	4,1	2,2	-0,7
Serbia	12,7	6,45	12,4	8,1	6,2	11,2	7,3	7,7	2,1
Macedonia	3,2	2,3	8,3	- 0,7	1,5	3,9	3,3	2,8	-0,3
Kosovo	0,6	4,4	9,4	-2,4	3,5	7,3	2,5	1,8	0,4

Source: 1) Statistical Annual 2010; 2) *http://www.factfish.com/statisticcountry/bosnia%20and %20herzegovina/inflation,%20gdp%20deflator*

The presented statistical framework with official data on inflation in the observed countries represents partly a basis for drawing conclusions on the effects of low inflation rate. Namely, although statistics does not point to any satisfactory effects of the economic environment and implementation of economic policies, many analyses and researches do not adequately look into the relevant factors that determine low-inflationary environment and economic-social dimension of the civil standards. We here have in mind fundamental internal and external causalities, delayed and prolonged presence of the problem, eliminating/fixing domestic currency for the sake of a foreign one, persisting on the same destructive economic models, non-economic behaviour of the states, retrograde mechanisms of neoliberalism and market fundamentalism, an endless spiral – exponential growth of debts etc.

1. Theoretical Approach to Reduction of Inflation: Monetary and Fiscal Policy and Aggregate Demand

Inflation is a complex notion, which is why the focus is on its causes and consequences rather than on its precise definition. In that sense, different schools of economic thought had different approaches to the causes of inflation. For the civil economic thought, excessive demand, i.e. surplus of aggregate demand in relation to supply, leads to price growth. Monetarists believe that "inflation is always and everywhere a monetary phenomenon" and that price growth is caused by a faster increase of the amount of money in relation to the production growth. Compared to the Monetarists, the Keynesians believe that the basic cause of price growth is disharmony between investments and savings, where the interest rate plays the crucial role. While Levinson (1974) considers that multinational companies are the basic source of inflation, Eckstein (1981) believes that it is core inflation or the trend of wages and expenses.

Understanding the process of causes of inflation, as one of the fundamental issues of every modern state, is of special importance for the monetary and fiscal policy authorities. In that sense, anti-inflation policy, as an instrument of stabilization policy, has relied on different theoretical premises, which has led to the application of different models of stabilization, and that eventually influences the choice of operational measures of stabilization strategy. There are different explanations of disinflationary processes based on restrictive monetary and fiscal policies, aimed at reducing the aggregate demand and achieving the anti-inflationary goals.

Thus, depending on the nature of undertaken measures, it is basically possible to differentiate between (1) orthodox stabilization programmes that focus on restrictive monetary and fiscal policy and devaluation of the national currency, as well as monetarist position regarding the proportionality between trends of money supply and inflation, and (2) heterodox programmes which add the policy of income to the fundamental measures. Heterodox programmes imply the need for a firm link between monetary and fiscal policies if low budget deficit weakens the pressure on money creation and reduces inflation tax which represents a spillover mechanism for income and debts.

Still, by the end of the1990s, monetary policy represented the crucial instrument of stabilization policy in many countries, which is especially supported by long and variable lags characteristic of fiscal policy. These lags could often influence the counter-effect of previously undertaken measures due to possibly changed circumstances that occurred in the meantime. Firm monetarist opinions, such as those of Friedman and Schwartz (1963) who attribute inflationary tendencies to excessive and unbalanced monetary expansion that arose from the assumption that inflation is always and everywhere a monetary phenomenon, lead to the fact that there is no need for its coordination with fiscal policy for the purpose of fighting inflation. There is extensive literature that sees the interaction of monetary and fiscal policies as an uncooperative game between the government and the central bank, which is aimed at achieving Pareto efficiency.

On the other hand, proponents of the Fiscal Theory of Price Level (FTPL) – Leeper (1991), Sims (1994), Woodford (1994, 1995), and Cochrane (1998, 2001, 2005) believe that fiscal policy, especially the internal debt, plays an important role in the process of determining the price level. For that reason, all research of this kind is aimed at coordination and interaction of monetary and fiscal policies. To put it short, followers of this theory prove that the government policies of deficit and budget constraints are directly linked to price levels.

Accordingly, Sargent and Wallace (1981) notice that if the government wants to observe the budget constraints, activities of monetary and fiscal authorities must be synchronized because unsustainable fiscal policy would make the monetary authorities respect budget constraints, which finally influences the price level. Based on this, it is possible to conclude in a simplified manner that fiscal theory of price level represents elaboration of some aspects analysed by Sargent and Wallace (1981), where fiscal policy imposes constraints on monetary policy. The crucial idea proposed by the followers of this theory starts from the fact that the inter-temporal budget constraint and fiscal policy represent the factors that determine the price level.

In that sense, the difference between Ricardian and Non-Ricardian regimes has important implications for the economic policy. Such a good monetary policy based on the Ricardian regime is necessary and is a suitable precondition that guarantees low inflation, since an independent central bank with strong institutional commitment to price stability should make those in charge of fiscal policy conduct a responsible and adequate fiscal policy. Compared to this position, the Non-Ricardian regime implies that good monetary policy is not a sufficient condition that ensures low inflation unless additional measures are taken into account in order to limit the freedom of monetary authorities. Apart from the previously mentioned theoretical research, there are also those which are of mixed character that is a result of the Post-Keynesian economic theory, which was described by Godley and Lavoie (2007), while McCallum and Nelson (2006) analysed the link between theory of prices and monetary and fiscal components, finding cases in which these theories are combined, as well as those in which they differ.

Based on this, it is possible to conclude that the problem of inflation is caused by both monetary and fiscal policies, which means that changes in any of these policies must finally have an impact on the price level. It should be pointed out here that although most economists from the pre-crisis period reject the possibility of using discretionary fiscal policy for stabilization purposes, modern literature sees fiscal policy as a powerful instrument for achieving price stability whose success requires adequate interaction with monetary policy. This was especially obvious in the period after the Great Economic Crisis which again emphasized significance of fiscal activism (Cagliarini, Christopher and Stevens, 2010).[1]

2. Consequences of Low Inflation in the Fixed Exchange Rate Regime

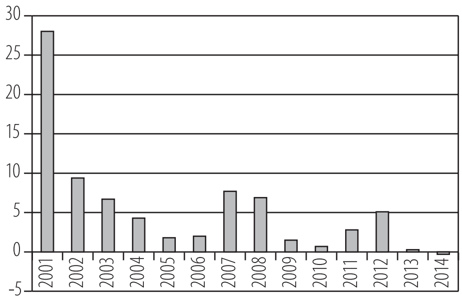
The issue of strategic choices, along with the issue of transmission mechanism and adequacy of instruments are in the focus of theoretical and empirical analysis of monetary policy. The choice of a monetary regime or an exchange rate regime cannot be fully attributed all positive or negative characteristics of the situation in an observed economy. A convincing strategy supports stabilization of inflationary expectations at the desired low level. There is a question of how much inflation reduction can be of macroeconomic use, if the economic growth is jeopardized and whether the fiscal balance is weakened more visibly, with further social repercussions.

The period after the implementation of official euroisation regime in Montenegro is characterized by low growth rate and high inflation rate, which is known in the economic theory and practice as slump inflation. In the conditions of convertibility and stability of currency, as the long-term benefits (until the escalation or crisis), growth of money supply in GDP would be a positive effect. In the period 2003 – 2007, the share of M2 in GDP increased fourfold, while the amount of monetary aggregates has not been presented after 2007. After the initial high level, a much lower inflation rate (retail prices index) was recorded. The higher inflation rate in the period 2007 - 2008 was a consequence of the expansive fiscal policy. The loss of flexibility of monetary and fiscal policies was not compensated

[1] For more details see: Šehović, 2015, p. 103-104.

for with the benefits of low inflation in a long term. Analyses show that the types of inflation in Montenegro are inflation of costs, structural inflation and imported inflation (Central Bank of Montenegro, 2010). Figure (2) shows a significant reduction of inflation rate[2].

Figure 2: Trend of inflation rate (2001-2014)



Source: Monstat and Central bank of Montenegro

One of the advantages of implementation of official euroisation was mentioned in literature – reduction of the inflation rate was achieved. Medium term inflation rate in Montenegro approached the anchor states. Some positive macroeconomic effects achieved after the introduction of euroisation lessened at the beginning of the economic crisis. According to the forecasts of the European Commission for Montenegro, the expected inflation is 0.4% in 2015, and 2% in 2016. We stress that achieving internal and external balance is one of the crucial questions that the economic theory has been permanently trying to answer. Internal balance is achieved through full employment without inflation, while the external one is achieved in the situation when the balance of payments is even and when there are no changes of the exchange rate. In order to achieve this complex goal, it is necessary to influence the income, interest rates and balance of payments. The equilibrium is possible to achieve by manipulating the measures of monetary and fiscal policies.

In the Montenegrin conditions of low, stable and sustainable inflation, there are macroeconomic problems. The lack of flexible monetary and exchange policy is followed by an inadequate countercyclical approach of the fiscal policy. Repercussions of the low-inflation environment in the economic system and international economic relations are: the existing low level of GDP, problematic liquidity of the system and budget, as well as a high level of non-performing loans. In the context of diverse debts (e.g. tax ones), the most prominent problems are growth of the government debt and the current account deterioration, inadequate elasticity of international flow of capital, taking into account the interest rates that are quite high. The span of lending and deposit interest rates is wide, which is confirmed by the fact that banking loans are characterized by limited and expensive credits.

[2] HICP for 2011, 2012, 2013, and 2014.

Growth or decline of the Montenegrin economy is also influenced by fluctuations of the main currencies: American dollar, Russian rouble and Serbian dinar.

Decline of the industrial production and export mildly recovered during last year. Cheaper import products are in direct correlation with inflation, while the leading export products (electric power, aluminium) are in correlation with the oil prices. Earlier literature (e.g. Bogetić, 2000) suggested that dollarization could have a positive influence on the distribution of income by reducing inflationary expectations. Namely, it will not be necessary to use new assets to protect the old ones from losing value. Negative consequences of the inflationary environment as early as in the initial stage of full dollarization regime were a reduction of citizens' participation in the distribution of income. Therefore, the problem of redistribution of wealth has not been resolved and this problem has contributed to the structural poverty in the conditions of extreme indebtedness of households (more than 1 billion U.S. dollars) and lack of income of citizens. Unemployment at the level of 180,000 of the working age population contributed to all this. The impact on domestic demand is negative as a result of inadequate credit placements. Montenegro largely shares these problems with countries in the region, which include the brain drain of young people who do not see good prospects ahead of them.

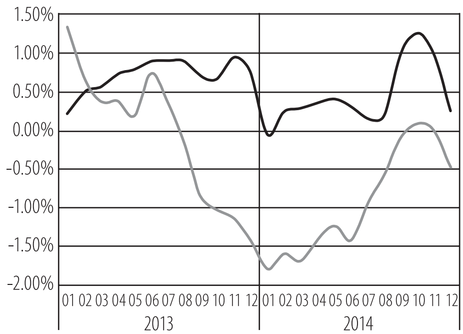
Price effects that are seen as a favourable and permanent increase of a part of export products (lower stages of processing) in Bosnia and Herzegovina are followed by a mild reduction of the export value compared to the previous year regarding the most important export products. When it comes to some export dependant industries, only the service of labour ("lohn" jobs) is charged in most of the production. Increasing production and export of some groups of products is a result of recovery on the global scales – trends in the world market, with a higher share of added value. Weak purchase power of population may be recognized by low GDP per capita. According to the Annual Report (CBBIH, 2014), gross added value of industrial production remained almost unchanged, growth rates of the industrial production are quite uneven, while there was a strong decline in agriculture. These are activities that have a special importance for the level of economic activity.

In the observed countries, especially in Bosnia and Herzegovina, implications in the economic system are largely linked to the situation of the global economy. However, on the international level, in the so-called advanced economies, last year was characterized by the effects of limiting factors based on deflationary pressures, i.e. a declining inflation trend with a turn into positive economic developments and a mild reduction of unemployment (the case of EU) and a somewhat higher growth rates of real GDP, as well as a declining inflation trend (USA). Compared to countries that do not have the monetary policy sovereignty (Montenegro, Bosnia and Herzegovina, and Kosovo), economic policy instruments, with the focus on instruments of monetary and liquidity management, were used for fighting deflationary pressures, strengthening aggregate demand, and facilitating crediting conditions. The Federal Reserves in the previous year announced keeping of the crucial interest rates on the lowest level ever (0.00% - 0.25%). The ECB applied non-standard expansive monetary policy measures, including lowering reference interest rates.

Price indicators in the banking system of Bosnia and Herzegovina are a reflection of the overall poor economic environment. Starting from the fiscal system analysis presented in the Report on Financial Stability (2014), which is characterized by problems in maintaining fiscal stability of the country, the drop of lending interest rates is linked to a decline in interest rates on the international financial markets. Still, most systemic banks have not changed the level of an average interest rate. Some banks reduce interest rates in order to take a more significant position in the corporate sector. A growth of interest rates has been recorded for the state owned banks, as a result of more expensive sources in the country and the impossibility of international funding. Despite the downward trend of interest rates, the decline of housing loans has continued, along with the growth of the loans aimed at general consumption, which means low living standard of population. Debit cards have contributed to an increase of average indebtedness.

Floods have been mentioned as the basic source of price growth and other indicators. Figure 3 shows the relation between the actual and estimated core inflation. Deflationary pressures started easing up since the beginning of the last year, while general consumer prices (CPI) were lower compared to the year before. Last year, long-term inflation trend, measured by core inflation, was higher than the real inflation. Inflation, measured by GDP deflator (price per unit of GDP), was an indicator of the price growth during 2014 (the second and fourth quarters). At the same time, the administrative rate of unemployment (43.5% in 2013)

Figure 3: Actual and estimated core inflation



Source: BHAS, Annual Report 2014, Central Bank of Bosnia and Herzegovina showed a declining trend last year, in addition to slowing down its growth, although these were small positive trends. The growth of nominal wages slowed down (low level and stagnation), exports reduced, and the growing trend of the external debt continued. Business environment was unfavourable, which influenced the low level of investments in Bosnia and Herzegovina. The import of capital goods during last year will have a negative fiscal balance in 2015.

After a depreciation trend, due to changes of the euro value, the trend of appreciation of the nominal effective exchange rate continued. The consequences of such a trend for the price competitiveness of Bosnia and Herzegovina are negative. The level of competitiveness of the economy is low bearing in mind foreign trade and investment. Against the backdrop of unfavourable macroeconomic environment, disintegration process has an adverse effect on foreign exchange reserves. A significant growth of import and a mild increase of export resulted in the deepening of the trade deficit. Due to the budget deficit and inadequate implementation of structural reforms, borrowing of the state from international financial institutions increased. The reason is the lack of agreed tranches based on the stand-by arrangements and growth of the indebtedness of the state with commercial banks and on the domestic capital market. According to the credit rating agencies, the sovereign rating of Bosnia and Herzegovina is in the sphere of the speculative credit standing, along with a high credit risk.

Positive trends in the real sector are inadequate and slow, while indicators of the level of population wellbeing, such as real individual consumption (purchase power standard) and GDP per capita, are on a pretty low level. Weak domestic demand of households and legal persons is expected in the future, which will limit the growth of economic activity. Population is oriented to saving rather than consumption. Growth of deposits of population is a result of economic uncertainty. People get into debts in order to cover their basic living needs. Despite weakening of deflationary pressures last year, general consumer prices were lower compared to 2013. In December 2014, deflation was 0.4% on the annual level, while average consumer prices were 9% lower. Unemployment was slightly lower, the living standard was low, and growth of average net salaries was also low. Growth of loans for general production was caused by low disposable income. Sustainable economic recovery is necessary for growth of private production.

Officially, the CPI inflation in Kosovo decreased last year. Still, the reality is that with the low inflation rate, consumers were faced with a continuous increase of consumer prices and a declining living standard. Aggravated conditions of business operations in the poorly functioning economy are followed by an "export of cash", while due to the import of products (except cash for export) inflation is imported and consumer basket is seriously impaired. In such circumstances, it is not possible to maintain economic and social stability. In addition, Kosovo institutions stress that they do not have mechanisms to reduce prices. The problems of nepotism, unemployment, low level of education and a high share of informal economy (informal employment) are crucial factors preventing economic recovery. Kosovo is the poorest country in Europe: almost half of the population live in poverty, with the lowest GDP per capita in South-East Europe. Real GDP growth is a result of private consumption due to a more significant growth of salaries in the public sector and pensions in 2014. Despite relatively high economic growth (in comparison to countries in the region), growth of domestic and foreign demand slowed down.

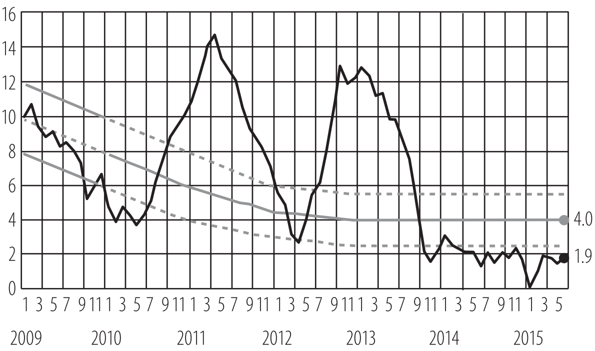
The official unemployment rate exceeds 40%, and probably between 45% and 50% of the working age population, mainly young people, is unemployed. Despite relatively weak direct trade and financial links with the world economy, the problem is dependence on imports and a poor export basis. The mentioned links with the euro area are limited, with minor inflow of capital (FDI) from it. Poorly implemented or non-existent regulatory framework and energy problems have an additional negative effect on the economy. Institutional and administrative capacities are weak and Kosovo is a country with the highest level of corruption in Europe (according to the Transparency International). In order to make the unilateral euroisation contribute to the stability of prices, continuous fiscal discipline is necessary, along with an increase of competitiveness in structural reforms and a stable financial system.

3. Inflationary Pressures in the Context of the Floating Exchange Rate Regime

Since it has become more difficult to implement the instrument-based rules, especially those relying on monetary aggregates, there was an idea that inflation targeting would be an adequate strategic choice. If inflation targeting was supported by appropriate fiscal measures, it would help creators of monetary policy to maintain the inflation rate on a low level more easily, allowing them certain discretion in stabilizing output. The approach for stabilizing prices by means of inflation targeting was accepted by numerous central banks during the 1990s, whereby the initial results were positive. Difficulties referring to the delayed effects of monetary policy and/or impossibility of direct and simple inflation control mean that sometimes the target cannot be achieved, which may lead to a growth of inflation expectations. Still, the crucial question refers to the quality of the indicators of monetary stability in the conditions of a low and sustainable inflation rate.

The strategy of medium term inflation targeting has been implemented in Serbia that recorded the lowest level of inflation (1.7%) in 2015 for the past four-year period, measured by growth of consumer prices. The achieved growth of consumer prices in 2014 was far below the projected inflation established by the Fiscal Strategy for 2014, with projections for 2015 and 2016 (5.5%), as well as the target inflation of 4% ± 1.5% for the period 2012 – 2014, according to the Memorandum of NBS. According to the NBS, the trend of targeted inflation reflects the intention to achieve the stability of prices without causing macroeconomic disturbances. Short-term deviation from the targeted inflation due to "exogenous shocks" is allowed. According to an official analysis, consumer prices had much lower growth intensity since inflation was measured by the consumer prices growth (with the exception of 2013). Despite the fact that the exchange rate of dinar dropped by three times compared to the general growth of consumer prices, reduced demand influenced an increase of consumer goods by only 0.6%.

Figure 4: Targeted and achieved inflation by months (year by year growth in %)

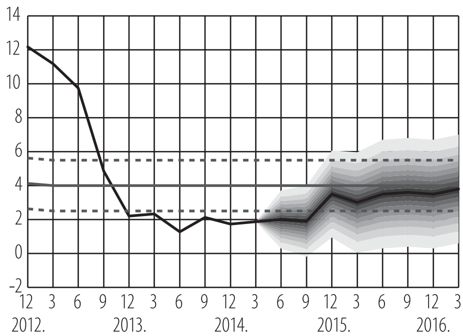


Source: National Bank of Serbia

The inflation goal was set in accordance with the assumption that by 2016 neither structural reforms and liberalization of prices nor nominal, real and structural convergence to the European Union will be completed. According to an official analysis, real inter-annual (2014/2015) growth of GDP in the second quarter amounts to 0.9%. The announced reduction of GDP decline this year would be influenced by the measures of "fiscal consolidation" and investments. However, long-term effects of low inflation rate in Serbia, such as unemployment, real reduction of salaries, increasing social hierarchy differences, drop of prices due to reduced aggregate demand (reduction of consumption), growth of levies paid to the state and other taxes, a high current account deficit and the like point more precisely to a serious problem of disinflation. The main disinflationary medium-term factor is low domestic demand. Disinflationary pressures caused by low aggregate demand and low inflation in the neighbouring countries were, according to the NBS (February 2015), in accordance with previous expectations.

At the beginning of this year, a moderate growth of the year-on-year inflation was predicted and it is expected that it would approach the limit of allowed deviation from the target (2.5%) until mid-2015. Low inflation in the previous year is explained to be a consequence of a significant drop of prices of agricultural products, a drop of oil prices on the world market and an unexpectedly low growth of regulated prices. The growth of the latter factor should allegedly bring inflation within the limits of the goal for 2015. There are different possibilities of achieving the planned inflation. Figure 4 shows possibilities for the next eight quarters. The darkest part of the Figure shows the central projection and the possibility that it will drop within this limit is 10%. The hues next to it include the same possibility, so the whole span covers 90% of the possibility to achieve the projection. There is a 10% possibility that the inflation in the next eight quarters will be outside the span. The assumption of the projection is to use the measures of monetary policy to actively bring inflation on a medium-term basis within the limits of the allowed deviation from the goal.

Figure 5: Projection of inflation in Serbia



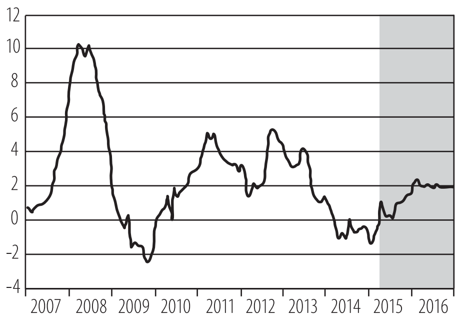
Source: National Bank of Serbia, Report on Inflation, May 2015

Reduction of salaries and high unemployment resulted in low purchase power. One of the basic characteristics of the Serbian economy is permanent borrowing, with monthly growth of charge for interests. This can represent, in negative terms, a counter-balance to reduced salaries and pensions (probably in the future too) and it can potentially or actually endanger financial consolidation of the budget, which makes its enforcement debatable. Expenditures for goods and services have increased, average deficit is high and public debt is increasing significantly. There are negative effects of the measure of fiscal consolidation on the consumption of households and the state. Real net income has been reduced owing to the application of fiscal consolidation measures, along with a reduction of salaries outside the public sector (in most areas). There are obvious repercussions of borrowing on the limited room for fiscal consolidation which is unsustainable in the conditions of GDP decline.

It is certain that the conditions of economic activities are worse, while decline of income tax and possibly of capital expenditures point to a reduction of economic activity (economic growth) in most sectors. GDP growth projection for 2015 is 0.0%. In most activities, the number of formal employees has been reduced owing to an increase in the number of unemployed persons that previously had a job. Economic activity is below the pre-crisis level and stagnation of GDP is expected instead of its decline in 2015. The NBS (January 2015) expects the credit rating of Serbia (B+, Fitch) to be maintained due to the "adopted measures of fiscal consolidation, continuation in implementing structural reforms and expected conclusion of an agreement with IMF". However, S&Ps agency has confirmed negative prospects (BB-) for the credit rating (Fitch stable). Net export and final consumption of households and the state have had a negative impact on the aggregate demand that has recorded a decline.

Citizens' refraining from consumption as well as the refraining of investors from investments represent negative effects of the economic framework of Macedonia. Focusing the activities of the National Bank of the Republic of Macedonia (NBRM) on maintaining stability of prices and the banking sector will not leave much room for enhancing economic growth. Macedonia belongs to the states with the highest forecasted growth rate in Europe: 4.1% in 2015 and 4.5% in 2016. However, there are current risks referring to growth due to the delayed effects of internal events and the trends in their environment. Due to lower prices of the food component, the general level of prices declines on monthly and yearly basis. On the other hand, core inflation growth has accelerated, which is a confirmation of the idea of reduced risks against future drop of prices. It is currently estimated that inflation will be within the projected values and that there are no price pressures. Figure 6 represents the current annual inflation rate and the projected inflation for 2015 and 2016.

Figure 6: Annual inflation rates in Macedonia



annual rates, in percent — forecast

2009	2010	2011	2012	2013	2014	2015	2016
-0,8	1,6	3,9	3,3	2,8	-0,3	0,5	2,0

Source: National Bank of the Republic of Macedonia, 2015

During 2014, inflation had a decelerating trend, entering the zone of negative annual change. The reasons for the deceleration are supply-related factors. Price growth in 2015 primarily reflects changes of prices of food and, to a lesser degree, future growth of domestic demand. Inflation should have a moderate growth in 2016, taking into account expectations regarding stabilization of export prices and increased price pressures concerning demand. Starting from the performances of the external sector (growth of export activity) and inflation, the NBRM considers that there is a favourable environment in the economy for a "solid economic growth". The problems arise in the sector of public finances: budget deficit last year showed a growing trend (4.2% of GDP). Apart from deterioration of the overall budget deficit, negative tendencies are visible in the primary budget deficit. A consequence is further growth of the central government debt and the total public debt (38% and 45.9% in GDP in 2015, respectively). The overall structural deficit and structural primary deficit worsened simultaneously.

Despite optimistic official statistics, social status and general economic situation make Macedonia the least developed of all countries of the former Yugoslavia. With apparent problems of corruption and crime, which is common for all SEE countries, as well as embittered population, uncertainty arises from the particularly difficult political and security environment of Macedonia. In this poor and clientelistic state, the unemployment rate is 30%, and 50% among the young. A large number of families receive social benefits and an exodus from the country has been striking for ten years now. There are unrealistic expectations in terms of stability, as well as general assumptions of stability. Structural problems arise from an inferior model of development. Macedonia is de facto exempt from the anti-crisis projects of the European Union and is not able to meet all the set preconditions imposed by the EU. Macedonia is especially susceptible to external economic and "non-economic" destabilizing shock which it cannot prevent and/or limit.

The inflation rate in Albania averaged 3.21% from 1995 until 2015, reaching an all-time high in 42% at the end of 1997. In 2014, the average inflation rate was 1.6%. Both inflation and inflationary expectations remained low, below the target of 3.0% set by the Central Bank of Albania. Inflation rate in June 2015 amounted to 1.3%. According to the Bank of Albania (2015), the environment of low inflationary pressures is characterized by cyclical weaknesses and a decline of imported inflation which enhanced disinflationary pressure in the economy. Growing aggregate demand was inadequate to fully use production capacities of the economy. Intermediation of the banking sector is low and balance sheets are burdened with non-performing loans. The current account deficit increased although the balance of payments is positive and the exchange rate is stable.

Due to a significant decline of industrial production, growth has slowed down. According to an analysis from the IMF report ("Western Balkans"), poverty has increased in Montenegro and Albania since 2008. The IMF approved loans to Albania, but they did not propose a single significant policy for enhancing economic growth. According to many analyses, Albania is still the poorest country in Europe, industry and particularly agriculture are underdeveloped, and business environment is poor in general. According to optimistic forecasts, the unemployment rate is at least 30%, affecting primarily younger population. Import is inadequately covered by export, spillover effects are strong and the state of the current balance of payments has worsened. There is prominent non-performing character of banking loans (24%). The situation with creating quality jobs, crediting and purchase power of consumers is pretty bad. Consumption is on a low level and there are no significant investments and, generally, no focus on enhancing economy. Fiscal stabilization ("shock therapy") seems to have caused damage to the economic recovery. Pubic debt is high and is increasing. There is a general opinion that, compared to Albania, economic and social situation is worse only in Kosovo.

4. Determining Strategic Framework of Monetary Policy in the Context of Inflation

Gradual accelerated growth of economic activity in the euro area has been achieved owing to the undertaken measures of monetary policy and liquidity policy, as well as drop of oil prices. Inflation in the euro area has a gradual upward trend and there are opinions that prolonged deflation has been avoided. Growth of economic activity has been especially influenced by external demand and final consumption by households. The speed of global economic growth, fluctuations of oil prices, and the euro exchange rate make inflation approach the set goal (below, but still near to 2%), but it is expected that inflation will start growing next year. Deflationary pressures are present also in Central and Eastern Europe. Inflation is in a negative zone in Macedonia and Bosnia and Herzegovina, while in Montenegro inflation was 0.9% after eight consecutive months of deflation. When it comes to the external factors of influence on the neighbouring countries' economies, there is a visible spillover of recovery in the euro area as a positive factor and unfavourable economic trends as a negative one. Generally speaking, it is expected that the growth will accelerate in SEE countries.

The absence of monetary policy in SEE countries with fixed exchange rates represents a serious limitation to the implementation of economic policy, coordination of monetary and fiscal policies, and other specific policies in the observed countries. Despite the fact that SEE countries with „built-in" monetary policies, i.e. using instruments of monetary policy, may directly influence the achievement of the final goals of monetary policy (sustainable inflation rate), macroeconomic indicators are far from satisfactory in these countries and this is supported by domination of political over economic considerations. Regulations of the Central Bank of Montenegro recognize instruments of monetary policy such as central bank loans and open market operations, although there is no adequate room for operations in accordance with these regulations. The role of reserve requirements is reduced to the prudential measure which is designed to maintain liquidity of the banking sector. The Central Bank of Montenegro, just like in the case of Kosovo, is not ready to act as a lender of last resort, which may worsen financial sensitivity.

The regimes of dollarization and currency board do not abolish all monetary shocks, which has been confirmed by the recent crisis circumstances, i.e. the currency shocks of an anchor country, which quickly produces a negative consequence. Bosnia and Herzegovina implemented the currency board strategy and this form of monetary-exchange arrangement is linked to the best inflationary performances as a result of better monetary discipline (lower rate of money growth). This should allegedly be followed by higher production growth, which is not the case with Bosnia and Herzegovina. Earlier experiences were indicators of relatively higher average annual growth per capita. Currency board could be an encouragement in case of increasing credibility of deflationary policy based on the exchange rate. With a given growth rate of money supply, money demand is increased as an effect of trust, which results in lower inflation. The currency board ostensibly stabilized the Bosnia and Herzegovina`s currency. Still, there was no "correction" of the world trends: growth of prices of energy products and other goods, more expensive production of goods for export in Bosnia and Herzegovina, favourable purchase of foreign goods on the market of Bosnia and Herzegovina. That eventually resulted in a continuous foreign trade deficit. The link of the Convertible mark for the German mark and then euro has not brought economic efficiency to Bosnia and Herzegovina.

Expansive monetary policy influences strengthening of demand and facilitates access to loans. The goal is to limit potential negative effects of structural reforms in short term. Using structural policies is an effort to increase economic growth on a long-term basis, which is determined by the factors of demand. In order to alleviate excessive short-term oscillations of the Dinar exchange-rate, the National Bank of Serbia has undertaken interventions in the interbank exchange market by selling and net buying of foreign currencies or buying and selling euro at three-month swap auctions. Trying to stimulate credit activities and turn the tendencies at the level of monetary aggregates, the NBS reduced the reference interest rate and changed the regulations referring to reserve requirements. It also adopted measures aimed at supporting citizens in overcoming difficulties in case banks unilaterally raise interest margins. The main role of monetary policy is to ensure that medium-term inflation moves within the allowed limits of the goal. Foreign exchange interventions contribute to achieving the targeted inflation rate if the reference interest rate cannot effectively influence inflation. According to the NBS (2015), a longer period of low current inflation and the expected lower inflationary pressures in Serbia will contribute to the stabilization of short-term and medium-term inflationary expectations in the period to come.

The primary goal of the NBRM is maintaining price stability starting from the fact that price stability creates the best macroeconomic environment for economic development which is sustainable on a long term. From 1995, the nominal exchange rate of Denar was linked to the German Mark and since 2002 to the Euro, as the strategy of exchange rate targeting. The NBRM (June 2015) estimated that a favourable trend was recorded in the loan market within a longer period of time, which suggests relatively efficient transmission of monetary measures aimed at credit activity and stable expectations of domestic banks. However, possible adaptation of the monetary policy to the forthcoming uncertainty arises from a closer monitoring of future macroeconomic trends and possible materialization of risks. A decline of the reserves of foreign currencies is partly a result of the intervention – net sale of foreign currencies on the exchange market by the NBRM. The direction of the NBRM interventions with market makers aimed at buying has been changed due to two factors: the beginning of the season of high inflow of foreign currencies and a relatively good exchange position of banks.

The main goal of the monetary policy of Albania is achieving and maintaining price stability in the form of a low and positive inflation rate: annual growth of domestic consumer prices of up to 3%. The monetary policy has been managed by the expected performance of inflation in a long term and is balanced in order to correct medium-term fluctuations in the economy. The goal is not to influence (improve) a long-term economic growth by measures of monetary policy. By conducting flexible monetary policy, the Bank of Albania contributes to alleviating "the shocks on the side of demand and stabilize the output and employment close to their long-term trends". The basic indication of oscillation of inflationary pressure in the economy is the deviation of the medium-term inflation forecasts from the targets. The indicators for measuring price growth in economy are the consumer prices index (CPI), the producer price index (PPI), the index of salaries etc. The Bank of Albania uses the CPI for defining stability of prices and managing monetary policy. To achieve the main goal of the central bank, open market operations, standing facilities, and reserve requirements are available as instruments of monetary management.

Conclusion: Repercussions of the Inflationary-Deflationary Environment

During 2014, there was a standstill of the economies of SEE countries, with the growth rate of 0.2% and with this level of economic activities it is not possible to reduce the high unemployment rate in the region and improve the living standard. According to the estimates of the World Bank (January 2015), the level of economic growth of Kosovo and Montenegro was reduced, while Macedonia and Albania demonstrated signs of a more sustainable development due to increase of exports. The projected growth in the region of 1.3% will probably mitigate weak recovery of Bosnia and Herzegovina. In addition to weak domestic demand and the problem with foreign demand, prominent problems in the financial system are the burden of non-performing loans on domestic banks and/or high interest rates in the conditions of high competition in the banking system. The role of the monetary policy in achieving economic growth has been pretentiously pointed out, whereby the responsibility of creating and implementing the overall economic policy has been neglected.

The inflationary-deflationary environment in SEE countries has been influenced by internal and external factors, in an undefined ratio, starting from the dominance of the political (geopolitical) influence determining the economic trends and performances in long-term, particular interests based on illegal patterns of operating and „non-benevolent“ and paternalistic relation of foreign and international financial and other relevant institutions. In all SEE countries, foundations of economic freedoms are fragile, while power networks of companies control national economies. Macroeconomic environment of the observed countries is characterized by four crucial negative processes:

- Low GDP level: extremely slow and mild growth;
- High foreign and internal indebtedness;
- Low level of economic competitiveness;
- High unemployment rate.

The so-called privatization in SEE countries has been carried out in the conditions of underdeveloped free market infrastructure. One of the repercussions is a dominant foreign ownership in the financial sector that collects citizens' savings.

Privatized companies exhaust public finances. At the same time, the unemployment rates have been constantly increasing in all countries of the region. Without higher level of investments, it is not possible to ensure growth of employment, but due to structural problems in the region, there is no interest for investments, among other things. Average and minimal salaries are low and a large share of population is on or below poverty line. Taxation of labour is important, along with low income tax rates. On the other hand, there is high participation of public consumption in GDP. High participation of current expenditure prevents reduction (limiting) of government involvement in the economy.

Fundamental requirements for higher rates of economic growth have not been met because there have been no necessary changes in the policy of employment and improving conditions on the labour market, which has caused a lack of an active integrative industrial policy in addition. Another discouraging phenomenon is that the number of budget users is larger than the total number of employees. Migrations of population from all neighbouring countries are actually a consequence of bad employment policies and even worse development policies. A large number of young people are exposed to the risk of economic and social exclusion, with consequences on the demographic and social scale. Decline of aggregate demand has been also caused by reduction of a part of salaries and pensions, causing growth of unemployment and further decline of aggregate demand.

The continuous burden of economic problems in the analysed countries will get a long-term form of:

- Pretty uncertain limitation of negative trends in economy;
- Impossibility to resolve all problems in the economy with monetary and fiscal policy measures;
- Crucial relying on capital flows, especially on foreign direct investments determined by selective political decisions;
- Destructive relation towards crucial institutions of the economic system;
- Problematic rationale, efficiency and sustainability of the "solutions" such as fiscal consolidation, financial liberalization, macroeconomic stabilization, lifting business barriers etc.

A long-term trend of inflations in the SEE countries is almost the same despite the strategic choice of monetary policy, the exchange rate regime, or the possibility of proactive implementation or non-implementation of the monetary policy. Also, there are the same or very similar problems in the region referring to economic activity, sustainability of crucial macroeconomic indicators or economic perspective. The flow of capital from Western European countries is quite modest and it is mainly not possible to limit the negative effects of the world economy price changes to the observed countries. Psychological factors, which cannot be measured in quantitative terms, such as different expectations, predictions of or inclination to consumption, are the indicators of future problems in the functioning of the economic systems of SEE countries. It is obvious from our analysis that low inflation rates do not correspond to satisfactory economic indicators.

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